ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for Determination of Need for Hines Unit 4 Power Plant

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Submitted for filing:

DIRECT TESTIMONY OF CHARLES G. BEURIS

ON BEHALF OF PROGRESS ENERGY FLORIDA

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IN RE: PETITION FOR DETERMINATION OF NEED

BY PROGRESS ENERGY FLORIDA

FPSC DOCKET NO. _____

DIRECT TESTIMONY OF CHARLES G. BEURIS

I. INTRODUCTION AND QUALIFICATIONS

Q. Please state your name, your employer, and business address.

A. My name is Charles G. Beuris and I am employed by Progress Energy Service Company. My business address is 410 S. Wilmington Street, Raleigh, North Carolina, 27601.

Q. What is your position with Progress Energy?

A. I hold the position of Director of Financial Operations for Progress Energy.

Q. Would you please briefly outline your qualifications and professional experience?

A. I came to Progress Energy as Director – Financial Operations in November 2000 immediately following the acquisition of Florida Progress. I report directly to the Treasurer and am responsible for all capital raising activities for Progress Energy and its subsidiaries. My responsibilities include short-term and long-term financing, bank credit facilities and cash management.

Prior to joining Progress Energy, I was employed by Florida Progress for 17 years. My experience with Florida Progress included various financial positions in accounting, budgeting, treasury, and investor relations.

I have a bachelor's degree from the University of Florida and a master's degree in business administration from the Florida Institute of Technology. I have the following professional certifications: Certified Public Accountant, Chartered Financial Analyst and Certified Cash Manager.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to discuss the credit analysis performed by nationally recognized rating agencies related to long-term purchased power agreements (PPAs) and their impact on our financial policy. Their treatment of these contracts affects financial ratios, in particular leverage ratios, used to determine a company's credit rating. As Director of Financial Operations, it is my responsibility to maintain Progress Energy Florida's capital structure in a manner which supports our target credit rating, therefore I must take into consideration the adjustments a rating agency may make when developing its financial ratios to assess its credit rating.

III. TREATMENT OF PPAs IN RATING AGENCY CREDIT ANALYSES

Q. How many rating agencies perform credit analysis on Progress Energy Florida (PEF or the Company)?

A. We currently engage three rating agencies, Standard & Poor's Rating Service, Moody's Investor Service, and Fitch Ratings who provide credit ratings for PEF.

Q. How do these rating agencies treat long-term purchased power agreements when evaluating a company's credit profile?

A. While each one's specific method may vary, they all base their analysis on the premise that long-term fixed payments associated with these contracts are essentially debt-like in nature, much like a long-term lease on property, plant, and equipment. Excerpts from the three rating agencies follow:

MOODY'S

"Moody's will continue to view these off-balance sheet obligations as debt – in particular those purchased power obligations that are above market."

Credit Implications of Power Supply Risk, Moody's Special Comment, June 2000.

STANDARD & POOR'S

Standard and Poor's Ratings Services views electric utility purchased-power agreements (PPA) as debt-like in nature, and has historically capitalized these obligations on a sliding scale known as a "risk-spectrum".

Standard & Poor's Research: "Buy versus Build": Debt Aspects of Purchased-Power Agreements. May 8, 2003.

FITCH

For purchased power agreements, operating leases, tolling arrangement, and synthetic leases, Fitch policy varies from GAAP accounting rules in order to capture operating leverage.

Fitch presentation to Progress Energy, October 2003.

Q. What is the impact on a company's credit profile when rating agencies treat long-term purchased power contracts as debt-like?

A. The main effect is that a company is considered to have more leverage than if you calculated its leverage ratio based only on the debt recorded on its balance sheet.

Q. Does PEF have long-term purchased power contracts?

A. Yes, PEF has a substantial amount of purchase power commitments relative to its total generation mix. As of December 31, 2003, PEF had 474 MWs of purchased power with other utilities and 833 MWs with certain cogenerators (QFs).

Q. Does each of the rating agencies make the same adjustment to PEF's financial ratios for long-term purchased power supply contracts?

A. No. In addition to each rating agency's having its own general methodology, each agency also has its own view of the impact these long-term PPAs have given the nature of the contracts and the recoverability of these payments through tariffs.

Q. What adjustments do the rating agencies make when evaluating PEF's credit profile?

A. It does not appear that Moody's makes an adjustment to PEF's credit ratios due primarily to the recovery of payments associated with these contracts through approved regulatory pass-through clauses. While Moody's certainly recognizes the significance of these contracts, particularly the high-priced QF contracts, they also take into account the high degree of certainty surrounding the recovery of these costs through pass-through clauses, such as those in Florida.

Fitch does not make an adjustment for contracts with "Qualifying Facilities" (QF) due to the regulatory status of these contracts and the recoverability through pass-through recovery clauses. For other purchase power contracts, Fitch will evaluate these individually and make a determination on how much debt should be imputed.

