

DOCKET NO. 030438-EI: [Petition for rate increase by Florida Public Utilities Company.]

**WITNESS: Direct Testimony of Daniel Lee,
Appearing on Behalf of Staff**

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FPSC-COMMISSION CLERK

1 | **DIRECT TESTIMONY OF DANIEL LEE**

2 | Q. Please state your name and business address.

3 | A. My name is Daniel Lee. My business address is 2540 Shumard Oak Blvd.,
4 | Tallahassee, Florida, 32399.

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

6 | A. I am employed by the Florida Public Service Commission as an Engineer
7 | IV in the Division of Economic Regulation.

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

10 | A. I received a Bachelor of Science degree with a major in Mechanical
11 | Engineering from Feng Chia University in 1980 and then served in the military
12 | for two years in Taiwan. I received a Master of Science degree in Mechanical
13 | Engineering from California University at Long Beach in 1985. Since joining
14 | the Florida Public Service Commission in 1989, I have held responsibilities
15 | relating to engineering aspects of regulatory policy research, cost recovery,
16 | distribution reliability, territorial disputes/agreements, and ratemaking
17 | matters. Since 1999, my responsibilities have been focused on the electric
18 | utility industry.

19 | Q. What is the purpose of your testimony?

20 | A. The purpose of my testimony is to address Florida Public Utilities
21 | Company's (FPUC) request for a cost-performance award of 100 basis points
22 | added to the allowed return on common equity (ROE), as described on pages 46-
23 | 50 of the direct testimony of witnesses Bachman and Camfield.

24 | Q. Is FPUC's request of a performance award of 100 basis points on ROE
25 | based on financial modeling?

1 A. No. Based on my review of the direct testimony by witnesses Bachman and
2 Camfield, determination of performance incentives is a matter of judgment
3 based on principles that do not appear to involve financial modeling.

4 Q. What are the principles of performance-based incentives?

5 A. I believe a properly designed performance-based incentive mechanism
6 motivates a utility to achieve a targeted performance level for the benefit
7 of both the utility and its customers. The key for such an incentive to work
8 is setting targets beforehand. If a company believes an award can be earned
9 regardless of whether a specified performance target is met or not, then the
10 award is not likely to motivate the utility to achieve a targeted performance
11 level and it should not be called a performance incentive. The use of rewards
12 tied to performance targets is not a new idea, as shown in Exhibit DQL-1,
13 which is an overview of key elements of performance-based regulation by
14 distinguished University of Florida professors Sanford Berg and Paul
15 Sotkiewicz. They also noted that the performance must be observed accurately,
16 be verifiable, must reflect the utilities' efforts, and must not be greatly
17 affected by random variation. In addition, FPUC witnesses Bachman and
18 Camfield acknowledge the need of measurable net benefits to customers and the
19 assurance that the net benefits induced by the performance incentive are
20 greater in magnitude than the performance award, on page 49 of their direct
21 testimony.

22 Q. Is FPUC's request for a performance award a form of performance-based
23 regulation?

24 A. Yes. FPUC witnesses Bachman and Camfield state on lines 8-9, page 47
25 of their direct testimony, that "A cost-performance award is a form of

1 | incentive contracting, and our request for a rate of return incentive is a
2 | form of performance-based regulation.” Therefore, I believe FPUC’s proposal
3 | should be reviewed based on the principles outlined above. This is not to say
4 | that the Commission’s discretion in making an adjustment to ROE is limited
5 | only by the application of the principles of performance-based regulation.

6 | Q. Based on your review, do you think the Commission should grant FPUC’s
7 | request for a performance award of 100 basis points on ROE?

8 | A. No, I believe the request should not be granted because FPUC’s proposed
9 | incentive contract in its present form is not consistent with the principles
10 | of performance based regulation. I have a number of concerns about FPUC’s
11 | proposal in its current form. Most importantly, it does not provide clear
12 | performance targets tied to the award. Without that, there is no assurance
13 | that the award may induce any net benefits to customers. On pages 48-50 of
14 | their direct testimony, FPUC witnesses Bachman and Camfield discuss FPUC’s
15 | relative price and distribution cost performance, and suggest potential
16 | further gains in the future; however, there are no clear performance targets
17 | for price, cost, or quality of service tied to the proposed award. Some may
18 | argue that clarification is not needed, because the Commission has the
19 | authority to initiate a rate proceeding if actual performance deviates
20 | significantly from the expected performance; just as in cost-based regulation
21 | when actual costs deviate significantly from the expected costs. However, I
22 | believe for incentive contracting to work effectively, it is best that the
23 | contract clearly contains performance targets for price/cost and quality of
24 | service tied to the award.

