BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 030001-EI

In the Matter of:

FUEL AND PURCHASED POWER COST
RECOVERY CLAUSE WITH GENERATING
PERFORMANCE INCENTIVE FACTOR.
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VOLUME 6

Pages 808 through 980

PROCEEDINGS:	HEARING
BEFORE:	CHAIRMAN LILA A. JABER COMMISSIONER J. TERRY DEASON COMMISSIONER BRAULIO L. BAEZ COMMISSIONER RUDOLPH "RUDY" BRADLEY COMMISSIONER CHARLES M. DAVIDSON
DATE:	Wednesday, November 13, 2003
TIME:	Commenced at 9:00 a.m. Concluded at 6:35 p.m.
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	TRICIA DeMARTE, RPR Official FPSC Reporter (850) 413-6736
APPEARANCES:	(As heretofore noted.)

I N D E X

WITNESSES

I N D E X (Continued)

WITNESSES

EXHIBITS

NUMBER:		ID.	ADMTD.
31			825
32	MJ-1 through MJ-9	827	849
33	WMZ-1 and WMZ-2	850	876
34	JWR-1 through JWR-5	878	901
35	WBM-1 through WBM-3	907	978

P R O C E E D I N G S

CHAIRMAN JABER: Okay. Let's get back on the record. Mr. Hart, you were cross examining Ms. Brown.

SHEREE L. BROWN

continues her testimony under oath from Volume 5:

CONTINUED CROSS EXAMINATION

BY MR. HART:

Q Ms. Brown, if we look at the number that you calculate to be the impact on ratepayers for additional fuel costs for 2003, that number is on Line 8 of Page 20 of your testimony; is that correct?

A Yes.

Q And you were asked a number of questions about the fixed cost associated with the Bayside gas purchase right before lunch; is that correct?

A That's correct.

Q Do you know how much that fixed cost is?

A I have seen no analysis of that. Ms. Jordan indicates that it's $13.20 a megawatt hour.

Q Now, isn't it correct that if the actual cost -- let me strike that question; start over again.

If the actual cost of running Bayside Unit 1 by itself is greater than your proxy, you've overstated the impact on ratepayers as a result of the early shutdown of the Gannon units; isn't that correct?

A No. I've understated it if it's greater. Then the $46 would have been a higher number, and then when I subtract out the cost of the Gannon units, the differential would have been greater.

Q In your calculation when you eliminate the running of Bayside 2, in your scenario you assume that all of the cost of gas for Bayside 2 can be avoided; isn't that correct?

A No. I assumed that the cost of Gannon are avoided and the cost of Bayside are substituted as a proxy.

Q Is it your testimony that the $47 million does not change regardless of the gas cost to Bayside?

A No, that's not my testimony.

Q We'll move on to another issue. Now, you have attempted to calculate what you refer to as the impact on O&M savings from the early shutdown of the Gannon units on a number of occasions, haven't you?

A I have calculated it twice, yes.

Q Well, you calculated it once in your original prefiled testimony, did you not?

A I calculated two numbers in my original prefiled testimony.

Q And you calculated other numbers on your deposition, did you not?

A No. I used a different number from my original testimony in my deposition.

Q But you asserted that that number would replace the number that you had in your prefiled testimony, did you not?
A Yes, I did.
Q Okay. And it turns out that's not correct, is it?
A No, not based on the information that Mr. Whale gave in his deposition.
Q So, in fact, this is the third time you've calculated what you believe to be the O&M impact on ratepayers; isn't that correct?
A No, it's the second time I've calculated it. I calculated the first two numbers in my original testimony, and I revised that -- those two numbers, I revised to the number I now have based on the information that Mr. Whale gave in his deposition which changed -- his exhibit had indicated that it was maintenance only. He then indicated that, no, it was operations as well. And he also indicated that the 2003 number was incremental and that the 2004 number was not incremental. So I felt like it was important to present the Commission with the right number based on the information presented to me in the deposition.
Q Isn't it true that a number of the items that you referred to as O&M savings are capital expenditures?
A They would not be capital expenditures given that the company would not have capitalized them at this point in time. The company would have expensed them given the short time frame

before they would have taken the units down anyway.

Q And the company would have -- had to expense them even if they had had a 10- to 15-year life; isn't that correct?

A That's correct.

Q And a substantial amount of the 57 million falls into such a category, does it not?

A 28.4 million.

Q And that would be your calculation of -- well, those are items that would have a long-term capital life that in order to continue running the Gannon units, the company would have had to spend and, even though it had a 10- to 15-year life, write it off in a year?

A Absolutely.

Q In your proposal to the Commission, you have not included any of the impacts other than fuel-related to Bayside coming on-line, have you?

A I'm sorry, I don't understand your question. Could you repeat it?

Q Well, you didn't include the O&M expense of Bayside in your calculation.

A No, I did not.

Q You didn't include the rate base impact of Bayside in your calculation, did you?

A I didn't include the rate base impact of Bayside or Gannon.

Q Or any of the three Polk units?

A No.

Q And you didn't even include the O&M of other plants in your calculation, did you?

A No, I did not. I isolated the Gannon impact.

Q So you took the O&M of some plants and compared it to the fuel cost of a new and different type of plant of a different capacity; is that correct?

A Not exactly. I took the O&M cost that the company would save -- the overall cost the company was going to save as a result of the shutdown. And I wouldn't say that I actually compared it to the fuel cost as much as I just demonstrated what the replacement fuel costs were.

Q And is it your testimony that the issue of these other items is too complex to include in this proceeding?

A I know we discussed this in my deposition. The idea of complexity is something that, yes, I mentioned it. What I intended to mean and do mean is that there are many issues that would be considered in the context of a full-blown rate proceeding, and there are a lot of things that have happened that would have to be considered in light of labor layoffs, the shutdown of the Gannon units. Those units would have to come out of rate base, the depreciation is going to come out. There are many things that have happened over the last ten years or however long it's been since the last rate case.

These are complex issues. Could they be done in this proceeding? They could be, but it's not the intention to do those type of adjustments in this proceeding. I believe the intention here was to look at the specific impact of taking down the Gannon units.

Q Well, you've heard the testimony that's gone on yesterday and today, haven't you?

A Most of it.

Q And there was testimony that the O&M money that might have been spent on Gannon was spent on other units; isn't that correct?

A Mr. Whale presented an exhibit to show what the O&M cost and budget were. I don't think that that implies that the money that would have been spent on Gannon was necessarily spent on the other units. The money that he discussed that would have had to have been spent on Gannon would have been in excess of those budget amounts.

Q Well, he also presented an exhibit that showed the overall level of O&M for all of the plants for a number of years, did he not?

A Yes, he did. And he showed about a 47 -- or $43.7 million decrease over two years.

Q But that's not the number that you're talking about in your case, is it?

A No, it is not. He limited his number to O&M and did not include capital reductions.

Q Yes. But the O&M number you're talking about is not over the last two years. The O&M number you're talking about was a number that you thought was projected for 2003, 2004.

A The number that he had the 43.7 was over 2003, 2004 as well.

Q Do you have his exhibit with you?

A I believe I do. I don't know for sure that this is the one you're talking from, so if we could have that verified.

Q It's Exhibit 22.

A I don't have a number on the page.

Q It says, "Actual O&M for 2001, 109 million."

A Yes.

Q And it has actual O&M for 2003, 110 million.

A That's correct. And 124.962 for 2002.

Q That's correct.

The O&M actual number for 2003 is approximately the same as it was in 2001; isn't that correct?

A That's correct.

Q And that shows a $47 million decrease to you?

A It shows a 47 million -- hold on a minute. It's not 47 million. If you look at 2002 you've got 124.962, and if you look at 2003 it went down to 110.274. That's 14.688. And then it's going to go down further to 96 in 2004, which is 124.962 minus 96.

Q Well, now, you've switched to start comparing actual and budget. You have actual amounts for those early years as well, don't you?

A For the early years?

Q Yes.

A I don't have an actual amount for 2004. All you have is a budget number for 2004. I'm looking at what you're projecting to save.

Q Well, the difference -- well, even under this scenario, the budgeted amount for 2004 versus 2002 is not $47 million less, is it?

A It's 43,650,000 over two years, which is the number that would correspond to the number I have given you which includes capital and O&M.

Q So now you've got capital, not just the O&M expenses?

A Yes. As we discussed a minute ago, the number that I have includes the capital that has been avoided that would actually be an O&M expense because of the time frame.

Q But most of those numbers are before the shutdown of the Gannon units; isn't that correct?

A Which numbers?

Q The numbers that you just gave, from 2002 --

A The numbers on this exhibit here?

Q Yes.

A The 2002 number is before. 2003 would have partial shutdowns, and the 2004, I'm assuming, would have the entire shutdown.

Q Now, when you talk about the 47 million -- or 43 million, the number that you just used, you're not using the numbers on this page, you're adding some capital numbers to them?

A No, I'm not. I'm using the numbers off of this page.

Q Okay. The budgeted number for 2001 is 107 million.

A That's correct.

Q The budgeted number for 2004 is 96 million.

A That's correct.

Q That's not a $47 million, $43 million difference in O&M between those years, is it?

A No, it's not. I'm looking at 2002, your last actual of 124.962, comparing that for 2003 to the 110.274 actual, that gives you 14 million savings for that year, and then comparing the actual 2002 to the budget because that's the best information that you have at the time of 96 for 2004, and then adding those two numbers together and that gives you 43,650,000 that is shown on this exhibit that will be saved over two years.

Q Well, the difference in O&M expense though is only the difference between 124 million and 96 million.

A For one year. We're talking about two years here. We're talking about 2003 and 2004.

COMMISSIONER DEASON: Let me ask a question at this point. Did you do any analysis on the actual number for 2002 to determine if that is a reasonable number or if it is an aberration?

MR. HART: I believe Mr. Whale testified there were two major outages in --

COMMISSIONER DEASON: I'm asking this witness.

THE WITNESS: No. This is Mr. Whale's paper. I limited my analysis to the Gannon units.

COMMISSIONER DEASON: So you didn't analyze the actual -- you didn't analyze what may have happened in 2002 to determine whether the 124,962,000 is a reasonable number to expect in a normal year.

THE WITNESS: No. I just got this paper yesterday; I haven't analyzed that.

BY MR. HART:

Q But it is safe to say in your analysis that in your analysis you did not look at the O&M of any other plants other than Gannon; isn't that correct?

A That's correct.

Q And so you didn't really form an opinion as to whether those numbers went up or down or what happened to them at all?

A Which numbers?

Q The O&M numbers for plants other than Gannon.

A No. I limited my analysis to the Gannon units.

Q You're aware, are you not, that Tampa Electric's last base rate case was in 1992?

A I'm aware it was a while ago. I don't know the exact date.

Q When you say an expense is covered by base rates, you're not talking about expenses that were included in the actual base rate calculation. You're just talking about expenses that are normally paid out of revenues that come from base rates; isn't that correct?

A I believe that's correct, yes.

Q In your testimony, you also refer to some Commission practices regarding recovering similar types of items in the fuel clause; is that correct?

A That's correct.

Q And you actually refer to Hines Unit 2?

A Yes.

Q Now -- and you refer to that because you assert that there are certain operating maintenance and capital costs that are recovered through the fuel clause to the extent of fuel savings; is that correct?

A That's correct.

Q Are you aware that when that decision was made it was made in the context of a full rate review of all of the revenue and expenses of Progress Energy?

A That was made actually from a settlement, but it was in the context of a full review, yes.

Q But in this case we don't have a full review of Tampa Electric's rates, capital costs, operating and maintenance expenses, do we?

A No, we absolutely do not.

MR. HART: No further questions.

CHAIRMAN JABER: Thank you, Mr. Hart.

Staff.

MS. RODAN: We have no questions.

CHAIRMAN JABER: Commissioners?

Redirect, Ms. Kaufman.

MS. KAUFMAN: Thank you, Chairman.

REDIRECT EXAMINATION

BY MS. KAUFMAN:

Q Ms. Brown, I just have one redirect question. If you turn to Page 20 of your testimony, a great deal of Mr. Hart's cross-examination related to your calculations beginning, I guess, on Line 8 through Line 12. Just so the record is clear, can you explain what you did and why you believe your calculation is appropriate?

A Yes. I looked at the Gannon generation over several years. The generation in 2002 was actually less than it has been historically already. So I took the 2002 generation and I assumed that because the units would be totally out in 2004, that that would be the level of generation replaced in 2004. For 2003 I took a pro rata portion of each month and calculated what the replacement energy would be based on the actual dates that the units were to be taken out of service. That gave me the generation that would be replaced.

I then calculated what the replacement cost would be using the Bayside gas cost as a proxy. The reason I used that as a proxy is because it was $46 a megawatt hour which was the overall gas cost as well. However, when I looked back at the actual cost for 2003, the gas costs were $57 for 2003, the purchased power was $61.56 for 2003, and the purchased power in 2004 was $53.50. So I believe that the $46 I used as the replacement cost was actually very conservative.

I then subtracted out the fuel cost of the Gannon units using the Gannon fuel cost, the cost of coal. The differential then is how I calculated the numbers on Line 8 and again on Line 15.

MS. KAUFMAN: Thank you, Ms. Brown. I have nothing further.

CHAIRMAN JABER: Thank you, Ms. Kaufman. Ms. Kaufman, you've got an Exhibit 31?

MS. KAUFMAN: Yes, ma'am. I'd move that into evidence.

CHAIRMAN JABER: Without objection, Exhibit 31 is admitted into the record.

(Exhibit 31 admitted into the record.)

CHAIRMAN JABER: Ms. Brown, thank you for your testimony.

THE WITNESS: Thank you.

(Witness excused.)

MS. KAUFMAN: Shall I collect those?

CHAIRMAN JABER: Sure.

Mr. Vandiver, your witnesses are here today; right?

MR. VANDIVER: Yes, ma'am.

CHAIRMAN JABER: But they weren't sworn yesterday.

MR. VANDIVER: No, they were not.

CHAIRMAN JABER: If I could ask that -- and you have two witnesses; correct?

MR. VANDIVER: Yes, Mr. Majoros and Mr. Zaetz.

CHAIRMAN JABER: If I could ask both Public Counsel witnesses to stand, please, raise your right hand.

(Witnesses collectively sworn.)

CHAIRMAN JABER: Thank you. And, Mr. Majoros, come on up.

MICHAEL J. MAJOROS, JR.

was called as a witness on behalf of the Citizens of the State of Florida and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. VANDIVER:

Q Good afternoon, Mr. Majoros.

A Good afternoon.

Q Could you state your name for the record, please, sir.

A Yes. My name is Michael J. Majoros, Jr.

Q Are you the same Michael J. Majoros, Jr., that caused to be filed 16 pages of direct testimony in this case?

A Yes.

Q And did you cause to be filed nine exhibits with that testimony, sir?

A Yes.

MR. VANDIVER: Could we get a number for those exhibits, please, Madam Chairman.

CHAIRMAN JABER: Let's insert Mr. Majoros's testimony into the record first.

MR. VANDIVER: Very well.

CHAIRMAN JABER: The nine pages of prefiled direct testimony of Michael J. Majoros, Jr., shall be inserted into the record as though read. And then, Mr. Vandiver --

MR. VANDIVER: I believe it was 16 pages of testimony and nine exhibits.

CHAIRMAN JABER: Thank you. Let the record reflect 16 pages of testimony. And then for exhibits, I've got MJ-1 through MJ-9?

MR. VANDIVER: Yes, ma'am.

CHAIRMAN JABER: Shall be identified as composite

Exhibit 32.

MR. VANDIVER: Thank you, Commissioner.

(Exhibit 32 marked for identification.)

BY MR. VANDIVER:

Q Mr. Majoros, could you please provide a summary of your testimony.

A Yes. I have a few minor changes.

Q Oh, thank you. Could you provide those changes to the Commission?

A Yes. On Page 7 --

CHAIRMAN JABER: Excuse me. Are your changes to your testimony or to your exhibits?

THE WITNESS: To the testimony.

CHAIRMAN JABER: Okay. Strike the insertion of the testimony into the record.

Go ahead, Mr. Majoros.

THE WITNESS: On Page 7, Line 13, at the end of that sentence it states, "Page 20," that should be "Page 21."

Then on Line 16, at the end of the sentence it says, "Page 15," that should be "Page 16."

And on the list of exhibits, the index of exhibits, the third one currently states, "Whale, August 26, 2003," that ought to be "Whale, August 26, 2002."

BY MR. VANDIVER:

Q And with those changes, if I ask you those same questions, would your answers today be the same?

A Yes.

Q And would your exhibits remain the same, sir?

A Yes.

MR. VANDIVER: And at this --

CHAIRMAN JABER: Do you have any other changes? No changes to the exhibits?

THE WITNESS: No.

CHAIRMAN JABER: Okay. The prefiled direct testimony of Michael Majoros shall be inserted into the record as though read.

REDACTED DIRECT TESTIMONY

OF

MICHAEL J MAJOROS, JR.

DOCKET NO 030001-EI

INTRODUCTION

Q. Please state your name.

A. My name is Michael J. Majoros, Jr.

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

A. I am Vice President of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"), an economic consulting firm with offices at 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

Q. Have you attached a summary of qualifications and experience?

A. Yes. Appendix A is a brief description of my qualifications and experience. It also contains a listing of my appearances before state and Federal regulatory bodies.

Q. At whose request are you appearing?

A. I am appearing at the request of Florida Office of Public Counsel ("OPC")

BACKGROUND OF CASE

Q. Please explain your understanding of the background in this case.

A. On February 24, 2003 Tampa Electric filed a petition before the Florida Public Service Commission requesting approval of its proposed modifications to its fuel and purchased power cost recovery factors. The Company claimed it faced an under-recovery of $60.6 million over the remainder of 2003. The projected under-recovery is due to several factors, including increased commodity costs in natural gas and oil, leading to increased purchased power costs and unusually cold weather. The

Company's projections reflect the shutdown of Gannon Units 1 and 2 and the tie-in of the repowered Bayside 1 unit.

The PSC did not accept the Company's request in its entirety. It allowed a portion of the costs to be recovered, but deferred recovery of $26.0 million in replacement power costs associated with the early shutdown of Gannon Units 1-4, until the Commission could determine the prudence of the decision.[1]

SUBJECT OF TESTIMONY

Q. What is the subject of your testimony?

A. My testimony addresses the benefits received by Tampa Electric's stockholders as a result of the early closure of Gannon Station, while ratepayers are correspondingly charged higher rates for fuel costs in this docket. Tampa Electric has failed to recognize the benefits it will achieve through lower operating expenses that stockholder's will enjoy, while its customers are charged higher fuel costs as a result of the Company's decisions. Since the closure of Gannon station earlier than planned was an economic decision that benefited the stockholders at the expense of the ratepayers, the Citizens are requesting that Tampa Electric's fuel cost recovery be offset by $9.1 million for 2003 and $16.0 million for 2004, so that Tampa Electric's stockholders are neither better nor worse off as a result of the early closure of the Gannon plants, while ratepayers receive some offset to the higher fuel costs. Tampa Electric proposes to charge these excess replacement fuel costs to its ratepayers through its Fuel and Purchased Power recovery charges. I disagree with Tampa Electric's proposal. The incremental O&M savings of $9.1 million for 2003 and

[1] Order Approving Mid-Course Correction to Fuel and Purchased Power Cost Recovery Factors, Docket No. 030001-EI, Order No. PSC-03-0400-PCO-EI, Issued March 24, 2003, at page 9.

$16.0 million for 2004 should be offset by the Commission in the fuel clause calculations in this docket.

Q. Please describe the circumstances behind the early shutdown of Tampa Electric's Gannon plant.

A. Tampa Electric has six coal fired units at its Gannon facility. On December 6, 1999 Tampa Electric entered into a Consent Final Judgment ("CFJ") with the Florida Department of Environmental Protection, and on February 29, 2000, a Consent Decree ("CD") with the United States Environmental Protection Agency, regarding Gannon Station. Under the CFJ and CD Tampa Electric agreed to cease coal-fired operations at Gannon by December 31, 2004. Additionally, the CD required Tampa Electric to repower coal-fired generating capacity at Gannon of no less than 200 MW by May 1, 2003.[2]

As part of its 2002 Ten Year Site Plan, Tampa Electric stated that it would operate Gannon 1-4 until the December 31, 2004 deadline and would repower Gannon 5 and 6 by May 2003 and May 2004 respectively.[3] The 2002 Tampa Electric budget process contemplated closure of Gannon's coal units in September, 2004, in compliance with the CFJ and CD agreements (Exhibit No. MJM-1). On February 6, 2003 the Company announced its decision to shut down the Gannon plant early. Tampa Electric anticipated that Gannon Units 1 and 2 would cease operations in mid-March 2003, and Gannon Units 3 and 4 would cease operations by October, 2003.[4]

Tampa Electric expected to lose 867,000 MWHs of coal-fired generation as a result of the early shutdown of Units 1-4. It also projected to spend $52/MWH to replace the lost generation. According to the Commission, the average fuel cost for

[2] Direct Testimony of William Whale ("Whale"), page 3.
[3] Order Approving Mid-Course Correction to Fuel and Purchased Power Cost Recovery Factors, Docket No. 030001-EI, Order No. PSC-03-0400-PCO-EI, Issued March 24, 2003, at page 6.
[4] Id.

coal-fired generation is approximately $22/MWH or $30/MWH less than Tampa Electric's estimated replacement power cost. Hence, staff estimated the incremental replacement power cost to be $26 million, i.e., 867,000 x $30. That is the amount of money that Tampa Electric proposed to pass-through to the ratepayers in its filing with the Florida PSC on February 24, 2003.

Q. What is the current status of the Gannon units?

A. Units 1 and 2 were actually shut down on April 7 and 8, 2003.[5] In May 2003 Gannon 1 and 2 were returned to service due to weather and other circumstances. They operated for several days and then were returned to long-term standby. According to Tampa Electric witness William Whale, Units 3 and 4 will be shut down around October 15, 2003, allowing Bayside Unit 2 to utilize the transmission facilities currently used by Gannon Unit 4.[6] Unit 5 was shut down on January 30, 2003 to allow conversion of its steam turbine generator to the Bayside Unit 1 combined cycle configuration.[7] According to the Company's website, Bayside Unit 1 went into commercial service in May 2003. Unit 6 is expected to shut down around September 30, 2003, in preparation for conversion to Bayside Unit 2. Although the website lists Bayside Unit 2 as scheduled for commercial service in May 2004, Mr. Whale's testimony gives a planned in-service date of January 15, 2004.[8]

CORPORATE DECISION TO SHUT DOWN GANNON STATION EARLY

Q. Did Tampa Electric make a corporate decision to shut down Gannon Units 1-4 early?

A. Yes. As discussed above, the Company was not obligated to shut these units down before December 31, 2004. In fact, the original plan appeared to be to run the units

[5] May 13, 2003 deposition of Buddy Maye, page 12.
[6] Whale, pages 3 and 4.
[7] Id., page 3.
[8] Id.

until sometime in September 2004, which would allow several months in which to accomplish the shutdown.