S&P's approach has recently been modified. (See Exhibit ___ CGB-1, *"Buy versus Build": Debt Aspects of Purchased-Power Agreements. May 8, 2003*). S&P takes the net present value of future capacity payments and discounts those payments using a 10% discount rate. That amount is then multiplied by a risk factor, the result of which is the amount of imputed debt. For PEF, S&P uses a risk factor of 30%.

Q. What is the basis for S&P's risk factor adjustment?

A. As stated in their article *"Buy versus Build,"* the overriding factor influencing the risk factor is the likelihood of payment by the buyer. It notes that the probability of non-delivery by independent generators is quite low, thus the probability of a buyer having to pay for purchased power is quite high. Given the high likelihood

of payment by the buyer, these long-term fixed obligations are assigned a higher risk factor for purposes of imputing debt.

S&P's generic guideline for utilities with PPAs having terms over three years is to use a 50% risk factor. S&P further states that:

"This risk factor assumes adequate regulatory treatment, including recognition of the PPA in tariffs; otherwise a higher risk factor could be adopted to indicate greater risk of recovery."

Q. How much debt does S&P impute when assessing the impact of PPAs on PEF's credit ratios?

A. As of December 31, 2003, the present value (using a 10% discount rate) of PEF's future capacity payments for its QF and utility PPAs was approximately $2.4 billion. S&P then computes the amount of imputed debt by applying a 30% risk factor for PEF, which results in approximately $730 million of imputed debt.

Q. Why does S&P use a 30% risk factor for PEF instead of its generic 50% risk factor for utilities with PPA terms over three years?

A. S&P uses a risk factor of 30% for PEF instead of 50% primarily due to the favorable regulatory recovery mechanism which exists to recover these costs.

Q. What is the impact of S&P's approach on PEF's capital structure when imputing debt associated with long-term PPAs?

A. PEF's leverage ratio before making any adjustments for off-balance sheet obligations was 51.5% as of December 31, 2003. After adjusting for purchase power commitments, the leverage ratio increases to 58.3%.

Q. How does S&P's treatment of these contracts affect your financial policy?

A. Our financial policy must take S&P's adjustments into consideration if we are to achieve our target debt rating for PEF. This means that when developing target capital structure ratios, we must consider the impact of off-balance sheet items, in particular long-term power supply agreements due to their materiality and the impact it has on PEF's leverage.

S&P clearly adjusts PEF's credit ratios and Progress Energy's consolidated credit ratios, since PEF is a wholly-owned subsidiary of Florida Progress, which is wholly-owned by Progress Energy. If we were to ignore long-term purchase power contracts, as well as other off-balance sheet obligations, we would be setting target leverage ratios which would be inconsistent with S&P's view of our leverage.

Q. How should your financial policy affect the evaluation of long-term PPAs?

A. We manage Progress Energy's and PEF's capital structure to achieve a certain long-term credit rating. The amounts of leverage associated with a particular credit rating and how it is calculated are established by the rating agencies, and I must recognize their methodology if we are to achieve our goals.

In particular, for PEF, long-term PPAs are material off-balance sheet obligations and have a significant impact on our leverage ratios. Under S&P's methodology, every additional PPA would increase the amount of imputed debt and, all else being equal, require additional equity to offset the effect of the incremental imputed debt.

Q. Can you generally address the appropriateness of the specific adjustments described in the RFP?

A. Yes. Since long-term PPAs can have the same effect as issuing debt and equity to build a power plant, analyzing the all-in costs of a PPA should include the full impact on the capital structure of PEF.

Therefore, including an adjustment to costs for the additional equity that would be required to ensure we meet our target capital structure is appropriate in the evaluation of the proposals in the RFP analysis. The adjustment PEF has made is consistent with S&P's methodology for imputing debt associated with PPAs.

Q. You have stated that two rating agencies, Moody's and Fitch, do not make adjustments, and only S&P makes an adjustment. Why do you follow S&P and not Moody's or Fitch?

A. We adjust for PPAs primarily for two reasons. First, it is recognized by all three rating agencies that long-term fixed payments are debt-like in nature and should be treated as debt. While each agency differs in how they adjust for these types of fixed payments, they all start from the same basic premise that the PPAs are debt-like in nature. Second, the capital markets generally price debt securities based on the lowest rating when there is a difference among rating agencies on the rating assigned. Therefore, in order to achieve the benefits of PEF's long-term target debt rating of single A, the lowest rating must be single A. This market convention forces us to recognize S&P's methodology as it pertains to the treatment of long-term PPAs.

Q. Does this conclude your direct testimony?

A. Yes.

Exhibit CGB-1

"Buy versus Build": Debt Aspects of Purchased-Power Agreements. May 8, 2003, S&P

Return to Regular Format

Research:

"Buy Versus Build": Debt Aspects of Purchased-Power Agreements

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Standard & Poor's Ratings Services views electric utility purchased-power agreements (PPA) as debt-like in nature, and has historically capitalized these obligations on a sliding scale known as a "risk spectrum." Standard & Poor's applies a 0% to 100% "risk factor" to the net present value (NPV) of the PPA capacity payments, and designates this amount as the debt equivalent.