25 | Q. What are your other concerns?

1 | A. First, FPUC witnesses Bachman and Camfield only addressed cost
2 | performance; they did not address the need to measure the level of service
3 | quality performance. There is a need to ensure that cost performance will not
4 | be achieved at the expense of service quality. Second, staff witness Ruth
5 | Young's testimony on the audit of 2002 distribution reliability indices raises
6 | several concerns about the accuracy of the data used to assess trends in
7 | FPUC's reliability performance. Third, because of FPUC's small size, some
8 | performance measures may be greatly affected by random variation if assessed
9 | over a short time frame.

10 | Q. If FPUC's request is not granted, will there be any incentive for
11 | productivity improvement in the rate setting mechanism?

12 | A. Yes. Once base rates are set, cost savings can be translated into higher
13 | shareholder earnings, as long as the earnings are within the authorized range
14 | and adequate service is maintained. Therefore the authorized range of ROE
15 | provides utilities with an incentive for productivity improvement. The
16 | productivity performance asserted by FPUC appears to support the effectiveness
17 | of the existing incentive. Although I would like to see the use of additional
18 | incentives by a performance-based mechanism to further motivate FPUC, I
19 | believe it will only work if FPUC provides performance targets tied to the
20 | award. Although recommending the ROE range is outside the scope of my
21 | testimony, I'd like to also point out that if the proposed 100 basis award is
22 | granted, the incentive provided by the ROE range may be lost. By convention,
23 | the ROE range is plus or minus 100 basis points around the authorized ROE.
24 | Setting rates at the top of the ROE range as proposed by FPUC would put a
25 | company at risk of over-earning for any increase in earnings above the level

1 | assumed in the Company's projections.

2 | Q. Briefly, could you summarize your testimony?

3 | A. FPUC's embrace of the concept of performance based regulation is a step
4 | in the right direction. However, FPUC's proposed incentive contract in its
5 | present form is not consistent with the principles of performance-based
6 | regulation. Until FPUC addresses the concerns that I have outlined, I believe
7 | the proposed incentive contract should not be granted.

8 | Q. Does this conclude your testimony?

9 | A. Yes, it does.

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Excerpts of Presentation by Sanford Berg and Paul Sotkiewicz

available at
http://www.aneel.gov.br/aplicacoes/Audiencia_Publica/audiencia_proton/2000/ap007/PaulSotkiewicz-IncRegulation.pdf



*Introduction to the
Fundamentals of Incentive
Regulation*

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**Sanford V. Berg
& Paul Sotkiewicz**

Public Utility Research Center,
University of Florida
October, 2000



Performance-based Regulation

Performance measures are used to establish targets for rewarding the utility

Performance must

- be accurately observed and verifiable
- reflect the utilities' efforts
- not be greatly affected by random variation

It may be conditional on a utility's geographic area

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

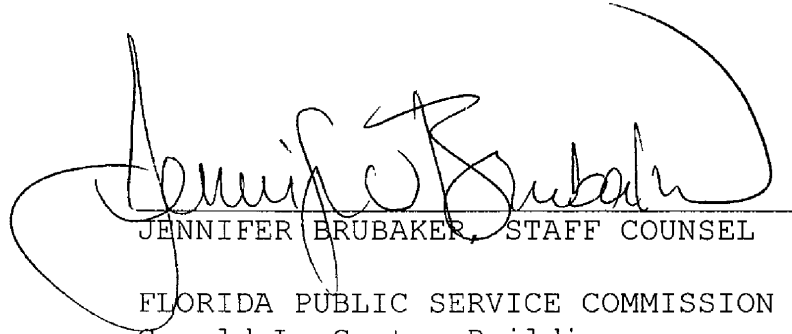
In re: Petition for rate
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the Direct
Testimony of Daniel Lee was furnished to **Norman H. Horton, Jr.**,
Messer, Caparello & Self, P.A., P.O. Box 1876, Tallahassee, Florida
32302-1876, and **Stephen C. Burgess, Esquire**, Office of Public
Counsel, c/o The Florida Legislature, 111 West Madison Street, Room
812, Tallahassee, Florida 32399-1400, by U.S. Mail, on this 9th day
of January, 2004.



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