For example, Exhibit No. MJM-1 is an email from Bill Whale to Karen Sheffield, dated May 20, 2002. In this email Mr. Whale indicates that for the 2003/2004/2005/2006 budgets that are being asked for, Ms. Sheffield should assume that Gannon 1 through 4 will continue coal operation until September 30, 2004.

In another example, at page 17 of the May 13, 2003 deposition of Joann Wehle, Benjamin Smith and William Smotherman, Mr. Smotherman states "Prior to the mid-course correction our plan was to attempt to run the [Gannon] units through –through the summer of '04."[9]

Finally, Exhibit No. MJM-2, entitled "Tampa Electric Company Gannon Early Shutdown Issues Paper", states "Given the additions of Bayside 1 in May 2003 and Bayside 2 in December 2003, Tampa Electric does not need to run Gannon Units 1-4 through September 2004 as originally planned."

Q. When does the Company claim they made the decision to shut down the units early?

A. The Company claims that it "refined" the shutdown dates in late January and early February of 2003.[10]

Q. When do you believe Tampa Electric decided to shut down Units 1-4 early?

A. I believe that Tampa Electric made a corporate decision as early as October 2002 to shut down these units in 2003.

Q. Why do you believe that Tampa Electric made this decision in October 2002?

A. According to Bill Whale, the Company began planning an early shutdown in the fall of 2002. (Whale TR, p. 50). Bates page 3653, labeled "Key Strategies for 2003 –

[9] May 13, 2003 deposition of William Smotherman, page 17.
[10] Whale, page 8.

Gannon" is dated October 3, 2002. This document shows the Company's "base case" as assuming Gannon Units 1 and 2 would shut down on March 15, 2003, Units 3 and 4 would run until September 1, 2003 (or until the O&M dollars were gone), Unit 5 would shut down in February 2003 and Unit 6 in September 2003.

Although some of these dates have slipped, this is essentially the "early shut-down" time frame. This document demonstrates that as early as October 2002 the Company had made the decision that it would shut down its Gannon units earlier than called for in the Consent Decree. The finalized version of the Gannon Station Business Plan was completed in October 2002 and published with minor revisions on November 15, 2002. The October 2002 and November 15, 2002 versions of the business plan are based on the Company plan that was adopted in late September/early October 2002 for the early shut down of Gannon. This document is contained in the testimony of Public Counsel witness Zaetz (Exhibit No. WMZ-1).

Q. What was the basis of Tampa Electric's decision?

A. According to Mr. Whale:

> By late 2002, it became apparent that the units needed to be shut down in 2003. This realization was driven primarily by four factors: the declining availability and reliability of the units; the significant expenditures that would need to be incurred in an effort to keep the units running reliably; the potential for safety incidents; and, the short window of time until the units would be required to shut down under the CFJ and CD, regardless of how much the company might invest in an effort to keep them operating.[11]

Q. Of the reasons given for the early shut down, which do you feel was truly driving the decision?

A. I believe this was an economic decision. The Company shut the plants down in an effort to meet internal earnings goals.

[11] Whale, page 11.

Q. What is the basis of your conclusion that Tampa Electric decided to shut down Units 1-4 early to meet its internal earnings goals?

A. One only needs to read Mr. Whale's August 26, 2002 presentation to the corporate officers to understand how the Company plans to shut down Gannon in September 2004 were advanced to 2003. In this presentation to the Tampa Electric senior management Mr. Whale clearly articulates the economic advantages of the early shutdown of Gannon (Exhibit No. MJM-3). The Company would achieve substantial capital and O&M expense savings which would accrue to shareholders, and yet would pass the acknowledged higher purchased power costs through to ratepayers. As the Gannon plan evolved in 2003, all four units were required to run several weeks longer than originally planned. In the same presentation Mr. Whale laid out the adverse consequences that would directly impact customers, including the higher costs of purchased power (Exhibit No. MJM-3, page 21 ~~page 20~~).

Q. How did Tampa Electric plan to meet its budget?

A. The presentation by Mr. Whale to the officers on August 26 included the specific wording (Exhibit No. MJM-3, page 16 ~~page 15~~):

"Reductions to Achieve 2003 & 2004 Plug"

"Gannon – Accelerated Shutdown".

Through our depositions with Tampa Electric personnel, including Mr. Whale, we have determined that the phrase "Plug" means a budget reduction target.

Q. Were there other indicators that the decision was for economic purposes?

A. At a meeting of all the Tampa Electric officers on September 9, 2002, there was a discussion regarding business plans, described by Tampa Electric Vice President Phil Barringer in his deposition (P 20, L12-16) as "a business planning meeting, so we go through a process during the summer and fall of creating the business plan and going through budgets." The agenda includes a wide variety of cost-cutting measures under consideration (Exhibit No. MJM-4, pages 1-2). Among the items included for discussion by Mr. Whale was "Operations: Implement items presented to achieve O&M of ***C***. Evaluate moving Gannon 3 & 4 closing up to May '03." Included in the agenda notes were five scenarios for the early closure of Gannon (Exhibit No. MJM-5).

Q. Mr. Whale states that significant expenditures would need to be incurred to keep the units running reliably. Does he discuss these expenditures?

A. Yes. On page 16 of his testimony he states: "Given the current condition of these units, Tampa Electric estimates that it would need to incur additional O&M expense of approximately $57 million to try to keep Gannon Units 1 through 4 operating somewhat reliably beyond the actual and currently planned shutdown dates and through 2004."

Q. What do you believe is the source of this estimate?

A. Exhibit No. MJM-6 is an estimate of the Total Project Costs needed to operate the Gannon units through 2004. The document was prepared March 3, 2003 for Bill Whale. It shows a cost of $53.94 million to run the plants through 2004 at 80% to 85% availability. This estimate was prepared by Buddy Maye, at the request of Bill Whale.[12] I believe this is similar to the source of Mr. Whale's figure in his testimony.

Q. Is this a useful and fair estimate of the costs necessary to run the Gannon units through 2004?

A. No. In his deposition, Mr. Maye was asked about the feasibility of running Gannon 1-4 at 80 to 85 percent availability (Exhibit No. MJM-6). He stated that it was not

[12] Maye deposition, page 80.

very realistic. The same analysis shown on page 3 reflects 60% availability. It shows a total cost of $36.94 million to run Gannon 1-4 through December 2004. Mr. Maye admitted that this is a more realistic scenario and the 60 percent availability more closely reflects the typical availability of the Gannon units.[13] This is discussed further in the testimony of my colleague, Mr. William Zaetz.

Q. What do you conclude?

A. The Company claims in part that it shut Gannon 1-4 down early because the costs to keep the units running reliably through 2004 would be $57 million. This is misleading assumption. To keep Gannon 1-4 running at the availability level they normally operate would cost far less.

<u>RESULT OF EARLY SHUT-DOWN DECISION</u>

Q. What is the result of Tampa Electric's decision to shutdown Units 1-4 early?

A. There was an early estimate of $26 million in February 2003. Based on the most recent response from Tampa Electric, it would appear that the combined costs of the more expensive fuel to run Bayside, plus additional purchased power costs to replace Gannon capacity is $116.4 million (Exhibit No. MJM-7).

<u>SAFETY AND RELIABILITY</u>

Q. You mentioned earlier that Tampa Electric cited safety and reliability concerns as the reasons for the early shut down. Do you believe Gannon was unsafe?

A. No, I do not believe Gannon was unsafe. The Company has not provided any evidence demonstrating this. Mr. Zaetz addresses the Company's safety claim in his testimony.

Q. Have you found any evidence that Gannon was unreliable?

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[13] Id., pages 80-81

A. Not necessarily. While it is true that Gannon was an aging plant, it still appeared to be meeting its performance goals. Any reliability issues can be traced to decisions made by the Company regarding maintenance issues. Mr. Zaetz addresses reliability and maintenance in his testimony.

BENEFITS TO COMPANY

Q. Did the Company believe that the early closure of Gannon Station would result in a reduction of O&M expenses?

A. Yes. In his August 26, 2002 presentation to the company officers that I discussed earlier, Mr. Whale included a slide indicating that the Company expected to achieve savings by accelerating the shutdown of Gannon Station. The 2003 savings are reported as being $11.2 million and the 2004 savings are reported as being $16.0 million (Exhibit No. MJM-3, page 16). According to Mr. Whale (Whale TR, p. 26) these savings amounts refer to O&M savings.

Q. Do increased earnings benefit shareholders?

A. Yes, as a general proposition increased earnings benefit shareholders.

Q. Did the Company expect to reduce its labor force by shutting down the plants early?

A. Yes. It appears that the Company would benefit from a reduced labor force. Labor is discussed in the July 29, 2003 deposition of Ms. Karen Sheffield. Based on the discussion it appears that at least 192 jobs have been/will be eliminated from Gannon, replaced by at least 42 positions associated with Bayside. Ms. Sheffield confirms that "it takes less people to operate Bayside and perform whatever has to be done at Gannon than it does to operate the six units at Gannon."[14]

IMPACTS TO RATEPAYERS

[14] July 29, 2003 deposition of Karen Sheffield, page 53.

Q. Did the Company envision any consequences in shutting down Gannon early?

A. Yes. In Mr. Whale's August 26 presentation there is a slide with the heading "Changes & Consequences." A subheading indicates this slide details the consequences related to the accelerated shutdown of Gannon. The bullet points are as follows: Higher Purchase Power Costs; Tampa Electric Transport coal movements reduced; Wholesale Sales Impact; At Big Bend, slower Unit turnaround times from outages (Exhibit No. MJM-3, page 20).

Q. Was the Company aware that the early shutdown of Gannon would result in increased costs that would be passed on to the ratepayers?

A. Yes. I have found several instances where the Company calculates an impact to customers due to the early shut down of Gannon Station.

For instance, when asked about the "higher purchase power costs" listed in his presentation as a consequence of the accelerated Gannon shutdown, Mr. Whale indicated that he was aware that consumers would bear that increased cost (Whale TR, page 27).

Perhaps one of the more important examples of the Company's assumptions regarding savings and customer impact can be found in the Scenario Analysis (Exhibit MJM-8) dates 9/16/02. This document shows the various scenarios for the Gannon shutdown, along with estimated O&M/NRF costs. It also shows the base O&M costs and the difference (savings). Scenario 5 most closely matches actual events, calling for Gannon 1 and 2 to shut down on March 16, 2003 and Gannon 3 and 4 to shut down on September 1, 2003. It shows an O&M/NRF savings of $10.4 million from the base case for 2003.

Likewise, Exhibit MJM-5 shows, for the most part, the same scenarios and numbers as Exhibit No. MJM-8, leading one to believe that it was prepared after

Exhibit No. MJM-8.[15] However, this document also shows "Clause Impacts" from fuel and purchased power, coal contracts and dead freight, along with an average customer bill impact. For scenario 5, the fuel and purchased power clause impact is ***CON***. The coal contracts impact is ***CON*** and the dead freight impact is ***CON***. The total clause impact is ***CON***. Directly below the Clause Impact section is a line showing "average customer bill impact". For scenario 5 this number is ***CON***. It is unclear as to whether this means ***CONFIDENTIAL***. Regardless, it is clear that at this point the Company expected to realize approximately ***C*** in net savings to operating income, while expecting a ***CONFIDENTIAL*** clause impact.

Q. Are you claiming the early closure of the Gannon units in and of itself harmed the ratepayers?

A. No. Our position is that the customers should see some of the benefits of these demonstrated savings rather than bearing all the related costs while stockholders realize all the benefits.

Q. Please discuss the fuel cost impacts of the decision.

A. The difference between the cost of coal, which is the fuel used by the Gannon units, and natural gas, the fuel used by the Bayside units, is substantial. At pages 57 and 58 of the deposition of Buddy Maye, he is asked about the approximate fuel costs for Bayside and Gannon. In the week the deposition was taken he stated that the cost of gas for Bayside was approximately $5.5 per MMBTU. He guessed that for Gannon, the fuel cost was in the range of $2 per MMBTU. Fuel costs for Bayside were over twice that of Gannon on a per MMBTU basis.

Q. Has the Company discussed this fuel cost difference in the recent testimony?

[15] This document includes an amount for Bayside CSA savings of ***CON***, bringing the scenario 5 net savings to ***CONFIDENTIAL***.

A. The Company does not detail the difference. However, in her testimony Ms. Joann Wehle discusses the Company's view of the reasonableness of the replacement fuel costs. She states that "the company procures the fuel to operate all units based on their economic dispatch" and "Tampa Electric follows its Commission-reviewed fuel procurement policies and procedures." She further states "Tampa Electric's decision to shut down Gannon Units 1 through 4 in 2003 was arrived at only after careful and deliberate evaluation of many dynamic, competing and complex factors" and "therefore, costs for replacement fuel due to the shutdown of Gannon Units 1 through 4 in 2003 are reasonable and prudently incurred."

Q. Please discuss the purchased power impacts of the decision.

A. Due to the early shutdown, Tampa Electric has projected an 867 thousand MWH decrease in coal fired generation through the year 2003. According to its petition the Company is projecting to spend approximately $52 per MWH on purchased power to replace this energy. Tampa Electric is requesting recovery of the additional cost of this purchased power that is required to replace its coal-fired capacity ($22/MWH), which is already factored into the fuel clause recovery calculations.

Q. Does the Company address this issue in the September 12 testimony?

A. Yes. Mr. Benjamin Smith addresses replacement power costs related to the early shutdown of Gannon at pages 5 through 7 of his testimony. He does not, however, provide an updated amount of these costs. In fact, he indicates that it is not possible to calculate the exact amount of replacement power purchased due to the early shutdown:

> Although Tampa Electric projects its system capacity and energy needs, the company also states that because of system dynamics, it is neither feasible nor appropriate to

isolate and then attribute costs to a single variable, such as the shutdown of the Gannon units, on an actual basis.[16]

Q. What is the amount of the surplus coal purchase contracts that is being passed on to customers due to the 2003, rather than 2004, closing of Gannon?

A. Earlier in the planning process the Company estimated that it would experience significant damages by the early closure of Gannon due to existing coal purchase contract damages. At the present time, it does not appear that the Company will request compensation for contract damages during this recovery period.

Q. What dead freight costs were incurred and included in the fuel recovery clause due to the decision to retire Gannon in 2003 rather than 2004?

A. The Company originally calculated a significant penalty that would be passed to ratepayers due to the early closure of Gannon because its contract with TECO transport (an affiliated company) required the Company to pay transport costs relating to the minimum compensation provisions of the contract. It is our understanding that the Company no longer seeks compensation for dead freight in this docket.

Q. Did the Company realize that the benefit it would enjoy through the early shutdown of Gannon Station would be far less than the increased rates customers would pay through the fuel clause?

A. Yes. The examples above clearly show that the Company was aware of this mismatch.

Q. Does the decision to close Gannon 1-4 in 2003 for economic reasons represent an unavoidable expense on the part of the Company that is the type of expenditure the Commission has authorized for recovery through the fuel clause?

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[16] Direct Testimony of Benjamin Smith, page 6.

A. The decision to close even earlier was driven by internal economics. In general, I do not believe this type of cost would ordinarily be reflected in a fuel adjustment charge.

Q. Did the Company decide to take additional depreciation in 2003 to write off its Gannon investment?

A. Yes. The Company stated in early 2003 that it would write off its remaining depreciation for Gannon in 2003, consistent with the historical FPSC depreciation practices.

Q. Wouldn't the impact of additional depreciation in 2003 offset the O&M savings?

A. It provides a phantom offset. The Company keeps the O&M cash savings. The total depreciation recovery for Gannon did not change. The Company simply accelerated its recovery of its investment and that helped the Company's cash flow. Furthermore, the Company's most recent, June 30, 2003, Form 10-Q states the following:

> At Jan. 1, 2003, the estimated accumulated cost of removal and dismantlement included in net accumulated depreciation was approximately \$442.0. At June 30, 2003, the cost of removal and dismantlement component of accumulated depreciation was approximately \$451 million.[17]

This means that Tampa Electric has collected \$451 million from its ratepayers to dismantle and remove its plant, even though it does not have any legal obligation to incur such costs. Otherwise, those amounts would have been capitalized to plant under the auspices of the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 143.

I find it very hard to imagine that Tampa Electric will actually spend \$451 million to remove or dismantle any of its plants if it is not required to do so. That

[17] Tampa Electric Company June 30, 2003 Form 10-Q, Notes to Consolidated Financial Statements, Note 1, Depreciation.

would be "bad" internal economics. And given this Company's proclivity to enhance its positive internal economics I doubt that it would unnecessarily spend the $451 million. Furthermore, under the aforementioned accounting standard, the $451 million is a liability (amount owed) to ratepayers.

CONCLUSION

Q. What action should the Commission take in this case?

A. The Commission should require that both shareholders and ratepayers share the burden of the Company's decision to accelerate the Gannon Station retirement. The Commission should use the amount of O&M savings achieved by the Company in both 2003 and 2004 to offset the higher fuel costs associated with the Bayside natural gas plant. I calculate those savings as $9.1 million for 2003 and $16.0 million for 2004 (Exhibit No. MJM-9).

Q. Why have you included calculations for the 2004 O&M savings?

A. The issues regarding the Gannon Station early retirement are one-time issues, and the same principals that will apply in the current proceeding for 2003 should also be applied on a going-forward basis through the original, planned outage date of September 2004.

Q. Does this conclude your testimony?

A. Yes, it does.

BY MR. VANDIVER:

Q And could you please provide a summary of your testimony, Mr. Majoros.

A Yes. In 1999 Tampa Electric entered into certain agreements with the Florida Department of Environmental Protection and the U.S. Environmental Protection Agency to retire its Gannon plant earlier than originally anticipated, that is, by December 31st, 2004.

Apparently, the company accelerated its depreciation and decommissioning allowance to account for that fact. Then in October 2002, the company's management made a decision to further accelerate the retirement of Gannon Units 1 through 4. The result was vastly increased purchased power costs offset by internal operation and maintenance expense savings.

The company proposes to flow the increased purchased power cost through its fuel adjustment clause to ratepayers but retain the internal cash savings. It has, however, masked these internal cash savings with yet more accelerated depreciation. Thus, this is now a cash deal. Cash from ratepayers to the company and internal cash savings to the company.

This Commission withheld 26 million from TECO's 2003 mid-course correction to determine whether TECO's early retirement decision was prudent. The decision was only prudent from TECO's perspective because it has a fuel adjustment clause.

My testimony proposes a modest compromise adjustment in the form of an offset to the increased fuel adjustment charges to at least share the internal savings with ratepayers since they are paying the higher purchased power costs. I would like to point out that this is indeed a compromise. That is because, in my opinion, the higher cost is the result of a management decision which should have been addressed in base rates, not in a fuel adjustment charge case.

Ms. Jordan accuses me of mixing base rate issues in a fuel case. In my opinion, it was the company that proposed to file for a base rate case increase in a fuel case. For example --

MR. HART: Madam Chairman, Ms. Jordan hadn't put her rebuttal testimony into evidence yet. He's now engaged in surrebuttal, I believe.

CHAIRMAN JABER: Mr. Vandiver, your response.

MR. VANDIVER: Mr. Majoros only has this one shot at testimony, Commissioner.

CHAIRMAN JABER: It doesn't make it right. I'll sustain the objection. It is surrebuttal. It goes outside the scope of the direct case.

Mr. Majoros, your testimony needs to be limited -- your summary of your testimony needs to be limited to what's in the direct case. To the degree you had --

THE WITNESS: All I can do is look at the available facts. TECO decided to close Gannon early, that's number one. Number two, the result was increased fuel and purchased power costs. Three, another result was internal cash savings, and four, TECO proposes higher charges to ratepayers as a result of these actions. These are the facts as I have strung them together and they speak for themselves.

BY MR. VANDIVER:

Q That concludes your summary?

A Yes.

MR. VANDIVER: I tender the witness.

CHAIRMAN JABER: Thank you, Mr. Vandiver. Mr. McWhirter, I'm assuming again you all don't have any questions; right?

MR. McWHIRTER: I have no questions, ma'am.

CHAIRMAN JABER: Mr. Hart.

CROSS EXAMINATION

BY MR. HART:

Q Mr. Majoros, you're vice president of the company you work for; is that correct?

A Yes.

Q And what is your relationship to Mr. Zaetz?

A Mr. Zaetz works for my firm on a part-time basis.

Q Does he report to you when he does that work?

A Yes.

Q You were on the phone and heard Mr. Zaetz's testimony in his deposition; is that correct?

A Some of it, not all of it.

Q And you rely on Mr. Zaetz's testimony and your testimony on several occasions, don't you?

A On the issues of safety and reliability, yes.

Q Have you read Mr. Zaetz's deposition?

A Not all the way through, no.

Q Well, the portions that you heard and read, do you disagree with how he testified on his deposition?

A About what?

Q Anything that you heard or read in his deposition.

A About what?

Q What he testified to.

MR. VANDIVER: Can he direct the witness to a line and page number, please.

CHAIRMAN JABER: Mr. Majoros, you just testified that you've read some part of the deposition transcript. The question was, of the portions that you've read, is there anything you disagree with?

THE WITNESS: Not that I recall.

BY MR. HART:

Q Have you discussed Mr. Zaetz's deposition with him?

A A little bit, yes.

Q Have you discussed with him how he might recharacterize or change his testimony?

A No.

MR. HART: We have no other questions of this witness.

CHAIRMAN JABER: Thank you, Mr. Hart.

Staff.

MR. KEATING: Staff has no questions.

CHAIRMAN JABER: Commissioners.

Thank you, sir, for your testimony.

THE WITNESS: Thank you.

CHAIRMAN JABER: Mr. Vandiver, do you have redirect?

MR. VANDIVER: No redirect.

(Witness excused.)

MR. VANDIVER: I would move for admission of Mr. Majoros's exhibits.

CHAIRMAN JABER: Without objection, Exhibit 32 is admitted into the record.

(Exhibit 32 admitted into the record.)

CHAIRMAN JABER: And, Mr. Vandiver, Mr. Zaetz is your next witness.

MR. VANDIVER: We would call Mr. Zaetz to the stand.

WILLIAM M. ZAETZ

was called as a witness on behalf of the Citizens of the State of Florida and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. VANDIVER:

Q Could you state your name for the record, please.

A William Michael Zaetz.

Q Mr. Zaetz, did you cause to be filed in this -- did you file 12 pages of direct testimony in this cause?

A Yes, sir.

Q And attached to that are two exhibits, I believe; is that correct?

A Yes, sir.

Q And if I were to ask you those same questions today, would your answers be the same?

A Yes, sir.

Q Do you have any corrections to your testimony?

A No, sir.

MR. VANDIVER: I'd like to get an exhibit number for Mr. Zaetz's exhibits, please, Madam Commissioner.

CHAIRMAN JABER: Sure. WMZ-1 and 2; is that right, Mr. Vandiver, two exhibits?

MR. VANDIVER: Yes, ma'am.

CHAIRMAN JABER: WMZ-1 and WMZ-2 will be identified as composite Exhibit 33. And the prefiled direct testimony of William M. Zaetz shall be inserted into the record as though read.

(Exhibit 33 marked for identification.)

REDACTED DIRECT TESTIMONY OF
WILLIAM M. ZAETZ
DOCKET NO. 030001-EI

INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is William M. Zaetz. I am a Senior Consultant with the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

Q. WHAT IS YOUR PROFESSIONAL BACKGROUND?

A. Prior to joining Snavely King in February of 2001, I was a boilermaker for 33 years with Union Local No. 193, headquartered in Baltimore, Maryland, rising eventually to the position of General Foreman. In the course of this career, I participated in or supervised the fabrication, installation, repair and dismantlement of boiler plant, fuel-handling equipment, and environmental abatement facilities in electric generating plants operated by both public utilities and private industrial and commercial enterprises. In the course of 180 separate projects, I participated in operations in most of the major power plants in Maryland, the District of Columbia, southern Delaware and northern Virginia.

After leaving the Boilermakers' Union, I worked as a consultant and expert witness for the Department of Justice's Environmental Division in connection with their Power Plant Initiative. My duties consisted of analyzing and summarizing various "forced" and "scheduled" outage reports and providing the attorneys with contact lists from my association with the International Brotherhood of Boilermakers.

I joined Snavely King in 2001. I have provided technical support and advice in connection with that firm's analyses of steam generation facilities and costs, principally in connection with depreciation proceedings.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. After resigning my commission from the U.S. Naval Academy in 1967, I enrolled in the apprenticeship program of the International Brotherhood of Boilermakers and also served in the Naval Reserves as a boilermaker. I continued my education at Johns Hopkins University, Loyola College and the University of Baltimore. In 1971, I received a Bachelor of Science degree in Business Management from the University of Baltimore.

Q. HAVE YOU ATTACHED A SUMMARY OF YOUR EXPERIENCE?

A. Yes. Appendix A is a brief summary of my qualifications and experience.

Q. FOR WHOM ARE YOU APPEARING IN THIS DOCKET?

A. I am appearing on behalf of the Florida Office of Public Counsel ("OPC")

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The OPC asked me to review and analyze Tampa Electric Company's testimony, depositions and responses to data requests focusing on the reason for the decision to retire Gannon units 1 through 4 earlier than planned. In my testimony I will demonstrate that Tampa Electric's position that the Gannon plant was closed in 2003 due to reliability and safety reasons is not valid and not supported by factual evidence. I will demonstrate that any of the perceived safety and reliability factors as stated in witness Whale's testimony, (P-10, L 21-23) affecting Gannon were a direct result of the Company's failure to maintain adequate preventative maintenance.

Q. ON WHAT INFORMATION IS YOUR TESTIMONY BASED?

A. I will validate my findings by using 1) universally accepted "industry standards" 2) my 33 years experience as a field construction boilermaker and 3) Tampa Electric's testimony, depositions, interrogatories and documents provided in the course of discovery.

Q. FROM YOUR ANALYSIS OF THE DEPOSITIONS, DO YOU FEEL THAT SAFETY OR RELIABILITY WAS A FACTOR IN THE RETIREMENT DECISION?

A. Absolutely not. I could relate to the verbiage used by plant general manager Karen Sheffield when she stated: "Gannon was not very reliable. It was – we had a lot of safety concerns, we had reliability concerns. It didn't make any sense to us to spend a lot of money doing things to make it reliable when we knew that the remaining life' whatever that might be – we certainly knew it wasn't past December 31, 2004, so it just didn't make good sense to us."

"We felt that those dollars could be spent in areas which would give us better benefit for our dollars". (SHEFFIELD p.21 4-11) I was very impressed with Ms. Sheffield's analysis of the labor costs and imaginative contributions to cutting maintenance costs. I have to disagree, however, that safety and reliability concerns led to the decision to retire the plants.

Q. **COULD A PLANT EVER BE RETIRED BECAUSE IT WAS UNSAFE?**

A. I have never seen a plant retired because of safety issues. I've repaired boilers after explosions. I've worked on older units that were full of asbestos and had gas leaks that required you to wear protective gear as soon as you enter the plant. In each case, the repair was made and the unit returned to service. On page 22 of her deposition Karen Sheffield states: "Our safety record was pretty good at both Gannon and Big Bend."

Q. **WHAT SAFETY CONCERNS DID YOUR RESEARCH REVEAL?**

A. I believe the biggest concern at Tampa Electric during this time frame was budgetary. The Gannon Station safety budget went from \$86,200 in 2000 to \$355,160 in 2001 and \$336,320 in 2002. (Late filed Deposition exhibit of Buddy Maye No. 2)

Q. **DO YOU KNOW WHAT CAUSED THIS INCREASE?**

A. Yes. Ms. Sheffield explains: "The Gannon units were not very reliable. We were continually having forced outages due to many things. The ones that stand out in my mind because they brought the units off quite often were boiler leaks."

"We ran it seemed like all the time, continually, at reduced boiler header pressures in order to keep the units on or to keep them from taking themselves off. As far as safety is concerned, we had issues with casing leaks. On several occasions we had carbon monoxide in the plant where our employees worked and we had to shut down and take care of those problems and bring them back up. And, you know, sometimes they would reoccur and sometimes, you know, we would get the problem repaired and move on. There were also issues with duct work lagging in the back end of the plant that was loose." (SHEFFIELD p. 39 3-17)

Q. DOES HER STATEMENT SUGGEST A CAUSE AND EFFECT SCENARIO?

A. Yes it does. It also indicates that the carbon monoxide would be predictable and that as an engineer, Ms. Sheffield followed the required precautions (monitors, blood tests breathing equipment, etc.) that would prevent lost time. She wanted to preserve that "pretty good safety record".

Q. WHAT IS THE BASIS FOR YOUR ASSUMPTION?

A. The presence of carbon monoxide (CO) is an indication of incomplete combustion. One of the reference books used for many years throughout the industry is Babcock & Wilcox's *STEAM*. On page 9-8 of the 40th edition: " For example, 1 lb. of carbon reacts with oxygen to produce about 14,100 BTU of heat. The reaction may occur in one step to form CO2, or under certain conditions, it may take two steps. In the multi-step process, CO is first formed, producing only 3960 BTU per lb. of carbon. In the second step, the CO joins with additional oxygen to form CO2, releasing 10,140 BTU per pound of carbon. The total heat produced is again 14,100 BTU per pound of carbon."

A few pages later in *STEAM* on page 9-18: "One of the most critical parameters for attaining good combustion is excess air. Too little air can be a source of excessive unburned combustibles and can be a safety hazard."

As an engineer, Ms. Sheffield knew that by continually running the unit at reduced head pressure, and not fixing the leaks that reduced the airflow, the presence of carbon monoxide would have been inevitable. The timing of this action would have been coincidental with the increase in the safety budget.

Q. WERE THE ISSUES YOU ARE DESCRIBING HERE STRICTLY SAFETY ISSUES?

A. There is no bright line between performance and safety. If you fail to address obvious maintenance problems in a power plant you can quickly create a safety problem as well as a reliability problem. However, until Tampa Electric decided to move forward with the early retirement of Gannon 1-4, there was no real indication that there were serious safety or reliability issues affecting the plant.

Gannon was either safe or unsafe. As I stated earlier, I've never known a plant to be shut down for safety reasons and the safety issue is always the first consideration in an operational environment. However, if it was determined at any point in time that the plant was unsafe, then Tampa Electric was obligated to shut it down immediately. Whether you believe that the company made a decision for early retirement in October or February, if it was made because the plant was unsafe, then it should have been shut down at that point. Instead, Gannon 1 and 2 were operated until April and were restarted in May for a brief time.

Q. BUT DIDN'T THE PLANT EXPERIENCE A FATAL ACCIDENT DUE TO AN EXPLOSION PRIOR TO ITS EARLY SHUTDOWN?

A. Yes. That's correct. On April 8, 1999, a worker at the Gannon Station opened a cover on a generator that contained hydrogen, sparking an explosion that could be heard 35 miles away. Three people died, and about 50 were injured in the blast. OSHA cited Tampa Electric for safety violations and fined the company $30,075. After this accident, the company investigation revealed that it was a human error that caused the explosion. In late 2000 the company introduced substantial new modifications into its Hazardous Energy Control Program (Exhibit No.WMZ-2). Most importantly, there does not appear to be any equipment factors relating to the accident and, to my knowledge, no equipment was replaced as a result of the new procedures. As you can see, safety is a huge issue in any steam plant and if this plant was truly unsafe, then it should have been closed immediately, without delay.

I have also reviewed the confidential documents furnished by Tampa Electric, Bates Stamp 1428-2335 that contain all of the Gannon accident reports since January 1, 2000. These records reveal the normal range of incident and accident reports that are common for such a work environment, including the ordinary sprains, contusions, etc that occur when employees don't pay strict attention to what they are doing. The request for copies of all OSHA violations at Gannon since January 1, 2000 reveals that there were none. (Tampa Electric response to OPC's 2nd Request for Production of Documents, No. 12.)

Q. ARE THERE OTHER EXAMPLES THAT THE UNITS WERE NEGLECTED?

A. Yes. Karen Sheffield explains: "There was work that had not taken place that was going to cause higher operating costs, bowl mill maintenance, charging bowl mill maintenance, and burner maintenance." (SHEFFIELD p.35 14-17) The mills she is referring to pulverize the coal for its optimum combustion. The burners are self-explanatory. Again, these items affect the total combustion and the amount of carbon monoxide that was escaping.

Q. WOULDN'T REDUCED RELIABILITY BE A CAUSE TO RETIRE THE UNITS?

A. It probably would if all the preventative maintenance had been done and the units were still failing. Tampa Electric repeatedly disregarded reliability as an issue. When asked if he attempted to "factor in or quantify or address considerations of safety, reliability and other operating considerations that might preclude the units from running through the retirement date", Financial Director Craig Cameron replied: "No. No. At this point what we're doing is based on the consent decree that required the units to come off at the end of 2004, we made an effort to establish what the O & M and non-recoverable fuel would be as the units peeled off, but didn't consider to do an analysis to try to build in the additional incremental impacts of safety - performance, system demand."

> Q. "Did you just assume that they would be run through that September 2004 retirement date without considering anything that could preclude them from running that long?"
>
> A. "Yes." (CAMERON p. 31 17-25, p. 32 1-9)"

Q. WHAT SHOULD HAVE BEEN DONE TO IMPROVE THE UNITS RELIABILITY?

A Fix the tube leaks. There are various methods used, if the leak is small, called a "weeper", pad welding can sometimes repair it. If the leak is larger the repair might require the use of a "dutchman". When dutchmen are used, the damaged portion of the tube is removed, and a new section of tube stock is installed in its place. Sometimes the entire tube needs to be replaced. If the leaks were in a general area of the boiler (economizer, superheaters, slope panels etc.), the entire section would be replaced during the next scheduled outage.

If a contractor was brought in to fix the leaks, no matter how many, when the repairs are made, the unit must pass the "hydrostatic" test that requires the unit to hold one and one half times the operating pressure of the unit. If this had done, the units would have been able to run at their normal capacity. As previously stated by the TECO employees, they weren't going to spend dollars on reliability issues.

Q. DID THESE NEGLECTED UNITS STILL SATISFY THE PERFORMANCE ISSUES RELATING TO THE RETIREMENT?

A. There are four sources of data that stand out from a number of additional indicators that demonstrate that despite the company's failure to spend adequate maintenance dollars, its actual performance was not a valid reason for the early shutdown. They are as follows:

1. The Gannon 2003 Business Plan (Exhibit No. WMZ-1), dated November 15, 2002, shows that Gannon's unplanned outages declined in 2001 and again in 2002 from a high in year 2000 that was probably due to the plant explosion. (Page 4, B.S. 1818)

2. The Net Capacity, described in this document as the Station maximum dependable generation capabilities, shows that the projected "Net Capacity at the beginning of 2003 is projected to be the same as last year and it is 1.1% below the 5 year average." (Page 6, B.S. 1820) Likewise the Net Generation since 1998 in Megawat Hours (MWH) is 5599, 4963, 4355, 5085 and 4838. (Page 7, B.S. 1821)

3. The on-peak availability factor is basically flat since 1999, except for year 2000, and the 2002 performance actually exceeded the 1999 performance (74.4% in 2002 versus 73.4% in 1999) (Page 9, B.S. 1823) It should be noted that the Gannon performance during this time period was achieved while the Gannon workforce was reduced from 287 to 235 in 2002, an 18% reduction (Page 20, B.S. 1834) *****CONFIDENTIAL*****

So even though the company was spending less money on the plant, and despite its age, its performance was acceptable.

4. In reviewing the annual performance review of Plant Manager Maye, it is clear that he was performing at or above most of his performance objectives. In his deposition dated May 13, 2001, I noted the following exchange between OPC and witness Maye, (Page 64, L9-17)

Q. "And so for all of our deferred maintenance and everything, the Gannon units are trucking along pretty good, aren't they"

A. "I..."

Q. "Would you agree with that?"

A. "Met expectations."

Q. What other indicators did you observe showing the plants were operating as expected?

A. The base case scenario as outlined on page 25, B.S. 1839, in KEY STRATEGIES FOR 2003-GANNON WAS:

a. Shut down Unit 5 February, 2003

b. Shut down Units 1 and 2 on March 15, 2003

c. Run Units 3 and 4 until September 1, 2003 or until O & M dollars are gone

d. Shut down Unit 6 September 1, 2003

Under the heading "Station Performance Issues" on page 28, B.S. 1842, "Unit forced outage rates should not change from our current projections since Units 3 and 4 will have spring outages and units 1 and 2 will be shut down before the effects of not having their spring outages develop." It appears that most of the goals for Gannon operations were either met or exceeded based on the targets that were established for the plant.

Q. TAMPA ELECTRIC WITNESS WHALE STATES IN HIS TESTIMONY THAT IT WOULD TAKE $57 MILLION TO KEEP GANNON RUNNING. IS HIS TESTIMONY IN THIS REGARD REALISTIC?

A. Since there was no documentation provided in the testimony of Mr. Whale, we are left only with the earlier documents prepared by Plant Manager Maye for Mr. Whale that showed approximately $53 million was needed to achieve 85% availability at Gannon. One only needs to look at the Gannon Business Plan to know that the plant has been operating over the past several years between 60% and 75% availability. Even if a plant's availability were less than what one would expect from a new plant, the lower cost of generation could still make it attractive for continued use in meeting the primary generation needs.

Q. HOW WOULD THE EARLY SHUTDOWN OF GANNON REDUCE THE OVERALL O&M EXPENSE FOR TAMPA ELECTRIC?

A. Combined cycle gas generation is more costly than coal generation at the present time because the fuel costs are at least twice the cost of coal generation. However, in a state like Florida, where all of the fuel costs are passed directly to the customers as a separate line item on their bill, these higher fuel costs have nothing to do with the earnings of the company. What does impact the company directly is the significant labor savings that are achieved through gas generation as opposed to coal generation. These labor savings will have the effect of improving Tampa Electric's earnings while the customers pay significantly higher fuel costs. The actual amount of the O&M savings is addressed in Mr. Majoros's testimony.

Q. WHAT ARE YOUR CONCLUSIONS?

A. The Company made a conscious decision to run the Gannon Station as long as they could without spending any dollars to increase reliability or to make them safer. The initial path was decided by the consent decree and each decision thereafter was economic. Gannon's performance was predictable and any side effects that resulted were dealt with by spending the least amount of money possible.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

BY MR. VANDIVER:

Q Mr. Zaetz, could you please provide a summary of your testimony?

A Yes, sir. The Office of Public Counsel asked me to review and analyze Tampa Electric Company's testimony, depositions, and responses to data requests focussing on the reason for the decision to retire Gannon Units 1 through 4 earlier than planned. In my testimony, I will demonstrate that Tampa Electric's position that the Gannon plant was closed in 2003 due to reliability and safety reasons is not valid and not supported by factual evidence.

My analysis of the reliability issue is based on my experience with the International Brotherhood of Boilermakers from 1967 until 2000. The cyclone type boilers at Gannon would be very similar, if not identical, to a plant in my jurisdiction that I have extensive experience from the coal handling equipment to the boiler, air heater, bag house, and all the ductwork. This would be the Crane station plant at Carroll Island in Maryland. At this plant, I have shot studs in the cyclones, made the vent tubes for the throat and neck tubes out of tube stock --

MR. HART: Madam Chairman, this is not in the witness's direct testimony.

CHAIRMAN JABER: Mr. Vandiver, your response. The objection is that it goes outside the scope of his direct testimony.

MR. VANDIVER: Mr. Zaetz, I would ask that you just stick to your direct testimony, sir.

THE WITNESS: Yes. It was covered in my direct testimony -- it was covering my experience angle. I was questioned earlier in the deposition, and I was just clarifying my experience but I can stop.

CHAIRMAN JABER: Thank you, Mr. Zaetz. Let's keep it limited to the scope of your prefiled direct testimony and wait for any questions you may receive on your deposition.

THE WITNESS: Thank you.

CHAIRMAN JABER: Go ahead.

THE WITNESS: My statements concerning safety issues are based on 33 years of experience in every type of plant safety issue that came to light during that period from vanadium in lead poisoning to asbestos removal. I have combined space training in fossil fuel plants and steel mills.

Boilermakers are required to have daily toolbox safety meetings before work and a weekly job site meeting, safety meeting. There is also a ten-hour OSHA safety course --

MR. HART: I would repeat my last objection again.

CHAIRMAN JABER: Mr. Vandiver.

THE WITNESS: Okay. I would just like to finish my last sentence and I'm done.

CHAIRMAN JABER: You get to finish your last sentence if it's coming out of your direct testimony.

THE WITNESS: Yes. It has to do with my direct testimony on safety.

CHAIRMAN JABER: Go ahead.

THE WITNESS: There is also a ten-hour OSHA safety course that every boilermaker must attend before he can get sent out on the job. This concludes my summary.

MR. VANDIVER: Tender the witness.

CHAIRMAN JABER: Thank you, Mr. Vandiver. Again, Mr. McWhirter, you don't have questions; right?

MR. McWHIRTER: I have no questions.

CHAIRMAN JABER: Mr. Hart.

CROSS EXAMINATION

BY MR. HART:

Q Mr. Zaetz, you've testified you're a boilermaker by trade; is that correct?

A Yes, sir.

Q Isn't it correct that welding is a substantial portion of the job of a boilermaker?

A Yes, sir.

Q In fact, you've done a substantial amount of welding in your job; isn't that correct?

A Yes, sir.

Q Isn't it correct that in your capacity as a boilermaker, what you did was work for contractors who undertook specific engagements with people that owned boilers?

A Yes, sir.

Q In fact, you worked for about 180 different contractors; isn't that correct?

A No, sir. Could I clarify that? The 180 different jobs sometimes were for the same contractor. I would be estimating maybe there's 50 to 60 different contractors but over 180 different jobs.

Did that clarify it?

Q Well, it's different than your deposition if that's what you mean by clarify.

A Yes, that's what I clarify. You asked me a question, I believe, in the deposition, did I work for 180 different contractors, and I must have misspoke.

Q Mr. Zaetz, would you look at your deposition on Page 10, Line 4?

Were you asked the question, "Now, in your capacity as a boilermaker, who did you work for? Who was your employer?"

Answer: "I had over 180 different employers. I worked from a union hall that sent me to various jobs."

Do you recall that question and answer?

A Yes, I remember that question.

Q Now, you were primarily engaged in installing, repairing, and maintaining boilers; is that correct?

A Yes, sir.

Q You never worked for a utility company, and you've never had the responsibility for running a boiler; isn't that correct?

A No, sir.

Q That's not correct?

A No, that's correct. I've never been responsible for running a boiler.

Q And you've never worked in a control room either, have you?

A No, sir.

Q In fact, you're not licensed to operate a boiler in any of the states in which you've worked, are you?

A No, sir.

Q You are not licensed as an engineer, are you?

A No, sir.

Q And you don't hold any certifications for boiler maintenance, do you?

A No, sir.

Q You've never been involved in budgeting for station operations for a plant or a unit of a plant, have you?

A No, sir.

Q Now, in the various Tampa Electric documents that you went through, the Tampa Electric documents repeatedly referred to safety and reliability as factors they were considering in whether or not to shut down these units; isn't that correct?

A Yes, sir.

Q It is true, is it not, that safety can be a factor in a decision to retire a plant?

A You'd have to give me a specific -- I personally have never heard of a plant closing because of a safety issue.

Q Could you look on your deposition on Page 19, Line 16? Do you recall the question, "So safety could be a factor then in the decision to retire a plant?"

Answer: "Yes."

Do you recall that question and answer?

A Yes, I recall the question.

Q Do you recall the answer?

A It was a hypothetical question and I said yes.

Q You don't disagree with plant manager Ms. Sheffield that Tampa Electric had safety concerns about the plant, do you?

A I don't disagree that she said that.

Q In your deposition on Page 20, Line 17, do you recall the question, "So you don't disagree with Ms. Sheffield's statements then that Tampa Electric did have safety concerns about the plant?"

"No, I don't disagree. She made the statements."

Do you recall that question and that answer?

A Yes, it would be the same answer.

Q In fact, there were enough or sufficient leaks in the air ducts to cause a safety problem in the Gannon units; isn't that correct?

A Could I clarify that? If they were allowed to continue --

Q I would like you to answer the question.

CHAIRMAN JABER: Mr. Zaetz, the process here is that if you could answer with a yes or no first and then elaborate, I will allow that, but I need you to respond to the question and then clarify or elaborate as appropriate.

THE WITNESS: Yes, ma'am.

CHAIRMAN JABER: And, Mr. Hart, would you --

THE WITNESS: Could you repeat the question?

CHAIRMAN JABER: Mr. Hart, would you please repeat the question.

BY MR. HART:

Q In fact, there were enough or sufficient leaks in the air ducts to cause a safety problem in the Gannon units; isn't that correct?

A Yes.

Q Your testimony does not address any safety issues related to the turbine, does it?

A I didn't understand that last part of the question.

Q In addressing the safety issues that you've addressed in your testimony, you didn't address any safety issues related to the turbine, did you?

A No, sir.

Q In fact, prior to filing your testimony in this case, you did not even know what types of boilers were in the Gannon units, did you?

A No, sir. I didn't make a site visit.

Q Now, Mr. Zaetz, before this proceeding, you've never testified on whether or not a plant or an operating unit should be retired one year versus another year, have you?

A No, sir.

Q Isn't it true that you weren't sent all the testimony, deposition transcripts, and discovery responses in this case?

A Yes, that's a fact. I wasn't given everything.

Q In fact, you were sent some things to read and you were not sent other things for whatever reason because people didn't want you to read them; isn't that correct?

A I have no idea what the reason was. I read everything that was sent to me as part of the task handed to me.

Q On your deposition on Page 41, Line 10, do you recall the question, "And you were not sent other things because someone felt there was no reason for you to read that?"

Answer: "Yes, sir. They sent me things that they wanted me to read."

A Yes.

Q Do you recall that question and that answer?

A Yes, sir.

Q Do you know who made the decision about what part of the evidence you were to read and what part you weren't?

A No, sir, I don't.

Q In Mr. Whale's prefiled testimony he states that it may be possible to repair a unit, but that does not indicate that making the repair is a good business decision. You don't disagree with that statement, do you?

A Are you speaking specifically at Gannon or in general?

Q I'm speaking the same way I was in your deposition.

A Well, I would have answered the same way.

Q Well, what would that answer be then and where was that question?

CHAIRMAN JABER: Could I ask both of you to stop for a minute and remember that it's the decision-maker that gets to evaluate the evidence. So for our benefit, Mr. Hart, why don't you clarify your question, does it apply in a general fashion or just to the Gannon units, and then we'll have the witness answer that.

BY MR. HART:

Q I was using it in a general sense.

A In a general sense, there possibly could be a safety issue that would come into play when they wanted to retire a plant. I just stated that I had never seen a plant retired because of safety.

Q Well, now, would you look the your deposition on Page 50?

A Yes, sir.

Q The question was, "But you don't disagree with his statement that the fact that it's possible to repair one theoretically does not indicate that making the repair is a good business decision? You don't disagree with that, do you?"

Answer: "Absolutely not. There are times where you're not going to make a repair and then retire the unit. And that's what he's stating, and that's what I stated."

Do you recall that question and answer?

A Yes, sir, I do. I still stand by that.

Q You understand Tampa Electric's maintenance strategy of patch and go, don't you?

A Yes, sir.

Q And you don't disagree with that strategy, do you?

A I've used that strategy. And it's just like it says, it's patch and go, but you can't do that to the boiler. You can patch and go ductwork and boiler casing, but you don't patch and go the tubes. And the tubes, that's the number one reason for the unit to go off-line is when there's leaks in that boiler. So patch and go doesn't come into play when you're repairing a boiler.

Q Let's look at your deposition on Page 50, Line 13.

Question: "Okay. Do you understand Tampa Electric's maintenance strategy that they refer to as 'patch and go'?"

Answer: "Oh, absolutely. I'm very familiar with that."

"Do you think that was a prudent course of action for Tampa Electric?"

"Yes. But it didn't solve the problem. There's only so many patches -- patch and go means -- they're talking about gas leaks. Patch and go as far as the boiler leaks, you don't patch and go with the boiler leaks. You have to make those repairs."

Do you recall those questions and those answers?

A Yes, sir.

Q You understand that Tampa Electric modified its maintenance of these units as their condition worsened in order to maximize their availability especially during peak periods, don't you?

A Yes. Their strategy was to get as many hours out of those units as they could without spending any money, if that's what you mean.

Q It's your testimony, is it not, that you believe that without the Consent Decree, the maintenance and repair schedule would have been substantially different?

A Yes, sir, of course.

Q You don't disagree with Tampa Electric's decision to change the maintenance and repair schedules because they knew the units were coming to the end of their life, do you?

A No, I don't disagree with what they did.

Q If you'd been operating this plant, you would have made many of the same decisions as Tampa Electric, wouldn't you?

A Probably would as far as fixing the gas leaks.

MR. HART: No further questions.

CHAIRMAN JABER: Staff.

MR. KEATING: No questions.

CHAIRMAN JABER: Commissioners.

COMMISSIONER DAVIDSON: Chairman?

CHAIRMAN JABER: Commissioner Davidson.

COMMISSIONER DAVIDSON: A couple of questions. Just to be clear, at any point in time did you ever inspect Gannon Units 1 through 4?

THE WITNESS: No, sir. The site visit took place before I was brought in on the job.

COMMISSIONER DAVIDSON: At Page 3 of your prefiled direct testimony, you answer the question, "From your analysis of the depositions, do you feel that safety or reliability was a factor in the retirement decision?"

Your answer is, "Absolutely not."

Just so I'm clear, that absolutely not, are you offering that as an expert opinion or as your own view based on a review of the evidence that you had before you?

THE WITNESS: Looking at all of the evidence and reading their deposition, they repeatedly stated that reliability wasn't going to be an issue. They just didn't want to spend the money.

COMMISSIONER DAVIDSON: From a technical standpoint, do you have any direct knowledge as to the safety or reliability of Gannon Units 1 through 4?

THE WITNESS: Not from a site visit, only from reading depositions, but I did read all of their safety reports. I read all the accident reports.

COMMISSIONER DAVIDSON: And one final question. You are a consultant with the economic consulting firm of Snavely, King, Majoros, O'Connor & Lee, but you yourself, you're not an economist, are you?

THE WITNESS: No, sir.

COMMISSIONER DAVIDSON: And you're not holding yourself out as an expert in economics in this case?

THE WITNESS: No, sir.

COMMISSIONER DAVIDSON: Thanks.

CHAIRMAN JABER: Redirect.

MR. VANDIVER: Thank you.

REDIRECT EXAMINATION

BY MR. VANDIVER:

Q Mr. Zaetz, how many hours have you spent in cyclone plants like Gannon?

A Several thousand.

Q And do you believe that safety and reliability were the principal factors in the closure of Gannon?

A No, I don't.

Q And Public Counsel was provided about 15,000 pages of documents. Would the fuel cost documents have done you any good in your analysis of the safety and reliability of the Gannon units?

A No, sir.

MR. VANDIVER: Thank you. That's all the redirect I have.

CHAIRMAN JABER: Thank you, Mr. Vandiver.

MR. VANDIVER: I'd move the admission of Mr. Zaetz's exhibits.

CHAIRMAN JABER: Exhibit 33, without objection, will be admitted into the record.

(Exhibit 33 admitted into the record.)

CHAIRMAN JABER: Mr. Zaetz, thank you for your testimony. You may be excused.

(Witness excused.)

CHAIRMAN JABER: Staff, that brings us to your witnesses, I believe.

MR. KEATING: Staff calls Joseph Rohrbacher.

CHAIRMAN JABER: Were your witnesses in the room yesterday when I swore --

MR. KEATING: They were.

CHAIRMAN JABER: Thank you.

JOSEPH W. ROHRBACHER

was called as a witness on behalf of the Staff of the Florida Public Service Commission and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. KEATING:

Q Mr. Rohrbacher, could you state your name and business address for the record?

A My name is Joseph W. Rohrbacher. My business address is 4950 West Kennedy Boulevard, Suite 310, Tampa, Florida 33609.

Q And what is your position?

A I work for the Florida Public Service Commission as a regulatory analyst supervisor.

Q Mr. Rohrbacher, did you prepare or cause to be prepared direct testimony filed October 9th, 2003 and October 14, 2003 in this docket?

A Yes, I did.

Q Do you have any corrections or clarifications to make to that testimony?

A No, I don't.

Q Did you also prepare or cause to be prepared Exhibits JWR-1, JWR-2, JWR-3, JWR-4, and JWR-5 to your direct testimony?

A Yes, I did.

Q Do you have any corrections to make to those exhibits?

A No, I don't.

MR. KEATING: Staff would ask to have Mr. Rohrbacher's exhibits identified as a composite.

CHAIRMAN JABER: JWR-1 through JWR-5 are identified as composite Exhibit 34.

(Exhibit 34 marked for identification.)

MR. KEATING: And staff would ask to have Mr. Rohrbacher's prefiled testimony moved into the record filed October 9th and separately October 14th.

CHAIRMAN JABER: The prefiled direct testimony of Joseph W. Rohrbacher filed October 9th and October 14th shall be inserted into the record as though read.

DIRECT TESTIMONY OF JOSEPH W. ROHRBACHER

Q. Please state your name and business address.

A. My name is Joseph W. Rohrbacher and my business address is 4950 West Kennedy Blvd., Suite 310, Tampa, Florida, 33609.

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

A. I am employed by the Florida Public Service Commission as a Regulatory Analyst Supervisor in the Division of Auditing and Safety.

Q. How long have you been employed by the Commission?

A. I have been employed by the Florida Public Service Commission since January 1992.

Q. Briefly review your educational and professional background.

A. In 1967, I received a B.B.A. Degree in Accounting from Pace University. I also received an M.B.A. from Long Island University in 1972. I worked for approximately 14 years in various controller positions for two companies in New York before joining the Commission staff. I was hired by the Commission in 1992 as a Regulatory Analyst I.

Q. Please describe your current responsibilities.

A. Currently, I am a Regulatory Analyst Supervisor with the responsibilities of administering the Tampa District office, reviewing work load, and allocating resources to complete field work and issue audit reports when due. I also supervise, plan, and conduct utility audits of manual and automated accounting systems for historical and forecasted financial statements and exhibits.

Q. What is the purpose of your testimony today?

A. The purpose of my testimony is to sponsor three staff audit reports:

- Progress Energy Florida, Inc.: Base Year costs for security and hedging; Docket Number 030001-EI; Audit Control Number 02-340-2-2. A copy of the audit report is filed with my testimony and is identified as JWR-1.
- Progress Energy Florida, Inc.: Fuel Adjustment Clause; Docket Number 030001-EI; Audit Control Number 03-034-2-2. This audit report is filed with my testimony and is identified as JWR-2.
- Progress Energy Florida, Inc.: Capacity Cost Recovery Clause; Docket No. 030001-EI; Audit Control No. 03-036-2-2. This audit report is filed with my testimony and is identified as JWR-3.

Q. Let's begin by discussing the first audit report, the Progress Energy Florida, Inc. (PEF) Base year audit. Did you prepare or cause to be prepared under your supervision, direction, and control this audit report?

A. Yes, I was the audit manager in charge of this audit.

Q. Could you discuss the work performed in this audit?

A. Yes. For hedging, the utility stated it did not incur hedging costs until 2003. For security, the audit staff and I obtained security costs by function for the years 2000, 2001, and 2002. We determined the base year costs on calendar year 2001 and also on years ending September 30, 2001 and 2002 for comparative purposes. We also traced a randomly selected sample of security charges to the supporting documentation.

Q. Could you summarize your findings in this audit?

A. Yes. Disclosure No. 1 restates the fact that the utility did not incur hedging costs during 2002.

Disclosure 2 discusses Security Costs. Our review of the 2001 security expenses revealed that liability claims and administration costs were recorded as security costs in error. PEF staff agreed and determined that the security costs should have been $8,192,926. The 2001 security expenses originally provided to the auditor were overstated by $921,509. The utility's base rates were established in its rate case by Order No. PSC-02-0655-AS-EI7 issued May 14,2002, and were based in part on budgeted security costs of $7,074,068 for 2001. Since the actual expenditures are greater than budgeted, the $8,192,926 should be used for the base year.

Q. Now, in regard to the second audit report regarding the PEF Fuel audit, did you prepare this audit report?

A. Yes, I was involved in the preparation of this audit report.

Q. Could you discuss the work performed in this audit?

A. Yes, we compiled the Fuel Adjustment Clause (FAC) revenue and agreed it to the filing. We recomputed FAC revenues using rate factors and KWH sales. We also reconciled the revenue recap report to the general ledger, on a test basis. We compiled fuel and purchased power costs and tested the purchases of coal, heavy oil, light oil, and natural gas by tracing to the general ledger and journal entries. For the interexchange purchases and sales, we scheduled the monthly activity and judgementally selected three months of payments for further analysis. We traced payment activity to the source documentation. Additionally, we analyzed the "short cut" method of determining the equity and revenue requirement of Progress Energy Fuels (formerly Electric Fuels Corporation) and investigated the benchmark price and its annual escalation for the waterborne transportation costs of coal. We also verified that heat rates for the Generation Performance Incentive Factor (GPIF) determination were also used on Schedule A-5 and traced GPIF heat rates, service hours, reserve shutdown hours, and unavailable hours to the July and year-to-date Micro-GADS (Generating Availability Data System) reports published by the utility. We also verified that semi-annual adjustments to the coal inventory were performed according to Commission order.

Q. Could you summarize your findings in this audit?

A. Yes. Disclosure No. 1 discusses the fuel cost of supplemental sales. The 2002 fuel filing, Schedule A-1, Line 17 indicates Fuel Cost of Supplemental Sales was $68,144,269. We found two formula errors in the computation which will reduce the total. I recommend that the recoverable jurisdictional fuel dollars be increased for 2002 by $2,198,475.

Disclosure No. 2 discusses the waterborne coal transportation costs. Commission Order No. PSC-92-1231-FOF-EI, authorized a base year waterborne transportation cost of $23.00, effective January 1, 1993. This per-ton price was to be escalated each year on a weighted average of the change in five economic indexes published by the US Bureau of Labor Statistics (BLS). The utility stated that the BLS adjusts each quarterly index three times (preliminary, advanced and final). On the BLS website and in other computer databases, each set of numbers is overwritten. We analyzed and verified the periodic increases in the cost per gallon of the waterway user tax but were not able to determine the accuracy of the original per ton equivalent used in the base year cost effective at January 1, 1993. We verified that all subsequent increases were accurately computed. We were not able to verify the current benchmark price using the preliminary index amounts. However, the current amount is less than what it would be if final index numbers were used.

Q. Now, in regard to the third audit report regarding the PEF Capacity Cost audit, did you prepare this audit report?

A. Yes, I was involved in the preparation of this audit report.

Q. Could you discuss the work performed in this audit?

A. Yes, we compiled Capacity Cost Recovery (CCR) revenue and agreed it to the filing. We also recomputed CCR revenues using rate factors and KWH sales and we reconciled the "revenue recap" report to the general ledger on a test basis. We also analyzed capacity costs based on prior years charges and verified variances. We compiled capacity costs and agreed these to billing statements and performed audit test work to verify that Qualifying Facilities were paid according to contract for electric power supplied to the utility. We also verified that security costs recovered in the capacity clause are incremental to the security costs included in base rates.

Q. Could you summarize your findings in this audit?

A. Yes. There is only one disclosure in this report. It discusses Security Costs. PEF recorded $9,114,435 for security expenses on its books and records for 2001. In my previous discussion of the base year costs, I indicated that the amount should be $8,192,926. The utility incurred $14,118,094 of security expenses in 2002, an increase of $5,925,168 over the base year amount. The Utility is only seeking to recover $4,831,124 in its 2002 Capacity Cost Recovery filing. I believe that the 2002 incremental security expenses of $4,831,124 were a result of the utility's compliance with NRC Order No. EA-02-026 and are properly recovered through the Capacity Cost Recovery Clause.

Q. Does this conclude your testimony?

A. Yes, it does.

DIRECT TESTIMONY OF JOSEPH W. ROHRBACHER

Q. Please state your name and business address.

A. My name is Joseph W. Rohrbacher and my business address is 4950 West Kennedy Blvd., Suite 310, Tampa, Florida, 33609.

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

A. I am employed by the Florida Public Service Commission as a Regulatory Analyst Supervisor in the Division of Auditing and Safety.

Q. Are you the same Joseph Rohrbacher who submitted direct testimony in this proceeding?

A. Yes, I am. I filed my direct testimony in this docket on October 9, 2003.

Q. What is the purpose of your supplemental testimony?

A. The purpose of my testimony is to sponsor the staff audit report regarding Progress Energy Florida, Inc. Waterborne Transportation Costs (Docket Number 030001-EI; Audit Control Number 03-045-2-1.) A copy of the audit report is filed with my testimony and is identified as JWR-4.

Q. Did you prepare this audit report?

A. Yes, I was the audit manager in charge of this audit.

Q. Could you discuss the work performed in this audit?

A. Yes, we determined the relationship of the companies involved in procuring fuel for Progress Energy Florida's Crystal River power plant and read contracts for fuel purchases and waterborne transportation services and verified invoice prices to contract amounts. We tested randomly selected items and reconciled coal purchases by PEF to coal sales of Progress Fuels Corporation (PFC). We also verified that the pricing for the waterborne transportation services provided by PFC to PEF was in compliance with the market pricing mechanism authorized by Commission Order No. PSC-93-1331-FOF-EI and calculated the average waterborne transportation costs for PFC and PEF. We read PFC coal pricing procedures to PEF and scheduled the responses to the Request For Proposal for bids on coal purchases by PFC. We verified that General and Administrative (G&A) expenses included in the price computation of PFC for procuring and transporting fuel to PEF's Crystal River plant were consistent with the agreements and tested randomly selected G&A expenses. Selected audit work papers from this audit are filed with my testimony and are identified as JWR-5.

Q. Could you summarize your findings in this audit?

A. Yes. Disclosure No. 1 discusses Affiliate Companies. PEF purchases coal and other related fuels for the production of electricity from PFC, an affiliate company under Progress Energy, Inc. PFC purchases the coal and other related fuels from various suppliers. In 2002, the bulk of these purchases were from Black Hawk Synfuel LLC, Marmet Synfuel LLC, and New River Synfuel LLC. All of these companies are affiliates under Progress Energy, Inc. The fuel is trucked from the mines to an upriver terminal by Kanawha River Terminals, Inc. (KRT), for transloading to river barges which will transport the fuel down river to the New Orleans, Louisiana area. From here the coal will be shipped across the Gulf of Mexico to PEF's Crystal River complex by Dixie Fuels Limited. KRT and Dixie Fuels are also affiliates of PEF under Progress Energy, Inc.

Disclosure No. 2 discusses Coal Purchases. PFC has contracts with its suppliers, setting the prices and terms of delivery. In May 2001 PFC issued a Request For Proposal for bids on 2002 coal purchases. The prices under the contracts reviewed varied but all were FOB dock.

The waterborne coal purchased by PEF is blended with different per ton costs at the terminals upriver or in New Orleans, Louisiana prior to loading and shipment on barges to Crystal River. PFC accrues the coal inventory and computes an average cost per ton, including transportation costs, when billing PEF.

The cost to PFC is at the contracted price. In reviewing the invoices for PFC from its suppliers, I noted that prior to delivery to PEF a portion of the invoice cost is charged to "non-regulated" operations with the remainder charged to PEF. The utility spokesperson stated this non regulated portion was for the trucking of the coal from the mine to the KRT dock. This adjustment recognizes that the proxy price for transportation, in accordance with Order No. PSC-93-1331-FOF-EI, includes the cost from the mine to the generating plant.

Disclosure No. 3 discusses the Waterborne Transportation Cost. Commission Order No. PSC-93-1331-FOF-EI authorized a market pricing mechanism for waterborne transportation services. The base price of $23.00 per ton was effective January 1, 1993, adjusted January 1 of each year thereafter, using a composite index. The audit report discusses the escalated rate for 2002 and the split between the amount for transportation from the mine to the Gulf terminal and the amount for transportation across the Gulf to Crystal River. The market price for PFC's deliveries cover the transportation components from the coal mine to the Crystal River plant site. This includes short-haul rail/truck transportation from the mine to the up-river dock, up-river barge transloading, river barge transportation, Gulf barge transloading, Gulf barge transportation, and transportation to the Crystal River plant, as well as other charges, such as port fees and assist tug.

We determined the average cost of waterborne transportation for Progress Fuels Corporation for 2002. The companies providing transportation from the mines to the up-river dock and transloading to river barges and Gulf barge transportation to Crystal River is provided by Kanawha River Terminals, Inc. and Dixie Fuels Limited, both affiliated companies. Since the contracts were not put out for bid, we are unable to determine if the costs reflect a true market price.

Q. Does this conclude your testimony?

A. Yes, it does.

BY MR. KEATING:

Q Mr. Rohrbacher, have you prepared a summary of your testimony?

A Yes, I have.

Q Could you please provide your summary?

A Yes. The purpose of my testimony is to support four audit reports. Number one was Progress Energy Florida base year costs for security and hedging under Docket Number 030001-EI, Audit Control Number 02-340-2-2. And in this I ordered at base year cost for security and hedging costs to be allowed in the fuel cost recovery clause.

A second audit was Progress Energy Florida also, the fuel adjustment clause, Docket 030001-EI, Audit Control Number 03-034-2-2. And this I compiled fuel adjustments, revenues, and expenses for the year.

Audit number three was Progress Energy Florida also. It was the capacity cost recovery clause under Docket 030001-EI, Audit Control Number 03-036-2-2. And in that we compiled revenue and capacity costs and agreed them to the company's filing.

And the fourth audit was for the waterborne transportation of Progress Energy Florida. And I don't have a docket number on this on my notes here, I'm sorry. But that was to verify the pricing for the waterborne transportation that Progress Energy Florida was paying.

MR. KEATING: Thank you. And I would just note before I tender Mr. Rohrbacher for cross, he has filed -- he has a confidential version of his testimony and exhibits, and to the extent that parties have questions concerning the confidential information or would like to use those, we do have copies -- staff does have copies of that.

MR. TWOMEY: Mr. Chairman?

COMMISSIONER DEASON: Mr. Twomey.

MR. TWOMEY: Yes. If the staff would distribute those, I have a few questions that I would like to ask from the confidential portion.

COMMISSIONER DEASON: Very well. Let's start at this end of the -- first of all, the testimony has been inserted correctly; is that correct?

MR. KEATING: It has, yes.

COMMISSIONER DEASON: Okay. We can start at this end. We'll start with FIPUG questions. Ms. Kaufman.

MS. KAUFMAN: Thank you, Mr. Deason.

CROSS EXAMINATION

BY MS. KAUFMAN:

Q Mr. Rohrbacher, I just have one question for you, and it concerns your audit of the waterborne transportation portion of the work that you did.

A Yes.

Q Would I be correct, sir, that basically what you did in your audit was verify that the company had correctly applied the market proxy?

A That's correct.

Q And your testimony doesn't make any judgment or conclusion in regard to the reasonableness or the prudence of the prices that were paid; is that correct?

A That's correct.

Q And that's done in Mr. McNulty's testimony?

A That's correct.

MS. KAUFMAN: Thank you.

COMMISSIONER DEASON: Mr. Twomey.

MR. TWOMEY: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. TWOMEY:

Q Good afternoon, sir.

A Good afternoon.

Q I just have a few questions. At Page 2 of your supplemental testimony, the -- Page 2, near the top, you discuss the fact you calculated the average waterborne transportation costs for PFC and PEF. Is there any significance by calculating the average?

A Well, the reason I took the average, because not everything was charged out at the same amount of transportation costs. Some of the invoices that I happened to look at had a lower -- they had an amount pulled out, I guess, which the company claimed was transportation from the mine to the river.

Q Now, does that concern the potential double counting issue that I understand has been deferred for a later time?

A I'm not real sure. I believe it might, but I'm not sure.

Q Okay. Still on Page 2 in your discussion of your Disclosure Number 1 which relates to affiliate companies, you say at Line 15, "In 2002 the bulk of these purchases" -- and I think you're referring to coal and other related fuels.

A That's correct.

Q -- "the bulk of these purchases were from Black Hawk Synfuel LLC" -- is it pronounced Marmet?

A Yes.

Q -- "Marmet Synfuel LLC and New River Synfuel LLC. All these companies are affiliates under Progress Energy."

By bulk, do you mean majority?

A The majority, yes, sir.

Q Do you have a percentage or is that secret?

A I don't believe I have a percentage.

Q Okay. When you calculated -- I mean, you examined the amount the company paid for fuels -- for coal as well as transportation; correct?

A That's correct.

Q Did you calculate that on an average basis as well or by contract?

A I calculated it by contract and I also looked at invoices.

Q Okay. And there was at times, though, was there not a wide disparity between what was paid for the price of similar coals; is that correct?

A There was a difference, yes, sir.

Q Okay. We'll get to that in a second, perhaps. Also, at Page 2, you noticed as well that the KRT and Dixie Fuels are also affiliates of PEF; correct?

A That's correct.

Q On Page 3 you say that the waterborne coal purchased by PEF is blended with different per ton costs at the terminals upriver or New Orleans. You say that at Line 3. Did that include blending of synfuels, or do you know?

A I don't know.

Q Okay. At Line 8 you say, "The cost to PFC is at the contracted price." Is that in contrast to -- first of all, that's what the fuel affiliate pays for the coal and coal transportation services; correct?

A That's correct, sir.

Q And that would be or could be contrasted to what the utility seeks to recover from its ratepayers under the price proxy mechanism; correct?

A I don't quite understand your question.

Q Well, isn't it correct that the number you refer to on Line 8 at Page 3 is the amount that the fuel affiliate actually pays for having the services performed?

A Correct. That's correct.

Q And one of the tasks in your audit was to see whether the company escalated its price proxy pursuant to the agreement approved by the Commission in 1993; correct?

A That's correct.

Q And that price proxy cost is different than what the fuel affiliate actually pays; correct?

A That's correct.

Q Okay. In your Exhibit JWR-4 at Page 4 -- do you have that?

A Yes, sir.

Q That would be your Disclosure Number 2 at the top left corner?

A Page 4, yes, sir.

Q Okay. Now, I want to be careful because there are some allegedly confidential numbers there. In the statement of fact, your report says, "Progress Fuels Corporation, PFC, purchases its coal from various suppliers and through its affiliates acting as agents. The per ton coal prices reviewed ranges from 'blank' per ton from Pen Coal Corporation, a non-affiliated entity, under contract originating in 1998 to 'blank' per ton from Black Hawk Synfuel, an affiliated company, under a 2001 contract. The coal specifications in both contracts were similar."

By the coal specifications, are you referring to the type of coal and the Btu content?

A That's correct, sir.

Q I want to ask you if you're aware -- is it ever true that the synfuel process degrades the Btu content of the coal?

A I really don't know that answer.

Q Okay. Did -- in the performance of your audit, did you draw any conclusions from the price spread shown that are not disclosed there but the spread between the non-affiliate coal and the affiliate coal?

A No, I didn't.

CHAIRMAN JABER: What was your question again?

MR. TWOMEY: Yes, ma'am. I asked him in the performance of his audit, did he draw any conclusions from the price spread shown between the price per ton for the non-affiliate coal and that shown for the affiliate coal. And I think he said that he did not.

BY MR. TWOMEY:

Q Did you inquire why there was such a difference?

A I believe I probably inquired verbally at the time and was told -- and again, this is just my guessing, is that there were different contracts that they had at different times.

CHAIRMAN JABER: Mr. Rohrbacher, how did you interpret that? That the timing of the contracts had something to do with that differential?

THE WITNESS: That's correct.

CHAIRMAN JABER: Because of certain variables? I mean --

THE WITNESS: Like I said, it was given to me verbally, and it was during the length of the contract and the timing of the contract.

MR. TWOMEY: Are you through, Madam Chair?

CHAIRMAN JABER: Yes. Thank you.

BY MR. TWOMEY:

Q Yes, sir, but let me ask you, does it -- if the contract, coal, if the specifications were similar in terms of the nature of the coal, earlier in your testimony you mentioned -- or in your testimony or in your audit you mentioned that the cheaper non-affiliate coal was, I think, from a 1998 contract and the more expensive affiliate coal was three years later, in 2001. Doesn't it strike you that the rather substantial difference in the price for what is apparently the same type of coal would warrant more explanation?

A Well, no. It's just stated, you know, the cheaper contract began in '98 and ran into 2001. And the other contracts basically began in 2001 and ran forward into 2002. So I just thought it was a change in the three years in the market pricing.

Q Okay. And I don't know that this was part of the task of your audit, but in the conduct of your audit, did you have a chance to ascertain whether coal contracts of this type were going up or down?

A No, I didn't, sir.

Q Okay. Did you decide to -- whose decision was it to redact those numbers? Do you know?

A No, I don't.

Q The next page, Mr. Rohrbacher, Disclosure Number 3, Page 5 at the bottom --

A Yes, sir.

Q -- there are a number of redacted dollar amounts on that page. You say in the auditor's opinion, "We determine the average cost of waterborne transportation for Progress Fuels Corporation for 2002 was 'blank' based on company records." Has that figure been modified up or down since then?

A I don't know.

Q And then the calculation you do below that at the bottom of the page, that would show what the fuel affiliates' gross profit would be per ton; is that correct?

A That's correct.

Q Okay. Now, isn't it true that in their contracts, that they get -- the fuel affiliate, Progress Fuels, is compensated for all of its personnel administrative and general and other costs?

A I don't believe it's all there are. Some costs under the market proxy, G&A costs that I believe they are allowed to recover.

Q You mean recover outside the proxy?

A No, within the proxy.

Q Yes, sir, I'm sorry. I wasn't clear, I think. My question is, is that, aren't the personnel costs of Progress Fuels included within the proxy calculation?

A I believe personnel costs are, but I would not say it was all of Progress Fuels' personnel costs.

Q Okay. Just a few more. Let me see. On JWR-5, Page 14 of 39, I'm not sure how this -- in the upper right-hand corner.

A Yes, sir.

Q Your discussion of the Black Hawk Synfuel contract and as an agent for New River Synfuel, are both of those affiliates or just one? Are both of those corporations affiliates of Progress Energy?

A Both of them are affiliates, I believe, Black Hawk and New River.

Q Okay. The same page, the next to the last paragraph, I have a question related to something you say there. It says, "As agent for New River Synfuel, 950,000" --

COMMISSIONER DEASON: Wait. I'm sorry. That's --

MR. TWOMEY: I'm sorry. That's all --

COMMISSIONER DEASON: -- confidential information, I believe.

MR. TWOMEY: I'm sorry. It wasn't all blocked out. Every bit of that's -- the whole page is confidential?

MR. McGEE: That was the way it was marked.

MR. TWOMEY: Never mind. So we're not talking just numbers, we're talking all the text is confidential?

MR. McGEE: That was the way that the page was marked by staff. I am assuming that they were basing that on confidentiality requests that were granted on our part. How those two fit together, I don't have any knowledge.

MR. TWOMEY: Okay. Well, my client got in late, so we'll live with that.

BY MR. TWOMEY:

Q The last couple of questions, Mr. Rohrbacher, on Page 22 of 39 of JWR-5 -- do you have that?

A Yes, sir, I have it here.

Q Now, on this page, only the numbers are redacted as I see it. These are part of your audit work papers; is that correct?

A That's correct.

Q I have a question on the upper left-hand table of that page. You have cost of coal from different suppliers; correct?

A That's correct.

Q So if we go down, the Pen to Pen Dock, about a third of the way down, do you see that?

A Yes, I do.

Q That's the first apparent purchase, I guess, for that year -- or that month. That's a non-affiliate company; correct?

A That's correct.

Q And we see the number of tons which is not redacted, and then we see the cost per ton which is redacted; correct?

A Correct.

Q If you go down to Black Hawk/S, does Black Hawk/S does that mean synfuel?

A I'm not sure.

Q Or does that always mean spot?

A I'm not sure. This is a company-prepared document.

Q Sir?

A I said I'm not sure what the "/S" means. This is a document I got from the company.

Q Okay. Keeping that in mind, I want to ask you, if you look at the -- if you would count up from the bottom the companies on the left starting at InterAmerican, is that a foreign fuel, or do you know?

A I do not know.

Q Okay. One, two, three, four, five, six from the bottom, Black Hawk/S to KRT/Quincy --

A Yes, sir, I see it, Number K.

Q And you can see the price per ton which is redacted?

A Yes, sir.

Q Did your audit include any examination on the reasonableness of that price versus the redacted price for the non-affiliate Pen to Pen Dock or was that beyond the scope of your audit?

A I believe that was beyond the scope of the audit. I really didn't do anything on it.

MR. TWOMEY: Okay. That's all I have, Mr. Chairman.

COMMISSIONER DEASON: Mr. LaFace?

MR. LaFACE: (Shaking head.)

COMMISSIONER DEASON: Mr. Vandiver, did you have questions for this witness?

MR. VANDIVER: Just one, sir.

COMMISSIONER DEASON: Okay.

CROSS EXAMINATION

BY MR. VANDIVER:

Q Do you know why the audit was performed, Mr. Rohrbacher?

A Do I know why it was performed?

Q Yes, sir.

A I believe they wanted to revisit the market proxy that was developed back in 1992 to see if it was still applicable.

MR. VANDIVER: Thank you.

MR. McGEE: No questions.

MR. KEATING: Staff has no redirect. And we would move Exhibit 34, composite Exhibit 34.

CHAIRMAN JABER: Commissioners, did you have any questions of this witness? Okay.

Staff, without objection, Exhibit 34 will be admitted into the record.

(Exhibit 34 admitted into the record.)

CHAIRMAN JABER: Thank you for your testimony.

THE WITNESS: Thank you.

(Witness excused.)

MR. KEATING: Staff calls William B. McNulty.

And for reference, the red folder that was handed out with Mr. Rohrbacher's confidential testimony also contains Mr. McNulty's confidential testimony and exhibits. I believe the parties have that, but if any party does not have that, staff has additional companies.

WILLIAM B. MCNULTY

was called as a witness on behalf of the Staff of the Florida Public Service Commission and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. KEATING:

Q Mr. McNulty, you were sworn in yesterday; correct?
A Yes, I was.
Q Could you state your name and business address for the record?
A Yes. My name is William B. McNulty, and my business address is 2540 Shumard Oak Boulevard in Tallahassee, Florida 32311 (sic).
Q And what is your position?
A My position is supervisor of the cost recovery section in the division of economic regulation.
Q Mr. McNulty, did you prepare or cause to be prepared direct testimony filed October 14th, 2003 in this docket?
A Yes.
Q Do you have any corrections or clarifications to make to that testimony today?
A Yes, I do.
MR. KEATING: Commissioners, those corrections are contained on the errata sheet that was just handed out in the confidential folder. I will allow Mr. McNulty to -- well --
CHAIRMAN JABER: Did you give a copy of this to the court reporter?
MR. KEATING: I can give a copy to the court reporter, yes.
CHAIRMAN JABER: Okay. Let's do that. And the parties have a copy of this?

MR. KEATING: The parties do have a copy of that. They were provided that at the lunch break.

CHAIRMAN JABER: Mr. McNulty, just to make it easy for us, without revealing any of the confidential information, if you'll just go through and tell us where the corrections are, the page numbers and the lines, for the record, that would be great.

THE WITNESS: Certainly. I could go down the list or I could just basically -- I think the majority of these corrections have to do with the margin percentage calculation that is part of Exhibit WBM-2. And I could perhaps reference back to that exhibit and describe what that basic correction was, and it flows through to several other locations in the text of the testimony.

CHAIRMAN JABER: Let's do both. Maybe articulating the page numbers and the lines and then explaining the nature of the correction would help expedite things.

THE WITNESS: Okay. So you want to go from the top of the errata sheet?

CHAIRMAN JABER: Yes.

THE WITNESS: Okay. If we would please turn to Page 7, Line 16. There is referenced an order. Upon correction, I find that that information is actually contained in staff's second set of interrogatories to Progress Energy Number 52. It's not contained in the order per se.

Page 10, it leads us to Line 23, and there is a percentage that is shown there. And this is the margin percentage that was incorrectly calculated. It would -- to understand these margin percentages, I would reference you back to Exhibit WBM-2.

And basically the error that was made was on either one of these tables, either the domestic or the foreign waterborne coal transportation margin table, if you look at either one of those, in the left column we have labeled the various types of costs or proxies that are being calculated or percentages. The calculation that was done incorrectly was the margin, which is shown there in dollars, was divided by the market price proxy. And the definition of margin, as we commonly use it, is the profit over the excess profit or excess revenue, I should say, or profit over the total cost. So instead of margin over market price proxy, the appropriate calculation should have been margin over total cost. And that is the percentage that you see for domestic waterborne. That is the correction that you see on Line 23 of Page 10.

The next correction is on Page 11, the following page, Line 6 where we see a range that has been calculated around that same percentage. And using that same formula, I made that same sort of correction.

And then Page 10, Line 24 -- I'm going to cause you to flip back one page, I guess -- there is just a typographical error where it says -- on Line 24, it says, "directs," it should be "direct."

Back to Page 11 -- excuse me. Back to Page 12. We have additional percentages that are shown on two different lines, Lines 14 and 21, and those same types of corrections are necessary to be made as was referenced in Exhibit WBM-2.

Lines 18 and 21, the word "domestic" appears and should have been the word "foreign."

Now, if we go to Page 19, on Line 12, you'll see the phrase "such as upriver terminaling." And there is an assumption made there that there are existing contracts that are not expiring in the next year and a half, and that assumption was incorrect. And so because it was incorrect, I maintained that the question and the answer should be deleted.

Page 20. Page 20 was discussed, I think, yesterday in this hearing. The word -- the understanding that I had was that there was a particular word to be deleted with the understanding that what we were -- what was being conducted was a discussion between staff and Progress Energy, and an effort was being made at that time to arrive at a stipulation. I presumed at the time that the stipulation that was being pursued involved an understanding that this information would be modified in the way that it's described on my errata sheet, basically taking out that sentence and replacing it as is described here with the phrase that would be attached to the sentence before it. And I guess I maybe could read it just to make it clear as to what it would say.

"I have concluded that the current market price proxies for both domestic and foreign coal transportation are no longer relevant and sufficient for the purpose of assessing cost prudence, given the margins PFC has achieved for foreign and domestic waterborne transport." And I made this change which is as we say here is not a correction. I think everything else on this page would be considered a correction. This is not necessarily a correction, but I looked at this as not materially changing what my testimony said. In particular, there are references on Page 14 and 15 that would say essentially the very same thing. So with the understanding that this was not changing my testimony, I had no problem in the discussion of this and making this small change.

Okay. Then on Page 23, we've already gone through and talked about these changes that were necessary to the margin percentages. And that was the basis of my unfortunately somewhat lengthy errata sheet.

CHAIRMAN JABER: Thank you, Mr. McNulty. Mr. Keating.

BY MR. KEATING:

Q Mr. McNulty, did you also prepare or cause to be prepared Exhibits WBM-1, WBM-2, and WBM-3 to your direct testimony?

A Yes, I did.

Q Other than the correction that you've already described to WBM-2 on Page 23, do you have any additional corrections to those exhibits?

A No, I do not.

Q Have you prepared a summary of your testimony?

A Yes.

Q Could you please provide your summary.

CHAIRMAN JABER: Wait, wait, wait.

MR. KEATING: I'm sorry.

CHAIRMAN JABER: The prefiled direct testimony of William B. McNulty as modified today shall be inserted into the record as though read. The Exhibits WBM-1 through WBM-3 with the modifications described to WBM-2 will be identified as composite Exhibit 35.

MR. KEATING: Thank you.

(Exhibit 35 marked for identification.)

Q. Please state your name and business address.

A. My name is William B. McNulty. My business address is 2540 Shumard Oak Boulevard Tallahassee, Florida 32399-0850

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

A. I am employed by the Florida Public Service Commission as a Public Utility Supervisor in the Division of Economic Regulation.

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

A. I graduated from the University of Florida in 1981 with a Bachelor of Science degree in Psychology. I graduated from the University of Central Florida in 1989 with a Master of Business Administration degree. In that same year, I began employment with the Florida Public Service Commission as a Regulatory Analyst. In May 1998, I was promoted to Regulatory Analyst Supervisor in the Division of Research and Regulatory Review. I was promoted to my current position in May 2000.

Q. What are your present responsibilities with the Commission?

A. My responsibilities include assigning, directing, and supervising the activities of the Cost Recovery Section of the Bureau of Electric Reliability and Cost Recovery. Section activities include the development and presentation of analyses and recommendations to the Commission primarily related to cost recovery of various clause-related expenses (fuel, purchased power, and environmental), as well as to petitions/motions for territorial agreements and disputes and to reviews of reports of electric distribution reliability and related rulemaking. I also assign, direct and supervise the processing of customer complaints concerning distribution reliability and quality of service that may be assigned to the Division of Economic Regulation.

Q. Have you previously testified before the Commission?

A. No.

Q. What is the purpose of your testimony?

A. My testimony addresses the following two issues which have been identified by staff as preliminary issues in this docket:

1. Is the waterborne coal market price proxy that was established in Order No. PSC-93-1331-FOF-EI, issued September 13, 1993, in Docket No. 930001-EI, still a relevant and sufficient means for assessing the prudence of transportation costs paid by Progress Energy Florida to its affiliate, Progress Fuels?

2. Should the Commission modify or eliminate the method for calculating Progress Energy Florida's market price proxy that was established in Order No. PSC-93-1331-FOF-EI?

First, I will describe Progress Energy Florida, Inc.'s (PEFI) domestic and foreign market price proxies which were approved by the Commission in 1993 and 1994, respectively. Then I will present a brief review of the Commission's recent regulatory decisions and activities related to waterborne coal transportation service (WCTS) provided by Progress Fuels Corporation (PFC, formerly Electric Fuels Corporation, or EFC) for PEF (formerly Florida Power Corporation, or FPC). I will show that the growth rate of the Domestic WCTS market price proxy during the first five years it was implemented was not representative of the growth rate of market prices nationally. In addition, I will show that PEFI's WCTS market price proxies, including both the domestic market price proxy and foreign market price proxy, were not representative of the costs incurred by PFC to provide WCTS during 2002. Then I will present my arguments for eliminating PEFI's market price proxy for all components of waterborne coal transportation except for any component for which the utility is unable to obtain one or more competitive bids for such service. For any such component, I will explain why the Commission should establish a new market price proxy based on carefully determined base price, escalators, and weightings. Finally, I will present an administrative process whereby the Commission can transition away from the use of the current WCTS market price proxies for PEFI to the proposed regulatory prudence review explained above.

Q. What is the domestic waterborne coal transportation service (Domestic WCTS) market price proxy?

A. Approved by this Commission on September 13, 1993, in Docket No. 930001-EI per Order No. PSC-93-1331-FOF-EI, the Domestic WCTS market price proxy is the annually-adjusted price PEFI pays for waterborne transportation of coal from multiple points on the Mississippi/Ohio River System, to the Crystal River plant site. The Domestic WCTS was based on the charges EFC paid to its transportation suppliers, or vendors, for waterborne coal transportation in 1992. This base cost ($23.00) was approved as the rate for 1993 and has been adjusted annually by a set of five cost indices, including:

CPI-U (the Consumer Price Index-Urban)

PPI (the Producer Price Index)

No. 2 Diesel Fuel Index

AHE (Average Hourly Earnings)

RCAF-U (Rail Cost Adjustment Factor-Unadjusted

The weighting of each of the indices is [redacted] percent, except for [redacted], which is [redacted] percent. Thus, ninety percent of the base price is inflated according to the individual weightings of five indices. The remaining ten percent of the base price is fixed. Any governmental impositions placed on vendors of EFC after 1992 which the vendors choose to pass on to PFC are then added to the index-adjusted price. The escalators, weightings, and development of the Domestic WCTS market price proxy appears in confidential audit workpapers attached to staff Witness Rohrbacher's Direct Testimony of October 14, 2003 in this docket.

Q. What is the foreign waterborne coal transportation service (Foreign WCTS) market price proxy?

A. In Order No. PSC-94-0390-FOF-EI, issued April 4, 1994, in Docket No. 940001-EI, the Commission approved a counterpart to the Domestic WCTS market price proxy for foreign coal transportation for all shipments of coal received "freight on board" (F.O.B.) at the International Marine Terminal (IMT) in New Orleans. The Foreign WCTS market price proxy was determined to be a price equal to 50.2 % of the Domestic WCTS market price proxy. It was established on the basis of the proportion of EFC's transloading and Gulf transport barging costs to EFC's total 1992 waterborne transportation costs. Arithmetically, the resulting market proxy price is the same as simply multiplying the combination of the 1992 transloading and Gulf transport barging costs ($11.56) times the same composite index used to escalate Domestic WCTS for each year.

Q. What are the components of PEFI's Domestic WCTS?

A. The components are presented here according to the journey of the coal from mine to the Crystal River plant:

(1) Upriver transport (moving the coal from the mine to the river, such as the Kanawha, Big Sandy, and Ohio Rivers),

(2) Upriver terminal (the transloading of coal to river barges at the Kanawha River Terminal or Pen Dock),

(3) River transport (moving the coal by barge down the Ohio and Mississippi Rivers to New Orleans via MEMCO, the river transport company),

(4) Gulf terminalling (the transloading of coal for storage and blending purposes in New Orleans via International Marine Terminal, or IMT), and

(5) Gulf transport (moving the coal by ocean tug/barge across the Gulf to the Crystal River plant, including assist tug and demurrage, by Dixie Fuels Limited, or DFL)

Q. Is waterborne transport the only mode used by PEFI to transport coal to its Crystal River plant site?

A No. In fact, rail transportation of coal is, and has been for many years, PEFI's primary means of coal transportation. Each year the utility transports approximately [redacted] to [redacted] percent of its coal requirements by rail; the remaining [redacted] to [redacted] percent is moved by barge. The utility states that it maintains dual modes of transport in order to bring price pressure to bear on CSX, its rail transport vendor.

Q. Did the Commission preclude the possibility of either modifying or replacing the WCTS market price proxy at some later date when it was adopted by the Commission?

A. No. The Commission was silent as to how long the market price proxy should be used as the basis of WCTS cost recovery. Even FPC considered it to be experiment. When asked about the economic implications of replacing cost-plus pricing with market pricing, FPC Witness Karl H. Wieland responded on direct in Docket No. 930001-EI that "there is obviously no way to predict the future outcome of complex economic events and conditions with any confidence". Certainly, the Commission did not close the door to a review of the WCTS market price proxy based on a reasonable argument that it should either be modified or replaced.

Q. Why should these issues be considered by the Commission at this time?

A. In Order No. PSC-02-1761-FOF-EI, issued December 13, 2002 in Docket No. 020001-EI, the Commission approved a stipulation among parties that a review of the WCTS market price proxies should take place as part of the fuel and purchased power cost recovery clause proceedings. In addition, timing is an important concern because PFC contracts with vendors for WCTS are terminating in late 2004 (river transport and Gulf terminalling) and early 2005 (Gulf transport). PFC is the coal procurement subsidiary of PEFI, charged with arranging all coal purchases and coal transportation. Inasmuch as PFC's existing WCTS contracts are expiring and new contracts are taking their place in late 2004 and early 2005, I believe it is preferable to establish any new requirements and/or changes to the market price proxies the Commission deems necessary as soon as possible. By so doing, PEFI and PFC will be given due notice of any new requirements and proxy modifications prior to these entities signing new WCTS contracts with vendors.

Q. What actions have the parties and staff taken to further this review of the WCTS market price proxies to date?

A. Commission staff held a meeting among parties to the fuel docket on January 30, 2003, to discuss the WCTS market price proxy and its continued validity. While the meeting allowed for an information exchange that was productive, staff believed a more complete understanding of the past and current operations of the WCTS market price proxy would best be gained by completing a staff audit of the books and records of PFC. This audit was performed by the Division of Auditing and Safety (Audit Control No. 03-045-2-1). Staff Witness Rohrbacher is testifying about the findings of the audit. In addition, staff has conducted written and oral discovery regarding PEFI's WCTS market price proxy. PEFI's Witness Javier Portuondo has also filed direct testimony, dated September 12, 2003 regarding the WCTS market price proxy.

Q. Why is it important that the Commission concern itself with determining the cost of providing Domestic WCTS and Foreign WCTS if the prices that are charged for such services are market price proxies that escalate/de-escalate based on a composite index?

A. According to PEFI's response to Staff's Second set of interrogatories, No. 52 ~~Order No. PSC-93-1331-FOF-EI~~, PEFI's Domestic WCTS market price proxy was based on the EFC's 1992 cost of providing WCTS service to FPC. The market price proxy was a "best guess" as to what direction market prices would be for WCTS for PEFI, but it was based on the application of cost escalators that imperfectly gauge market price, especially over long periods of time. The potential has always existed for a significant mismatch between the market price proxy resulting from the application of these cost escalators and the actual WCTS market price. A market price proxy was established based on cost because there was insufficient market information available to set a market price. Thus, I maintain that the Commission should periodically review the costs of providing service for any market price proxy in order to ascertain that the mechanism is not allowing either an significant overrecovery or underecovery of costs.

Q. Does a market exist for PEFI's WCTS?

A. Yes, a market exists for most of the components of WCTS, including upriver transport, upriver terminalling, river transport, and Gulf terminalling. PEFI has identified eighteen upriver terminal companies, five river transport companies, and four Gulf terminal companies capable of providing WCTS in some measure for the utility. Upriver transport is competitively contracted by the upriver terminal or coal suppliers. However, it is unclear whether a market exists for Gulf transport. Witness Portuondo's claim in his direct testimony that a market does not exist for Gulf transport begs the question of whether a market could exist if the utility or its coal-procuring subsidiary were to seek a market directly through an open competitive bidding process. I believe it would be premature to conclude that a market for Gulf transport does not exist until the results of a fairly constructed competitive bid process proved the case.

Q. What WCTS market price information is available which may be used to assess the market price proxies' relationship to true market prices?

A. The best source of relevant market price information that is lacking at this time is the price information that could be gleaned from fair and open competitive bidding procedures. In November 1983, the Commission issued Order No. 12645 in which it stated its policy that fuel transportation expenses which are recovered via the fuel clause should result from "competitive procurement practices" and further recommended that long term contracts be awarded on the basis of a competitive bidding process. Unfortunately, neither PEFI nor PFC have solicited competitive bid information through a formalized request for proposal (RFP) for any components of WCTS during the past 10 years. PFC did seek information informally through telephone contacts for certain components judged to be more subject to competition, such as for the upriver terminal. However, for most of the major components, including river transport, Gulf terminalling, and Gulf transport, the utility states that it relied upon market research, experience-based market knowledge, and contract negotiations in order to assess market price rather than competitive bid solicitations.

Second, some data is available regarding WCTS from trade publications and government sources. Trade publications such as Coal Transportation and government sources such as the Energy Information Administration (EIA) provide some price data and analysis.

Third, proprietary studies are available with market price information for river transport and ocean transport. Information such as this has been presented in testimony offered by Tampa Electric Company (TECO) in this docket.

Fourth, inter-utility comparisons of WCTS market price are available. The Commission receives relevant WCTS cost data via monthly filings of Florida Form 423 by TECO that would provide some useful inter-utility WCTS market price comparisons. However, this information is classified by this Commission as confidential for a 18-month period based on the potential for competitive harm which may result to the utility and/or its affiliates. Such information cannot be shared with PEFI for that reason.

Q. What was the specific market data you reviewed, and what conclusions can be drawn?

A. I reviewed publicly-available information compiled by the Energy Information Administration (EIA). Such information is limited to the first five years that the market price proxy was implemented (1993-1997). My analysis shows that the growth rate of PEFI's Domestic WCTS market price proxy exceeds the growth rate of the market price shown in the EIA data for these years, as depicted in EXH WBM-1. The data shows that the market rate for multimode coal transportation rates decreased in real terms from 1993 though 1997 by an average of 3.50 percent per year, while PEFI's market price proxy [redacted] by [redacted] percent per year when adjusted for inflation on a per-ton mile basis (PEFI's waterborne transport is actually considered "multimode" because it requires upriver transport via truck to get the coal to the river). Unfortunately, the market data for the years following 1997 necessary for a more updated comparison is not available from EIA. The 1992 through 1997 price data comparison shows that the PEFI's market price proxies were not reflective of the market trend during this period and [redacted]

Q. What do you know about the relationship between PEFI's Domestic WCTS market price proxy and PFC's cost to procure Domestic WCTS on behalf of PEFI?

A. Based on the results of staff discovery and staff's audit of PFC's 2002 costs, PFC's 2002 cost of providing Domestic WCTS for PEFI is [redacted] than the 2002 Domestic WCTS market price proxy, as shown in EXH WBM-2. My estimate of PFC's 2002 margin for Domestic WCTS provided on behalf of PEFI is [redacted] percent, or [redacted].

Q. How did you determine the ~~directs~~ direct, or contractual, costs for Domestic WCTS, which are shown in your margin analysis of PEFI's 2002 Domestic WCTS?

A. This cost estimate was offered by PEFI. While there is outstanding staff discovery on this matter, the utility states that the is known within a range of $1.00 per ton. I have accepted the mid-point of the range offered. Thus, the actual number reported by the utility may be either $0.50 per ton greater or lesser than the amount I used, and the resulting impact on the range of the margin is from [redacted] percent up to [redacted] percent.

Q. In your calculation of the margin for Domestic WCTS, did you recognize all of the costs that were identified as recoverable in Order No. PSC-93-1331-FOF-EI?

A. Yes. The margin estimate I have calculated includes not only the eight types of costs explicitly identified in the Order as costs recoverable via the market price proxy, it also includes PFC's General and Administrative (G&A) costs of providing WCTS. The order does not explicitly state whether PFC's G&A costs are recoverable through the market price proxy. Because the Order explicitly identifies eight other recoverable cost items, one could argue that the list of items should be considered complete and exclusive. However, my calculation of the margin estimate includes PFC's G&A costs for two reasons:

(1) Prior to the inception of the market price proxy, such G&A costs were recovered via the fuel clause, and when the market price proxy was implemented, the utility ceased recovering such costs separately through the fuel clause.

(2) The language of the Order does not explicit state that such costs should be excluded. I have represented the impact of this cost in "indirect costs" as shown in EXH WBM-2.

Q. Does your analysis include costs associated with Dixie Fuel Limited's

(DFL) non-contractual operations and maintenance (O&M) costs?

A. No. My margin analysis excludes such costs. While PEFI claims that approximately $3 M to $4 M of non-contractual O&M costs were incurred in 2002 by DFL, these costs were not included in the contract between PFC and DFL for Gulf transport. The Order explicitly states that "the market price [proxy] would also cover, i.e., replace, the return of EFC's investment in IMT and Dixie Fuels currently provided under cost-plus pricing for water transportation." PFC owns a majority of DFL. Recognition of non-contractual O&M costs which may be a substitute for capital investment is counter to the explicit intent of the Order. Thus, there is no reason why these costs should be recognized in my margin analysis of PFC's WCTS.

Q. What would your margin analysis show if you allowed PEFI's claim of $3 to $4 M in non-contractual O&M costs incurred by DFL in 2002?

A. My analysis would show a margin of [redacted] percent.

Q. What do you know about the relationship between PEFI's Foreign WCTS market price proxy and PFC's cost of providing Foreign WCTS to PEFI?

A. Similar to Domestic WCTS, PFC's 2002 cost of providing Foreign WCTS appears to be substantially lower than the 2002 ~~Domestic~~ Foreign WCTS market price proxy, as shown in EXH WBM-2. My analysis is based on the results of staff discovery and Staff's audit of PFC's 2002 costs. My estimate of PFC's margin for ~~Domestic~~ Foreign WCTS is [redacted] percent, or [redacted] Also, my comparison of the costs of Domestic WCTS and Foreign WCTS reveals that the ratio of transloading and Gulf transport shipping costs to total domestic costs has [redacted], from 50.2 percent in 1992 to [redacted] percent in 2002.

Q. Wouldn't it be important to consider not only the costs incurred by PFC but also the profits that PFC should be allowed to receive in return for the additional risk it assumed when the market proxy mechanism was implemented?

A. Yes, the Commission did allow both profits and losses to accrue to the affiliate, EFC, when it approved the stipulation to implement a WCTS market proxy for FPC. However, most of the risk of cost increases were factored into the market price proxy via the escalators or by insurance coverage carried by EFC's vendors or EFC itself. For instance, the escalators included in the annual calculation of the market price proxy addressed fuel price risk through the application of the No. 2 Diesel Index. In Witness Portuondo's direct testimony, at Page 23, he references the possibility of a catastrophic loss to DFL related to its provision of service to PEFI, such as a vessel lost at sea. However, the cost impact of a lost vessel incident is not compelling. DFL carries vessel insurance, so the remaining risk would be payment of the deductible, which PFC indicates is $1.0 M to $2.5 M. However, even for that potential loss amount, the likelihood of a catastrophic incident actually happening is quite small. In deposition, a long-time PFC employee indicated she was unaware of any catastrophic event involving permanent loss of a facility or vessel having ever occurred in relation to PFC's coal transportation operations in the history of the company. PFC was formed in 1976.

In addition, PFC no longer owns all of the water transportation components that it did own in 1993 when the market price proxy was established, so the risk to PFC for losses associated with those components has been diminished. In 1993, EFC owned virtually every component, either in whole or in part, involved with transporting coal by water on behalf of FPC except for short haul transportation from the mine to the upriver terminal. At this time, PFC maintains a two-thirds ownership in the Gulf transport component, DFL, and PFC owns one of the upriver terminals, Kanawha River Terminal. PFC no longer owns a river transport company or a portion of the Gulf terminal.

Additionally, if PFC incurred costs that exceeded their revenue stream from the market price proxy, it would be within the discretion of PEFI to petition the Commission for relief on behalf of its subsidiary on a going-forward basis by seeking to modify or eliminate the market price proxy.

Thus, EFC's risk premium associated with the imposition of the market price proxy, while unknown, would appear to be small, so any allowance for price margins reflecting the additional level of risk assumed should be relatively small. While I am uncertain the exact definition of what may constitute a "small" price margin, it is clear from a current and historical context that the margins achieved by PFC for Domestic WCTS and Foreign WCTS in 2002 are [redacted]

Q. Do you have any concerns regarding the market price proxies' escalators and the escalator weightings?

A. Yes. PEFI's market price proxies are based on escalators that, in at least one instance, have no bearing on the transportation service provided by PFC. RCAF-U is an market price proxy escalator that provides a measure of changing rail costs, but rail is no longer used by PFC for upriver transport. Also, the escalators' weightings underestimate the level of fixed costs in the industry. As shown in EXH WBM-3, only 10 percent of the total costs are considered fixed costs in the proxy. However, in the inland waterway bulk freight industry, approximately 58 percent of costs are fixed, including the cost of capital equipment such as tugs and barges. Thus, the market price proxy contains a bias towards more costs being classified as variable and subject to escalation, thus allowing for a higher escalation of costs than is reflected in the market.

Q. What do you conclude regarding the reasonableness of the 2002 market price proxies (domestic and foreign) based on your review of costs of service and profit levels?

A. I conclude that both market price proxies exceeded the costs of providing service and allowed the affiliate, PFC, to achieve significantly more profit than is reasonable for this service given the level of risk assumed. Also, I conclude that the market proxies' escalators and their respective weightings do not reflect the cost structure of the industry.

Q. What regulatory action, if any, should be taken for 2002, 2003, and 2004 on the basis of your analysis of PEFI's market price proxies?

A. No action should be taken regarding the current market price proxy mechanism as it applies to 2002, 2003, and 2004. It would be inappropriate for the Commission to apply a new WCTS cost recovery method on a retroactive basis to 2002. Neither would it be appropriate to use a new WCTS cost recovery method for 2003 and 2004 because PFC and PEFI have relied upon such regulatory treatment in contracting for services in the near term.

Q. What regulatory action, if any, should be taken on the basis of the cost comparisons presented above and apparent lack of market price information for the years following 2004?

A. The Commission should move expeditiously to eliminate PEFI's market price proxies and replace them with a requirement that PEFI justify its projected

WCTS cost recovery upon the basis of a fair and complete competitive bid procedure for each component of WCTS. The Commission should establish a market price proxy for particular components of WCTS only in the event that PEFI and PFC are unable to procure a competitive bid from one or more qualified vendors after administering a fair and complete competitive bid process.

Q. Why should the current market price proxies be eliminated?

A. I recommend the elimination of the current market price proxy methodology for these reasons:

(1) Competitive markets already exist for most of the components of WCTS included in the market price proxies, so there is no reason why the Commission cannot avail itself of the most direct market information from PEFI or PFC based on their efforts to competitively bid the various components of WCTS,

(2) The market price proxies have worked to the detriment of PEFI's ratepayers by exceeding both the cost of service and the market price of WCTS,

(3) PEFI's market price proxies are based on escalators that in some instances have no bearing on the transportation service provided by PFC, and the weightings on the escalators underestimate the level of fixed costs in the industry, and

(4) The Foreign WCTS market proxy is completely obsolete at this time because it is based on a ratio of Gulf transport costs to total costs that existed 10 years ago but that has [redacted] since that time. It is particularly important that the Commission eliminate or replace the Foreign WCTS market price proxy because PEFI's foreign coal purchases are expected to increase significantly in 2004 and 2005. The increase in coal delivered via

Foreign WCTS is expected to replace much of the coal delivered via Domestic WCTS.

Q. Wouldn't a competitive bid procedure subject both the Commission and parties to the fuel docket to excessive administrative costs and regulatory tension?

A. No. As a point of clarification, the regulatory method that I am recommending is not a return to cost-plus pricing. The Commission can avoid the administrative cost and the potential for regulatory tension associated with a cost-plus pricing methodology by instead determining the recoverable market price based upon review of competitive market response documentation. Such a standard avoids the need for detailed cost analysis and the need for the Commission to maintain expertise regarding the costs for each of the various components that comprise WCTS.

While the Commission should not mandate PEFI to provide specific documentation, the Commission should direct PEFI to maintain as much detail as necessary to allow the Commission to fairly evaluate the bid process, including the RFP instrument, the criteria for selection, the solicitation schedule, the evaluation and screening process, and the selection decision. The Commission should require PEFI to provide staff written notification of the availability of such documentation 90 days prior to the November fuel hearing in the year prior to the expiration of the current contract in question. Such regulatory intervention can hardly be considered excessive or burdensome considering PEFI's aggregate cost of WCTS ([redacted] in 2002).

Q. What specific guidance should the Commission give PEFI and PFC regarding the competitive bid procedure for the Gulf transport component of WCTS?

A. The two-thirds ownership that PFC has in DFL would indicate the need for closer involvement by the Commission in the review of the competitive bid procedure for Gulf transport service. The Commission should strongly encourage PEFI and PFC to meet once or more with staff and the affected parties to discuss the formation of the bid proposal and the process by which the utility will conduct the bid procedure at least a month in advance of issuing the proposal. The Commission should encourage PEFI and PFC to consider carefully the input of the participants of such meeting or meetings.

Q. How should the Commission judge the prudence of PEFI's WCTS costs if a fair and complete competitive bid process fails to produce one or more competitive bids from qualified bidder(s), despite the best efforts of PEFI and PFC?

A. Gulf transport is the most probable transportation component for which no qualified bid may be received in response to a fairly constructed and administered request for proposal. In that circumstance, the Commission should require the utility to bring forth a petition that would essentially propose a new market price proxy specific to the component of WCTS for which one or more competitive bids from qualified vendors were not received. Any petition for a market price proxy should include a base price for the projected period that is built upon the most recent actual costs with pro-forma adjustments as appropriate. Annual cost escalators should reflect the costs of the waterborne coal industry. Weightings for each variable cost escalator should be applied based upon the percentage of related costs to total costs of the service for that component. The proposal should include both direct contractual costs as well as PFC's G&A expense specific to the component in question so that the full cost of the service for that component is represented. The Commission should require a petition to be filed no later than three months prior to the November fuel hearing in the year prior to the contract taking effect so that it can be fairly reviewed and properly deliberated before implementation. For instance, if PEFI and PFC were unsuccessful during the first half of 2004 in generating competitive bids for 2005 Gulf transport service, a market price proxy petition they submitted in August 2004 would reflect pro-forma 2005 costs for PFC's Gulf transport service. Such costs would be based on 2003 actual costs and 2005 pro-forma adjustments.

Q. ~~Under your regulatory proposal, how should the Commission determine the prudence of costs for existing contracts that are~~ not expiring during the next year ~~and a half, such as upriver terminalling~~?

A. The ~~Commission should determine~~ that ~~existing~~ contractual costs for ~~contracts that are not expiring are reasonable~~ upon proper execution of the ~~contract until such time that the contract in~~ question terminates or reaches ~~a renewal period. When that time approaches, the~~ regulatory mechanism would ~~change to either competitive bidding, if such bidding is successful, or a new market price proxy based on a petition filed by PEFI~~.

Q. If a new market price proxy is established for one or more components of WCTS, how often should the Commission revise such market price proxy(ies), and how should it do so?

A. The Commission should limit the effective term of every new market price proxy it develops to four to five years. The Commission should require PEFI to file a petition for a cost and market review of the market price proxy based on the same filing schedule as when the original market price proxy was initiated. Four years is within a reasonable range of the length of many WCTS contracts. If the contract underlying the market price proxy would expire in the fifth year, then PEFI would be relieved of filing for a new price proxy that year and its market price proxy would be extended an additional year in order to allow PEFI the opportunity to competitively bid that component of WCTS.

Q. Can you summarize your testimony?

A. Yes. In my testimony I have addressed two preliminary staff issues distributed to parties in the fuel docket. The first issue asks whether the PEFI's WCTS market price proxy is still a relevant and sufficient means for assessing the prudence of costs paid by PEFI to PFC, its subsidiary, and the second issue asks whether the market price proxy should be modified or eliminated. Based upon my review of both market information and recent cost information, I have concluded that the current market price proxies for both domestic and foreign coal transportation are no longer relevant and sufficient for the purpose of assessing cost prudence, given the margins PFC has achieved for foreign and domestic waterborne transport. ~~The margins PFC has achieved for providing domestic and foreign~~ waterborne coal transport are excessive given the ~~relatively~~ small additional risk PFC has incurred. Additionally, the growth rate of the Domestic WCTS market price proxy has not reflected the growth rate of the waterborne coal transportation market. In addition, the application of the proxy escalators and their respective weightings yield inaccurate estimates of the market price because they do not reflect the prevailing cost changes in the industry. The Commission should eliminate the use of the current market price proxy mechanism wherever possible and replace it with a more market-oriented approach. Competitive bid solicitations should provide the foundation for prudence review for each component which can be successfully bid. In those instances where competitive bids cannot be obtained, the market price proxy for that component of WCTS should be developed based upon updated actual costs and relevant escalators weighted to reflect the level of variable costs of providing the service. If a market price proxy is necessary for any component of WCTS, that component should be reset in either four years or five years depending upon the expiration of PFC's related contracts with transportation vendors.

Q. Does this conclude your testimony?

A. Yes, it does.

CHAIRMAN JABER: Mr. McNulty, now you can give your summary.

THE WITNESS: Thank you. Good afternoon, Commissioners. My testimony addresses Issue 13E regarding the market price proxy methodologies the Commission approved in 1992 and in 1994 for waterborne coal transportation service purchased by Progress Energy Florida. The market price proxies are the rates per ton that Progress Energy pays its subsidiary, Progress Fuels Corporation, for providing the utility with domestic and foreign waterborne coal transportation service.

In 1993 the Commission approved the use of the market price proxy mechanism for domestic coal transportation based on a stipulation reached among parties and staff. The proxy included a base price of $23 per ton and a composite index of five separate escalators to be applied to 90 percent of the base price each January 1st for coal delivered by barge from the central Appalachian coal mining region. Ten percent of the base price is fixed.

In 1994 the Commission approved Progress Energy's market price proxy mechanism for waterborne coal transportation of coal from foreign sources. The foreign market price proxy is Progress Fuels price for transloading of foreign coal received at the Gulf terminal in Davant, Louisiana, plus the transportation of foreign coal across the Gulf to Crystal River station. The foreign market price proxy was set at

50.2 percent of the domestic market price proxy, and that ratio had been applied to all coal shipments received from foreign sources each year since 1994.

My testimony is offered to show that these market price proxies are no longer appropriate for assessing the prudence of waterborne coal transportation costs and to recommend that these proxies be eliminated effective January 1, 2005 for the following reasons: First, my testimony shows that based on national market data during the 1992 through 1997 time period, the growth rate in the market price proxy was not reflective of the growth rate of market prices.

Second, my testimony shows that the costs Progress Fuels incurred in 2002 to transport coal by water on behalf of Progress Energy was significantly less than Progress Energy's market price proxies.

Third, my testimony indicates that some of the indices used to escalate the market price proxies from year to year are no longer relevant.

Fourth, my testimony shows that the weightings applied to the market price proxy escalators underestimate the level of fixed costs incurred in the river barge industry. This has been a contributing factor to the market price proxies escalating at a faster rate than the market for these services.

Fifth, and finally, my testimony shows that the market price proxy for foreign coal transportation is completely obsolete at this time because it's based on a ratio of the 1992 transportation costs from mine to plant in that year which was 50.2 percent. That ratio has decreased significantly since that time, yet 50.2 percent is still the ratio used to set the market price proxy for foreign waterborne coal transportation service.

For these five reasons I conclude that the market price proxies are no longer appropriate and should be eliminated.

Commissioners, while I believe it is appropriate to eliminate the current market price proxies as expeditiously as possible, I recommend that you allow Progress Energy to use the market price proxy methodologies as currently formulated for all years through and including 2004 for cost recovery purposes. These proxies have been relied upon by Progress Energy and Progress Fuels in their contract with each other and by Progress Fuels in its contracts with third-party providers of waterborne coal transportation service.

In my testimony, I recommend that you replace the market price proxies as of January 2005 with the pricing results of a request for proposal, or RFP, conducted by Progress Energy for each waterborne coal transportation component. The components that should be competitively bid in this way include upriver terminaling, river transportation, Gulf terminaling, and Gulf transportation.

In the event that any waterborne coal transportation RFP issued by Progress Energy for any transportation component fails to produce competitive bids, the Commission should establish a market price proxy for only that component in the year prior to the year the market price proxy would become effective. In order to meet this timetable, the Commission should require Progress Energy to submit its petition for a market price proxy in August of the year prior to the year the proxy would become available -- it would become effective. This concludes my summary, and I'm available for any questions you may have. Thank you.

MR. KEATING: Staff offers Mr. McNulty.

CHAIRMAN JABER: Thank you. Ms. Kaufman. Ms. Kaufman, I'm just starting this way and then we'll -- Mr. Vandiver, did you and Ms. Kaufman reach an agreement that you go first?

MR. VANDIVER: No.

CHAIRMAN JABER: Okay.

MS. KAUFMAN: Thank you, Chairman.

CROSS EXAMINATION

BY MS. KAUFMAN:

Q Good afternoon, Mr. McNulty.

A Good afternoon.

Q Mr. McNulty, you've been involved in quite a few fuel adjustment proceedings, have you not?

A Yes, I have.

Q About how many? Can you tell us approximately?

A I started my position in 2000, so I guess that would -- inclusive of this year would include four.

Q Is it your understanding that in fuel adjustment proceedings the Commission examines the costs that the companies have requested for recovery to determine if they are prudent or reasonable?

A Yes.

Q The issue that you're addressing, 13E, that was deferred from last year's fuel adjustment; correct?

A Yes.

Q And the proxy that we're talking about, whether we will or won't apply in this case, we're looking at costs from 2003 as well as costs projected for 2004; correct?

A Yes. And there could even be some 2002 costs that would also be trued-up in addition to the 2003 and 2004 costs.

Q So we're looking at perhaps some final true-up numbers from 2002, the true-up from 2003, and the projected numbers for 2004?

A Yes.

Q And the issue that you've addressed is whether or not this proxy ought to be what the Commission uses to permit recovery of these transportation costs?

A Yes.

Q Were you here yesterday during Mr. Portuondo's examination?

A I was listening by phone to some portions of it.

Q Well, Mr. Portuondo testified, I believe, that the contracts and the parties involved are the same as they were during the period of the 2002 audit. Do you have any reason to disagree with that?

A Can you repeat the question?

Q Sure. I believe that Mr. Portuondo testified that the parties to these contracts that we're talking about were the same during the time period of the 2002 audit that Mr. Rohrbacher just testified about. Do you have any reason to doubt that?

A No.

Q Okay. I think you said in your summary and you've said in your testimony that it's your opinion that the market proxies here allow the company to recover more profit than is reasonable today. Is that your opinion?

A My opinion is that it does allow for a higher level of profit than may be reasonable.

Q And I think, if I understand your testimony, it's also your opinion that these proxies have worked to the detriment of the ratepayers; is that correct?

A Yes.

Q And I know you made some changes to your testimony at

Page 20 that you discussed, but I think you said that really doesn't affect the substance of your opinion; is that correct?

A That's correct.

Q And you made reference to a stipulation that necessitated this change. There has been no stipulation among all the parties to this case; is that right?

A As far as I know there has been no stipulation.

Q The part you struck and substituted has a comment in there that the margins that have been achieved are excessive. That's still your opinion today, is it not?

A Yes, it is.

Q And you provided the Commissioners and the parties with an errata sheet that corrects some of the numbers on WBM-2; correct? And you made some changes in the text as well?

A Yes, yes.

Q And if you would look at WBM-2, Page 1 of 1, the -- I'll try not -- I'm going to do this without saying any of these numbers. If you look at the top quarter of the page, you've made some changes to those margins, and the margins that you now show have actually increased; correct?

A That's correct.

Q And similarly, if you look down to the foreign coal transportation, the numbers that you've now provided have increased substantially; correct?

A Yes.

Q Now, the number that is shown for the foreign coal transportation, without revealing what that number is, would you not characterize that number as extraordinary in terms of margin, or what word would you use to describe that number? I don't want to put words in your mouth.

A I would go back to what my testimony said, excessive.

Q Excessive.

A I'm not going to characterize beyond that just to say that it's more than it should be.

Q More than it should be?

A Right.

Q But nonetheless, you think that these are the margins that ratepayers ought to bear for at least part of 2002, 2003, and for the projection for 2004?

A Yes, I do.

MS. KAUFMAN: Thank you, Commissioners. That's all I have.

CHAIRMAN JABER: Mr. Vandiver.

CROSS EXAMINATION

BY MR. VANDIVER:

Q Mr. McNulty, at Page 15 of your testimony, Lines 8 through 12, you conclude that this allows PFC -- and that's Progress Fuels Corporation; correct?

A Yes.

Q -- to achieve significantly more profit that is reasonable for this service given the risks assumed; correct?

A Yes.

Q And that relates to the margins that Ms. Kaufman just went over with you; is that correct?

A That's correct.

Q And is it my understanding that prior to the proxy being established in the early '90s, this Commission used to set the return for PFC or its successor corporation; is that correct?

A Yes.

Q Now, were this Commission to ask you for a recommendation as to a reasonable return for PFC, what would that return be?

A That return would not necessarily reflect the same return prior to the Commission's decision in 1993 -- for the period prior to 1993 when the Commission was regulating based upon a cost plus or cost allocation methodology.

As I describe in my testimony, there may be some small additional risks that is borne by Progress for the fact that they are taking, Progress Fuels, for the fact that they are taking a market price proxy as the official rate for recovery. In other words, if there is the potential for certain things happening to Progress Fuels, that they would not necessarily have recourse to amend or correct, and so there would be a potential for loss for Progress Fuels. And understanding that that risk is changed, I wouldn't go back to the cost plus allocation methodology in which we basically assume that the return of the utility would be appropriate for Progress Fuels. I would suggest that there be some increment above that. However, as I also state in my testimony, I think that that risk level is small. And so when you get to the point of what is reasonable, I don't specify that. I don't have a calculation for that. I just looked at what I saw as coming out of the audit and staff discovery telling me that these numbers were clearly too high.

Q But it's considerably less than the numbers that are reflected on Page 23, isn't it?

A Yes, it is.

Q Okay. Do you have any reason to believe -- have you looked at the numbers at all for 2003 and 2004?

A What numbers are you referring to?

Q Because this audit, as I understand it, is for 2002; is that correct?

A That's right.

Q Do you have any reason to believe that the numbers for 2003 or 2004 would be substantially different than the numbers from the 2002 audit?

A I don't have any reason to believe that they would be dramatically different from the standpoint that we have contracts in place that dictate what the contractual costs are and we have a market price proxy that's in place which is formulated with some escalators that escalate and de-escalate with the various cost indices. But in general, I wouldn't expect there to be that much movement either in the revenue involved here or in the cost. So I would expect that there would be -- to some extent, there would be a similar pattern. If I didn't think that was true, then I wouldn't really have a very good basis for making my recommendation.

Q That's correct. So again, back to your testimony then on Page 15 at Lines 8 through 12, those costs would not be reasonable either, would they? There would be significantly more profit than is reasonable for those services as well?

A What is reasonable in the short term with the fact that the company is engaged in contracts in terms of are they unfairly assessed by the company is a difficult question because these contracts were engaged in by the utility and by its subsidiary, Progress Fuels.

In my mind, the contracts have some weight to them and should be considered in this process. My objective in filing this testimony was to point out that there was something broken here and needed to be fixed, but I also recognize the fact that what we have before us is a stipulation among parties. And when it comes to determining what is reasonable for the ratepayer to pay here, we also have to look at what is reasonable on the other side for the entities involved, Progress Fuels and Progress Energy Florida. And I guess my primary concern there was that if in assessing what that responsibility would be, that there certainly, I think, is some responsibility on the part of Progress Energy to monitor and know what's going on and making sure there's an arm's-length arrangement made with its subsidiaries and affiliates.

There's also some responsibility upon Commission staff to advise the Commission from time to time as to what is going on with and what is happening with these contractual relationships and with what the profit margins might be that are being incurred for these types of services. So -- and then the parties as well would bear some responsibility for looking into this. So when it comes to making -- when it came to making the recommendation as to what's reasonable in 2003 and 2004, I looked at 2003 and I said, 2003 is mostly done. All of these people were here in 2003 back in last November when we went to fuel hearing. We understood that we were deferring this issue, that we were going to look at it, but, you know, we really hadn't had an opportunity to -- for anyone to bring forth a reasoned analysis to say what is the appropriate thing to do in this instance.

When you look at 2004, as I mentioned in my testimony, we have contracts that are in place. Most of them through the end of 2004 are very close to the end of 2004, within a few months. And I looked at that as -- at these contracts as having some weight and some value here. I would say also that, you know, what I presented, as I said before, is that I was trying to put forth a -- my primary message is something here is broken and needs to be fixed. I also put forth an implementation plan that I tried to establish as what is a fair way to transition out of the market price proxies into something different. And in so doing, I presented 2004 as a reasonable period because of the contracts that are in place and because of the somewhat shared responsibility that we have to monitor what's going on with these market price proxies. I hope that answered your question.

MR. VANDIVER: It did. Thank you. That's all the questions I have.

CHAIRMAN JABER: Mr. Twomey.

CROSS EXAMINATION

BY MR. TWOMEY:

Q Good afternoon, Mr. McNulty.

A Good afternoon.

Q I think you acknowledged, did you not, in response to questions by Ms. Kaufman that this Commission has a responsibility to only include in the rates that it approves for customers of any of these utilities, this one included, reasonable and prudent costs? Is that a fair summary of what you acknowledged?

A Yes.

Q And shared -- I mean, contracts, in your opinion, existing contracts by an affiliate with affiliates wouldn't -- of this utility wouldn't change that requirement, would it?

A Not necessarily, in the sense that these -- a contract from affiliate to affiliate has to be somewhat fairly constructed. However, I would mention that my understanding of this is that these contracts have been in place over a number of years. The Progress Energy/Progress Fuels contract, I believe, contains discussion about the market price proxies, and it's been part of that for many years.

Q Yes, sir. But isn't it true that you recognize in your testimony that last year on December 13th, this is at Page 6 of your testimony, Line 9, last year on December 13th, the Commission issued an order approving a stipulation among the parties that a review -- or the price proxies would take place this year; correct?

A That's correct.

Q So you would agree with me, would you not, that all parties, including the utility and its affiliates, were put on notice at least a year ago that an examination of this proxy was going to take place this year?

A Yes.

Q And wouldn't it be reasonable as well to conclude that if an examination was undertaken, that the Commission might reach some resolution and some modification of the price proxy?

A Yes.

Q Okay. And don't you also state in your testimony that the initial Commission order in 1993, in your view, comprehended that the price proxy could be examined?

A That's right.

Q And isn't it true in your testimonies, and I apologize, someplace in here it says that you say that it needs to be examined with some -- periodically; right?

A Yes.

Q Okay. It is now November 2003, a decade, I guess, from the time that this was first approved, this price proxy was approved. Isn't this essentially the first examination by the Commission and staff of this price proxy mechanism?

A I'm not certain that this is the first time that any party has looked at or questioned this. I haven't -- you know, we have a list of issues that happen each year in the fuel hearing. I haven't reviewed an exhaustive list of all issues in all years to be able to tell you that that's the case.

Q Yes, sir. But would you agree with me that this examination now, whether it's the first or not, ten years after its initial approval would not be reasonably considered premature?

A No, it's not premature.

Q Okay. I want to ask you some questions just right from your testimony, if I may. And in fact, at Page 6 of your prefiled testimony, starting at Line 18, you say, don't you, "I believe it is preferable to establish any new requirements and/or changes to the market price proxies the Commission deems necessary as soon as possible;" correct?

A Yes.

Q You say in your criticism of the price proxy at Page 7, starting at Line 19, "It," speaking of the price proxy methodology, "was based on the application of cost escalators that imperfectly gauge market prices, especially over long periods of time." Isn't it true that elsewhere in your testimony that you point out that data obtained by the staff and reviewed by the staff showed that the price escalators were out of whack, if I can use that term, the first five years of its existence?

A Yes, compared to national data that was -- yes, that's --

Q And basically isn't it your conclusion that the escalators utilized these last nine or ten years in short don't bear sufficient reality to the actual waterborne or multimodal transportation of coal to fairly present what customers would be charged for?

A When you say the escalators, you're talking about the indices, the five indices?

Q Yes, sir, the five indices.

A Specifically what I referenced was the rail cost adjustment factor unadjusted is one of the factors that I determined was no longer relevant. I said it was no longer relevant because the company now gets its upriver transportation by truck rather than by rail. And so that particular element or component or index, if you will, is no longer relevant. I did not dismiss all of the escalators that the company now uses. I had issues with perhaps what some of their weightings might be, but I didn't go beyond that in terms of specifying other indices that would be inappropriate.

Q Yes, sir. But isn't it your testimony bottom line that overall the indices used and the manner in which they're used, including their weightings, result in prices to be paid by the customers through their electric rates that are not sufficiently related to the actual cost of the transportation?

A The indices and the weightings combined together to create what I believe to be a higher growth rate for market price proxies than the market rate.

Q Yes, sir. I mean, and you've testified in your summary, I think, that the price proxy methodology is broken --

A Yes, sir.

Q -- correct?

A Yes.

Q That it needs to be fixed?

A That's correct.

Q That it needs to be fixed as soon as possible?

A Yes.

Q Page 10 of your testimony, starting at Line 3, that sentence, that addresses your examination of the five years of data that you were able to obtain after 1993; is that correct?

A Yes.

Q And you say that data shows that the market rate for multimode coal transportation rates decreased in real terms from 1993 through 1997 by an average of 3.5 percent per year. You would agree that's fairly significant, isn't it?

A Yes.

Q While PEFI's market price proxy went "blank" by something percent. Why is that -- why did the staff make that confidential?

A Those entities or those items that had been redacted or held as confidential were done so because the -- I think we had already looked at and reviewed these similar sorts of numbers in discovery that the company had provided and determined that type of information to be confidential, and my decision to show these as confidentials was based upon a consistency concern.

Q Okay. But just quickly, would you agree with me that if one doesn't know the weightings of the indices in the price proxy, that nothing could be disclosed that would be of any proprietary information by discussing those redacted numbers?

A Could you repeat the question?

Q Yes, sir. As I understand it, the weightings, given the indices in the stipulation, the majority of the weightings have been redacted as being confidential. There are five indices utilized; correct?

A Right.

Q And the weightings for four of them have been redacted for some reason?

A Yes.

Q Okay. Whatever that is, if those are, in fact, unknown, would you agree with me that disclosing what the overall proxy direction was in the percentage up or down couldn't lead to anything that could be disclosed?

A I'm not certain.

Q Okay. You've given us the changes also on Page 10 and the percentages which are redacted. Is the dollar amount the same on Line 23, Page 10?

A The same as what, sir? You characterized this as being the same as something, and I want to see what you're comparing it to.

Q I'm sorry. On Page 10, Line 23, in your list of changes, you changed the percentage that's redacted at Line 23.

A Yeah, in my errata, that's correct.

Q Yes, sir. And I'm asking you, is the dollar amount the same as shown in the confidential exhibit?

A That number has remained unchanged.

Q Okay. If the Commission accepted your apparent factual determination that the price proxy results in charges to the customers that are unreasonable or excessive or however you want to end up qualifying it, if they accepted that and decided to make an adjustment in this hearing, could they use that number as a starting point, the number that's at Line 23, Page 10?

A I don't mean to ask a question, but I would have to know what year you were speaking of in terms of making an adjustment. Are you talking a 2002 adjustment? 2003? 2004?

Q 2002, because your audit was of 2002; correct?

A Right. So you're asking, would that be the adjustment amount for that year. Well, that gets back to my testimony, and I would not be recommending an adjustment for that year for the reasons stated in my testimony.

Q Yes, sir, I understand that, and that wasn't my question. My question is, if this Commission found that the costs being proposed to be charged to the customers through the fuel adjustment for waterborne transportation were excessive, which you seem to have testified to, although perhaps on a more qualified basis than initially, if they accepted that there's an adjustment required for the year 2002, could they use that number that appears at the end of Line 23, part (sic) 10, not necessarily as the adjustment but as a starting point for an adjustment?

A Again, that would get back to the question about the return that would be appropriate for the amount of risk that was incurred incrementally when Progress Fuels/Progress Energy embraced the market price proxy methodology and the Commission approved it. So I guess the short answer to that question would have to be, I'm not certain if they would use this as a starting point as you phrased it. I only characterize this as to show that the level of margin or profit is excessive.

Q Okay. And you said excessive; right?

A Yes.

Q Okay. So it strikes me that -- and I want to ask you this in the form of a question, but it strikes me that if one makes a determination and testifies that something is, in fact, excessive or not reasonable, that as a base point for doing that one has to have a notion at least of what is reasonable and what is not excessive. And so my question to you is, is in finding that these numbers, these margins, these gross margins were excessive or not reasonable, what was your baseline -- do you have a baseline for making that determination?

A I don't have a calculated baseline that says anything above this amount is no longer reasonable. I looked at these numbers and these percentages, and I saw that on their face they were unreasonable and led me to conclude that I need not look for a baseline, that the information itself was itself apparent.

CHAIRMAN JABER: Mr. McNulty, I understand your testimony, but let's say we -- for whatever reason the proposed stipulation that resolves these issues is not accepted by the Commission, and we do look toward the substance of your testimony and accept your conclusion that the margin appears on its face to be excessive. What would you recommend we look at to determine what might not be excessive?

THE WITNESS: It would be a number smaller than the number that is shown here. And, you know, exactly what that percentage change would be or what that dollar amount would be, I would suggest that that number would be relatively small. Again, I don't have a specific number that I can provide you.

CHAIRMAN JABER: What is the -- remind me what Progress's return is at post the stipulation. Do you have that handy?

THE WITNESS: I'm sorry, I don't.

CHAIRMAN JABER: Okay. Go ahead, Mr. Twomey.

MR. TWOMEY: Thank you, Madam Chair.

BY MR. TWOMEY:

Q Let me ask you this as a follow-up to the Chairman's question. Does the staff have enough information in this proceeding through your audit, through your other discovery to make a reasoned recommendation to the Commission if they insist upon one for a downward adjustment of what's being requested for waterborne coal transportation for this company?

A I'm not certain in terms of what the adjustment would be if we're talking about an adjustment for 2002, 2003, 2004. I don't know that in terms of information that has either been provided in the record or would even be a result of discovery that we would have out there any number that would yield that target number that you discuss.

Q Yes, sir. But it strikes me that your testimony, the majority of it is what I would characterize as forceful. And my question is, given the nature of your testimony and stating that the costs were excessive or resulted in excessive margins and that they were not -- I forget the word you use -- not fair or something for the ratepayers, did not occur to staff that if you brought that testimony to the Commission, that they would possibly want to make an adjustment?

A Yes, it did occur to staff. And I think to some extent my testimony suggests a correction to the market price proxy and two concerns. One is the very obvious elimination of the market price proxies at a time certain, at the end of 2004. And the second is, as I discussed earlier, sort of a shared responsibility concern that there should be some responsibility here, I think, for Progress Energy for having some knowledge of what circumstances Progress Fuels has. And I think that that is reflected in my testimony in the sense that I suggest that if a new market price proxy is required for the Gulf transportation component, that a new market price proxy would begin and incorporate the entire year of 2005.

Now, there is a contract that exists for Gulf transportation that extends through March 31, 2005. And to the extent that a new market price proxy may be put into effect, it could have a material consequence on the utility for that three-month period.

Now, understanding that the company ships about 2 million tons of coal per year by barge and understanding some of the additional costs that have been reflected by Progress Energy for -- that have been incurred by Dixie Fuels Limited, its provider, of Gulf transportation and those additional costs, if we were to abide strictly by what I suggest would be a new market price proxy, which would include simply the contract costs plus the G&A costs associated with a specific component, would have a material impact on the company. So there was some consideration that I took in attempting to make sure that there was a consequence to the fact that the company, you know, did not provide a full level of oversight, in my view, over Progress Fuels and its other affiliates in these matters.

So that's kind of a long answer to your question, but that's where I basically would say, yes, the question did occur to me, should there be some sort of an adjustment, and as I say and I think it is clear in my testimony, that an adjustment of a sort was included.

Q Okay. I want to ask you some questions about the material impact on the company in a second, but I want to ask you first to explain to me a little bit more fully, if you would, your concept of shared responsibility. It's a new policy, I think, to me. And I want you to accept as a premise that my clients don't engage in that kind of thing.

But will you explain what you mean by shared responsibility and who's responsible for what in terms of allowing this company to keep charging for the remainder of 2003, for all of 2004, and not seeking costs that you've described as excessive or unreasonable and at the same time not seeking adjustments for the year 2002 which is still before the Commission? Who's participating in the shared responsibility notion?

A I think I may have touched on it earlier. And the shared responsibility that I refer to here involves, first and foremost, Progress Energy. I think that they need to maintain arm's-length transactions with its affiliates. The second entity that would have some responsibility would be the staff to monitor and to look at all the various costs that are flowed through the fuel clause to ascertain whether they -- to review whether or not they are prudent, and then make -- through their review of those costs and make that information known to the Commission. And then there are also some additional responsibility that I would suggest would be -- there would be some additional responsibility upon the other parties to any stipulation on that particular cost recovery.

And in this instance, I'm fairly certain that the other party involved was the Office of Public Counsel. So I would assume that there would be some responsibility there as well. So those are -- that is my understanding of a shared responsibility in this case.

Q Okay. Let me ask you more specifically. Are you suggesting at all that the staff has been in some way remiss in not bringing this issue up before, and that because of that the Commission should be precluded from making adjustments to excessive costs if it finds them?

A As I mentioned before, that there are various contracts that the company has engaged in. That was part of my reason for my recommendation as to how to transition from the point we find ourselves now and where we want to go.

But I would say that there is a burden on the company first, as I said earlier, but then staff also needs to maintain and understand what those costs are and should pursue issues as they find them.

And I would also state that it may not be possible for staff to follow and pursue every single possible penny that's run through the fuel clause. We have to, to some extent, choose our battles and that's exactly what we've done here.

Q Yes, sir. But isn't it a fact -- isn't it the Commission's policy -- isn't it essentially -- I know you're not a lawyer, but isn't it essentially your understanding of the law that the only burden that exists in this hearing here today this year rests upon this utility to prove each and every one of the costs that it seeks recovery for is necessary, reasonable, and prudent, and that whether the staff seeks a review this year or that year, in fact, doesn't modify that burden? Would you agree with that?

CHAIRMAN JABER: Mr. McNulty, it's late in the afternoon, and I need you to do the yes and no first, and then elaborate only if necessary.

A Yes.

Q Thank you. Page 12, your testimony, the new number you gave us at Line 21 --

A Yes.

Q -- would it be okay for me to say which way that went?

CHAIRMAN JABER: Mr. Twomey, wait a second. What page are you on?

MR. TWOMEY: Page 12, Madam Chairman. Line 21.

CHAIRMAN JABER: Oh, 12. Okay. I thought you said 21.

MR. TWOMEY: Line 21.

CHAIRMAN JABER: Page 12.

MR. TWOMEY: Line 21.

CHAIRMAN JABER: Okay. And your question is, is it okay to indicate whether the percentage went up or down? Is that what you said?

MR. TWOMEY: Yes, I think it is.

BY MR. TWOMEY:

Q In fact, it went up substantially, didn't it, Mr. McNulty?

A There would be no problem in saying that it went up because the number wasn't known before. It was a confidential number before, so I see no problem with saying that, yes, that number went up.

Q That number that we see there, that is the margin or gross profit to the fuel subsidiary, and now it's foreign coal; right?

A Excuse me? I didn't hear your question.

Q I'm sorry. You also changed the word "domestic" to "foreign;" correct?

A That's right.

Q So that somewhat large number is your estimate of their profit, gross profit margin on transporting foreign coal for the year 2002; correct?

A Correct.

Q You would agree that that number is not reasonable for recovery from this company's customers, including my client's?

A I would agree that that number is an excessive number.

Q Okay. And do you have any reason to doubt that that number would change markedly in the year -- this year, 2003, or that it would change markedly in 2004?

A No, I don't have any reason to question that to any large degree. Again, I don't have the exact numbers, and you can expect these numbers to change each year.

Q And if it didn't change markedly, wouldn't it be true that that number which you've described as excessive in 2002 would remain excessive in 2003 and in 2004?

A Yes.

Q Okay. At Page 15 of your testimony, Mr. McNulty, you say at Line 8, "I conclude that both market price proxies exceeded the costs of providing service and allowed the affiliate, PFC, to achieve significantly more profit than is reasonable for this service given the level of risk assumed. Also, I conclude the market proxies' escalators and their respective weightings do not reflect the cost structure of the industry." You have not changed your view there; correct?

A No.

Q And isn't it -- is it true that those proxies -- you have no reason, do you, to believe those proxies will change their relationship to the actual cost of providing service for the year 2003 or 2004; would that be correct?

A That's correct.

Q On Page 16, you have listed -- starting there, you've listed four reasons why the current market price proxy would be eliminated; correct?

A Yes.

Q Okay. Has reason Number 1, starting at Line 9, changed? Have you changed your view on that?

A I haven't changed my views for Item Number 1, no.

Q Okay. Number 2 says at Line 14, "The market price proxies have worked to the detriment of PEFI's ratepayers by exceeding both the cost of service and the market price of WCTS." That's still true; correct?

A Yes.

Q And that would be true in 2003 and 2004, would it not?

A Yes.

Q Okay. You say at Line 20 on that page, "The foreign WCTS market proxy is completely obsolete." Does that remain true?

A Yes.

Q And it will be true for 2003 and 2004?

A Yes.

Q Okay. The next page on Line 17 -- at Page 17, Line 23, there is a redacted number at the end of that line?

A Yes.

Q That number is the total of foreign and domestic coal; is that correct?

A That is a total cost Progress Energy paid in the year 2002 to Progress Fuels -- Progress Energy paid to Progress Fuels for waterborne coal transportation service.

Q Right. I'm sorry. It's not coal. It's just for coal transportation that it paid to its affiliate; correct?

A Yes.

Q Now, I want to go back very quickly and ask you about your apparent concerns for material impact on the company. That amount there is the amount that the utility paid Progress Fuels, what used to be EFC; correct?

A Yes.

Q That is an affiliate of the utility; correct?

A Yes.

Q Okay. As I understand your testimony and that of the auditor, what PFC actually paid its vendors, whether they are affiliates or non-affiliates, is based upon contract; correct?

A Yes.

Q And those are what you've described as the actual costs of providing service; correct?

A Yes.

Q Okay. So wouldn't it be true that if the Commission disallowed $5, $5 million or $20 million in this proceeding as being unreasonable, that wouldn't affect any of the vendors with PFC whether they are affiliate or not; isn't that correct?

A That's correct.

Q Because -- and it's correct because all they see is what they get through the contract price, and they don't know what the utility is actually paying PFC; correct?

A That's correct.

Q So those people can't be harmed; correct? You just said that, I'm sorry.

A I wouldn't go so far as to say that they can't be harmed because there still exists affiliates that are owned by Progress Fuels Corporation, and that would be Dixie Fuels Limited and also Kanawha River Terminals. And to the extent that Progress Fuels owns them, it impacts Progress Fuels, and there is some, I guess, symbiosis there. So I wouldn't say that they are totally not affected by what might happen in terms of being paid by --

Q Yes, sir, but they would still get their contract price; correct?

A To the extent that -- yes, they would.

Q So the people that might be materially affected, the parties here are the regulated utility and its unregulated affiliate fuels purveyor; correct?

A Yes.

Q Both of which are subsidiaries of a parent corporation; correct?

A Right.

Q So if there was a -- isn't it true that if there was a disallowance by this Commission because they found that costs sought to be shifted to the customers were excessive or unreasonable, it'd just be a matter of shifting from one pocket to another of the parent corporation in North Carolina; correct?

A I don't know if it's as simple as the way you've characterized it for the simple reason that a payment that isn't made from Progress Energy to Progress Fuels would affect its bottom line, and to the extent that Progress Fuels' bottom line is affected, it would affect the affiliates that are owned by Progress Fuels.

Q Yes, sir, but, Mr. McNulty, I guess the bottom line question is, is if they can't bear the burden of showing that their costs ought to be recovered here are reasonable and prudent and not excessive, why should we care who's materially affected? Why should you care who's materially affected if this Commission decides that there are excessive costs that they're not going to transfer through to the customers of this company? Why do you care?

A Again, I would simply say that the regulatory procedure in Florida is that affiliates sometimes are in the position of having to do some of the supply work that's required by the utility. There may not be -- as in this instance, Progress Fuels has no other entity for which to supply it waterborne coal transportation service in the ocean segment, at least so far as they know of.

Now, there hasn't been an RFP done, and it's not certain that that is still the case, but to the knowledge that everyone has at this point, they are the sole provider of that type service. So those contracts are important for the company to maintain an important relationship in this particular instance at least with one segment to, you know, maintain with this particular component.

CHAIRMAN JABER: Mr. McNulty, what I'm having difficulty grasping is the message you're trying to deliver -- what I think is a message you're trying to deliver, is there some sort of nexus between any affect on an affiliate with cost recovery that we're going to consider in this case, and frankly, I don't understand what you're trying to say, for whatever that's worth to you.

So the question is, if Progress Energy in this fuel proceeding has not met its burden of proof in terms of showing that certain costs should be recovered, why should we care? What is it you want me to know about this?

THE WITNESS: I guess it's just that there was a -- that I don't agree completely with what the company has stated is a hands-off approach to the stipulation. The stipulation basically said, a market price proxy will be set up with a very formulaic approach to what will be paid to the affiliate. And Progress Energy has basically taken the position that we knew what our costs were going to be; we didn't worry about it any further than that. We simply determined that because that was the new scheme, the regulatory scheme put forward by the Commission in 1993, that that would be the scheme that would be followed. And as I say, I don't agree with that, and I think that, you know, they need to look beyond that. And that was the basis of my testimony in which I -- as I indicated, that I think they bore some responsibility, and I think that my suggested implementation plan would allow for an adjustment there.

Again, what I put forth was testimony that attempted to fix something that I thought was broken. Is this the only reasonable implementation plan that's out there? I offered one. There could be other implementation plans that would also adequately serve the purpose. I don't present this as the only reasonable plan. I just present it as a single option.

CHAIRMAN JABER: So your testimony, what I've heard you say is that the costs -- some of the costs are excessive, the margin on its face looks excessive. You are not suggesting that somehow we consider the affect on the affiliate as some sort of mitigating factor in finding that the costs in the margin are excessive; is that true?

THE WITNESS: Yes.

CHAIRMAN JABER: Okay.

BY MR. TWOMEY:

Q I'm sorry. Did you just tell the Chairman that you're not testifying that they should consider affects on affiliates, or you are telling them they should consider affects on affiliates?

CHAIRMAN JABER: And I want to be clear on that. Let me ask the question because Mr. Twomey has just done a good job confusing the issue.

MR. TWOMEY: Sorry.

CHAIRMAN JABER: My question to you was, am I correct in understanding that your testimony is not that somehow we should consider the affect on the affiliate as a mitigating factor to your conclusion that the costs are excessive and the margin is excessive?

THE WITNESS: That's correct.

CHAIRMAN JABER: Now, can't you leave it alone? Are you moving on now, Mr. Twomey?

MR. TWOMEY: Yes, ma'am, I am.

BY MR. TWOMEY:

Q I want to ask you, though, if the Commission were to make an adjustment in the extreme, this is hypothetically, in the extreme and strip out the entire margin paid by the utility to PFC under the proxy, isn't it true, Mr. McNulty, that that would still leave all the money necessary to pay all of the costs per the contracts that PFC has with its providers whether it be upriver terminaling or cross-Gulf?

A Yes, it would.

Q Thank you. Whose idea was it to have the stipulation, Mr. McNulty?

A I believe the stipulation was put forth by Florida Power Corporation.

Q Okay. And I want to close questioning you by going through this. Do you recognize that if -- let me ask you first.

As I understand it, this Commission still has jurisdiction over the moneys that flow through the clause for the utility's coal transportation costs for the year 2002; is that correct?

A Yes, it does.

Q So normally if the Commission found that there were excessive costs being sought by the utility for the year 2002, it could make adjustments, could it not?

A Yes.

Q Okay. And clearly the Commission can make adjustments for 2003; is that correct?

A Yes.

Q Okay. And is it your testimony that by asking the

Commission to accept the stipulation between just the staff and the utility, that you want them to ignore any adjustments that might be available for not only it 2002 but any that might be available for 2003 and then going forward into 2004? Is that your proposal?

A I think one of the items that you included in your question I may not fully agree with. You suggested that I am in accord with any stipulation that may be pending between or being proposed between staff and Progress Energy, and I'm not certain that I agree with all aspects of that stipulation.

Q Which aspects don't you agree with?

A I believe that the proposed stipulation in the form in which I've seen it most recently would indicate that Progress Energy is seeking full recovery of Gulf transportation for the first three months of 2005 per a prorated application of the market price proxy. And as stated earlier, I don't agree with that. I believe that the recovery should be based on either a competitive bid result or based upon a new market price proxy as was discussed in my testimony. That would -- I think there was additional concern that I had that the proposal -- the stipulation included a five-year term for the market price proxy, and my testimony talked about -- presented a four-year term with an exception of a five-year term if a contract was expiring in the fifth year.

Finally, my petition -- excuse me. My testimony would have the utility provide its petition in August of the year prior to the year that the market price proxy would go into effect, and I think some of the provisions in the stipulation would be filed such that the market price proxy may actually have to be determined at a time later than the fuel proceeding in the year prior to the year that the market price proxy would go into effect. That was the primary areas, I think, that I saw as being different from what my testimony said.

Q Okay. Lastly, tell me if I'm right in these. You've acknowledged costs sought by the utility for the year 2000 (sic) related to waterborne transportation are either excessive or unreasonable or both in that year; correct?

A In the year 2002.

Q Yes. You've told me, I believe, and correct me if I'm wrong, that you have no reason to believe that those costs will change from being excessive or unreasonable in the years 2003 and 2004; correct?

A That's correct.

Q Notwithstanding that, would you agree that's pretty much in the nature -- that's a factual issue; correct?

A Yes.

Q Notwithstanding those factual findings or conclusions, it is your apparent ultimate conclusion that you want the Commission not to make any adjustments for the year

2002, 2003, or 2004, and that the transition period you want them to engage in or approve is based at least in part on the concept of shared responsibility?

A At least in part upon shared responsibility, yes.

MR. TWOMEY: Okay. Thank you very much.

THE WITNESS: Thank you.

CHAIRMAN JABER: Mr. LaFace.

MR. LaFACE: No questions.

CHAIRMAN JABER: Mr. McGee.

MR. McGEE: No questions.

CHAIRMAN JABER: Mr. Butler.

MR. BUTLER: No questions.

CHAIRMAN JABER: And Mr. Beasley.

MR. BEASLEY: No questions.

CHAIRMAN JABER: Commissioners, I have a couple of questions. I don't know if you all do or not.

Mr. McNulty, with regard to your testimony that was prefiled, I'm not looking at the confidential testimony because my questions don't go to any of the numbers necessarily, but it did strike me odd that you are not recommending any adjustments for 2002 and 2003. Am I understanding your testimony to indicate that the reason you're not recommending any adjustments is because you're concerned somehow with a retroactive ratemaking argument?

I may be reading into it, but on Page 15, you use the word "retroactive." Later on, you talk about how the company relied on the proxy and there are contracts in place. And my question to you is, if I'm characterizing your concern as one that relates to retroactive ratemaking, what constitutes retroactive ratemaking, in your opinion?

THE WITNESS: Well, for the fuel clause, it is understood that we are setting rates for really the year that is pending and then the year that we're in the year prior to. But what we typically do is look at projected costs and make a determination whether or not those costs as they appear to us appear to be prudent. And so I think there is an element of retroactive ratemaking that is present if we have allowed the company in its budgeting process and in its understanding of what our issues are for the year that is coming up to not have any indication that we would want to have a concern -- or have a concern about a particular issue.

And it is true in this case that we did defer this issue from last year. And so there could be some element of concern about a definition of retroactive ratemaking applying to the year 2003. However, we are most of the way through 2003. We gave them no clear direction as to what we were going to do other than to review it. So I think that retroactive ratemaking does have a certain presence here. It's a little bit different certainly than base rate proceedings where, you know, it's very clear what is retroactive ratemaking in those instances, and here it is maybe a little bit more murky. But it was an element that I considered.

CHAIRMAN JABER: That's very helpful to me because I couldn't reconcile with the concern that it was retroactive ratemaking, but yet the fuel cost recovery proceedings have a true-up mechanism that we consider each year. So you're not taking the firm position that this is -- any adjustments to 2003 and maybe even to a prior year constitutes retroactive ratemaking, it was just something that you considered.

THE WITNESS: It's just something to consider. I wouldn't say it's necessarily retroactive ratemaking.

CHAIRMAN JABER: With respect to again not making any suggested adjustments, you say the companies relied on such regulatory treatment. I heard staff say at a previous agenda not too long ago when we were deciding to defer the TECO items to a later date that the issue of the proxy model is a fair question each year. Would you agree with that assessment?

THE WITNESS: Yes.

CHAIRMAN JABER: Okay. Mr. Keating, let me tell you, I don't have any questions -- any other questions necessarily of Mr. McNulty, but when you prepare the recommendation for this issue, whether it's for the bench decision or some sort of written recommendation we've yet to decide, I need to understand retroactive ratemaking and whether it applies to this situation. So I'm putting you on notice that I may need to hear more about this.

MR. KEATING: Okay. We can do that.

CHAIRMAN JABER: Commissioners, do you have any other questions?

COMMISSIONER DEASON: I have just a few.

CHAIRMAN JABER: Commissioner Deason.

MR. KEATING: And, Chairman, just so you know, when you're finished with the questions, I did have a few redirect questions I think may be helpful as well.

CHAIRMAN JABER: Okay. Good. Commissioner Deason.

COMMISSIONER DEASON: Mr. McNulty, I'm looking at Page 10 of your prefiled testimony, and I don't want to get into the numbers, but I have a question about the calculation that is discussed on Lines 19 through 23 and more specifically the 2002 margin. And obviously to calculate a margin, you have to know a cost number, and you say that you derive that from information based upon discovery in staff's audit. Can you describe to me exactly what are those costs, what do they represent, in your mind?

THE WITNESS: Yes. To understand those costs, I would refer you to Exhibit WBM-2. And those costs are identified on -- for the item that you have in question, which is the domestic waterborne coal transportation service margin, would be the direct costs and indirect costs that are shown in the left-hand column there. And those amounts, the direct costs are essentially what the company pays under contract for the various services that are required for waterborne coal transportation on a per ton -- dollars per ton basis. There may be within that some other items that would relate to government impositions because back in the 1993 order, it was also established that if a vendor, a third-party vendor had certain costs that were incurred based upon a government mandate of one sort, taxes, fees, what have you, that if they were passed on to Progress Fuels, that they would be incorporated as costs. And then that would be the -- what would be the direct costs.

And then indirect costs that are listed there as simply the general and administrative costs that are shown for the utility, the utility gave us an estimate of what that amount was. We took that estimate and made that part of this calculation.

They also gave us -- well, yeah, that was essentially how I calculated that number, was looking at the direct and indirect costs. And the indirect costs, once again, the general and administrative costs were not specified in particular in the 1993 order that was issued, but we included that with an understanding that the company prior to 1993 was recovering this amount through the clause and then after -- and with the market price proxy was thereafter no longer recovering it through the clause except for it being reflected in the market price proxy which as we know is already established. So those were the basic costs that I identified and included in the calculation.

COMMISSIONER DEASON: Does PFC have any amount of investment at risk in obtaining the fuel, administering the contracts, and whatever other activities they're engaged in?

THE WITNESS: PFC has represented that they do have some risks. And I may have -- I mentioned it, I think, a bit earlier which was the fact that Dixie Fuels Limited, which is a partnership, owned 65 percent by Progress Fuels, has apparently been having $3 million to $4 million -- in the year 2002 had $3 million to $4 million of additional costs that were beyond the contract, and that dollar amount was related to maintenance of their tug/barge units. And I did not include that in direct costs as an indirect cost in my analysis on the basis that it was outside of the contract. And I believed that an arm's-length transaction here would require the utility to not reflect that in a comparison of what the market price proxy was offering in terms of a profit margin.

COMMISSIONER DEASON: Do you have any opinion as to if the Commission had not gone to a proxy methodology but had instead retained some type of a cost plus recovery arrangement as to whether the cost that you've just described would be at the level they currently are or more or less?

What I'm getting to is the fact that it seems that a -- one could argue that a market proxy gives an incentive for companies such as PFC to be aggressive and prudent and competitive and maximize their earnings because it's not a cost plus arrangement and maybe that has had the incentive for them to reduce their costs. Do you have any opinion on that?

THE WITNESS: Well, I would agree that that incentive does apply in this case. And that if you were to incorporate those additional costs, that the margins and the margin percentage would be lower than as presented here.

COMMISSIONER DEASON: I'm sorry, I didn't follow your answer, and maybe you didn't understand my question. But repeat your answer, if you could, please.

THE WITNESS: I thought the first part of your question was maybe getting to whether or not there would be a material change in the margin if you were to consider on this hypothetical basis that we didn't have a margin but we were just going on a cost basis like we were prior to the market price proxy mechanism of 1993, that there --

COMMISSIONER DEASON: Let me repeat the question because I think we may have had a little bit of miscommunication. I guess my question is a hypothetical. You've determined an amount of cost that you used to calculate a margin, and those costs have come about through the years to the level that they currently exist for your analysis. My question is, is that do you think those costs would be more or less or the same if we had not used the proxy given the consideration that perhaps using the proxy gives an incentive for companies such as PFC to be more efficient because they get to keep the difference between costs and the proxy?

In other words, if it's cost plus, do they have any incentive to keep costs down?

THE WITNESS: I understand. And I would agree that when there is an incentive like that, that normally the company does have that motivation to go out and get the best deal that it can and that way achieve, you know, greater margins. However, if we were to consider the previous methodology, the cost plus methodology, there was, I'm presuming, significant pressure brought to bear upon, you know, the utility and the affiliate to keep costs reasonable based upon the possibility of a prudence review showing that they didn't get the best cost possible. And an example of that would be if we were to hold them to doing a request for proposal for going out and getting these individual services, that the pressure that is brought to bear by, you know, a prudence review by this Commission would also provide a downward pressure on these costs.

COMMISSIONER DEASON: And that bring me to, I guess, my final question, and that is the fact that you're recommending that the proxy methodology be changed or be eliminated and that we go to essentially an RFP process because you believe the market is competitive. I may be oversimplifying, but that is one of your recommendations; correct?

THE WITNESS: Yes, that is correct for most of the services that are provided. The ocean transport -- excuse me. The Gulf transportation component, I believe, needs to be tested. It's not certain what level of competition exists in that particular market, but --

COMMISSIONER DEASON: Okay. Let me interrupt you there because I think you've answered my question to that extent. Given that it's your recommendation that we go to an RFP process to obtain market information to determine what is reasonable and we have not yet engaged in that, how do you know that the margins that you've calculated would result after an RFP process or they would be more or less?

In other words, you've calculated cost, but do we have -- I guess my question is, in your opinion, is it premature to jump to a conclusion that a particular margin is excessive until we get RFP information to verify what that cost structure should be based upon market forces?

THE WITNESS: Yes, Commissioner, I understand your question and that is relevant to this. And I would only say that my -- and this isn't part of my testimony or hasn't been included as an analysis in my testimony, but I would say that just my general reading on the subject of waterborne coal transportation, for most of the components that are incorporated in what Progress Fuels requires for waterborne coal transportation doesn't bear those types of returns. That has been what I basically have been able to read and understand about this service.

COMMISSIONER DEASON: Thank you.

CHAIRMAN JABER: Redirect.

REDIRECT EXAMINATION

BY MR. KEATING:

Q Mr. McNulty, could you refer to your errata sheet where it references Page 20, Lines 16 to 18? There was some discussion on the basis for that change with Ms. Kaufman.

Was that change made as part of a stipulation on the issue that your testimony addresses, or was it made to achieve an agreement from the company that it would not file rebuttal and would enter into settlement discussions using your proposed methodology as a starting point?

A I think what you've stated there is correct, that this wasn't as part of a stipulation but more of an agreement relating to rebuttal testimony, and if I stated that earlier, then I misspoke.

Q And, Mr. McNulty, there was some discussion you had with Mr. Twomey concerning the burden on companies coming in to the fuel proceeding to prove the reasonableness of the costs they're asking for recovery. Was one of the reasons that the market price proxy was created was to allow the Commission to determine the reasonableness of the costs that Progress Energy incurred in making paying to Progress Fuels?

A That's correct.

Q Until that proxy methodology is modified or eliminated in some manner, would that proxy remain the method by which the Commission determines reasonableness of those costs?

A I would presume that's the case.

Q And that proxy was in effect in 2002; correct?

A Yes.

Q Has it remained in effect throughout 2003?

A Yes.

Q And it is still in effect?

A Yes.

Q To the best of your knowledge, are Progress Fuels' contracts for the remainder of 2003 and 2004 already in effect?

A Yes.

MR. KEATING: That's all the questions I have. Thank you.

CHAIRMAN JABER: Thank you, Mr. Keating. Exhibits. Without objection, Exhibit 35 is admitted into the record.

(Exhibit 35 admitted into the record.)

CHAIRMAN JABER: Mr. McNulty, thank you for your testimony.

THE WITNESS: Thank you.

(Witness excused.)

CHAIRMAN JABER: Parties, I think it's appropriate to take a ten-minute break. By my list, I've got Mr. Brinkley as the next witness, and then we have two rebuttal witnesses; is that correct? We've got Mr. Whale and Ms. Jordan. Okay. Let's take a ten-minute break.

(Brief recess.)

(Transcript continues in sequence with Volume 7.)

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STATE OF FLORIDA)

: CERTIFICATE OF REPORTER

COUNTY OF LEON)

I, TRICIA DeMARTE, RPR, Official Commission 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' attorneys or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 21st DAY OF NOVEMBER, 2003.

Tricia DeMarte

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