While determination of the appropriate risk factor takes several variables into consideration, including the economics of the power and regulatory treatment, the overwhelming factor in selecting a risk factor has been a distinction in the likelihood of payment by the buyer. Specifically, Standard & Poor's has divided the PPA universe into two broad categories: take-or-pay contracts (TOP; hell or high water) and take-and-pay contracts (TAP; performance based). To date, TAP contracts have been treated far more leniently (e.g., a lower risk factor is applied) than TOP contracts since failure of the seller to deliver energy, or perform, results in an attendant reduction in payment by the buyer. Thus, TAP contracts were deemed substantially less debt-like. In fact, the risk factor used for many TAP obligations has been as low as 5% or 10% as opposed to TOPs, which have been typically at least 50%.

Standard & Poor's originally published its purchased-power criteria in 1990, and updated it in 1993. Over the past decade, the industry underwent significant changes related to deregulation and acquired a history with regard to the performance and reliability of third-party generators. In general, independent generation has performed well; the likelihood of nondelivery--and thus release from the payment obligation--is low. As a result, Standard & Poor's believes that the distinction between TOPs and TAPs is minimal, the result being that the risk factor for TAPs will become more stringent. This article reiterates Standard & Poor's views on purchased power as a fixed obligation, how to quantify this risk, and the credit ramifications of purchasing power in light of updated observations.

Why Capitalize PPAs?

Standard & Poor's evaluates the benefits and risks of purchased power by adjusting a purchasing utility's reported financial statements to allow for more meaningful comparisons with utilities that build generation. Utilities that build typically finance construction with a mix of debt and equity. A utility that leases a power plant has entered into a debt transaction for that facility; a capital lease appears on the utility's balance sheet as debt. A PPA is a similar fixed commitment. When a utility enters into a long-term PPA with a fixed-cost component, it takes on financial risk. Furthermore, utilities are typically not financially compensated for the risks they assume in purchasing power, as purchased power is usually recovered dollar-for-dollar as an operating expense.

As electricity deregulation has progressed in some countries, states, and regions, the line has blurred between traditional utilities, vertically integrated utilities, and merchant energy companies, all of which are in the generation business. A common contract that has emerged is the tolling agreement, which gives an energy merchant company the right to purchase power from a specific power plant. (see "Evaluating Debt Aspects of Power Tolling Agreements," published Aug. 26, 2002). The energy merchant, or toller, is typically responsible for procuring and delivering gas to the plant when it wants the plant to generate power. The power plant operator must maintain plant availability and produce electricity at a contractual heat rate. Thus, tolling contracts exhibit characteristics of both PPAs and leases. However, tollers are typically unregulated entities competing in a competitive marketplace. Standard & Poor's has determined that a 70% risk factor should be applied to the NPV of the fixed tolling payments, reflecting its assessment of the risks borne by the toller, which are:

- Fixed payments that cover debt financing of power plant (typically highly leveraged at about 70%),
- Commodity price of inputs,
- Energy sales (price and volume), and
- Counterparty risk.

Determining the Risk Factor for PPAs

Alternatively, most entities entering into long-term PPAs, as an alternative to building and owning power plants, continue to be regulated utilities. Observations over time indicate the high likelihood of performance on TAP commitments and, thus, the high likelihood that utilities must make fixed payments. However, Standard & Poor's believes that vertically integrated, regulated utilities are afforded greater protection in the recovery of PPAs, compared with the recovery of fixed tolling charges by merchant generators. There are two reasons for this. First, tariffs are typically set by regulators to recover costs. Second, most vertically integrated utilities continue to have captive customers and an obligation to serve. At a minimum, purchased power, similar to capital costs and fuel costs, is included in tariffs as a cost of service.

As a generic guideline for utilities with PPAs included as an operating expense in base tariffs, Standard & Poor's believes that a 50% risk factor is appropriate for long-term commitments (e.g. tenors greater than three years). This risk factor assumes adequate regulatory treatment, including recognition of the PPA in tariffs; otherwise a higher risk factor could be adopted to indicate greater risk of recovery. Standard & Poor's will apply a 50% risk factor to the capacity component of both TAP and TOP PPAs. Where the capacity component is not broken out separately, we will assume that 50% of the payment is the capacity payment. Furthermore, Standard & Poor's will take counterparty risk into account when considering the risk factor. If a utility relies on any individual seller for a material portion of its energy needs, the risk of nondelivery will be assessed. To the extent that energy is not delivered, the utility will be exposed to replacing this power, potentially at market rates that could be higher than contracted rates and potentially not recoverable in tariffs.

Standard & Poor's continues to view the recovery of purchased-power costs via a fuel-adjustment clause, as opposed to base tariffs, as a material risk mitigant. A monthly or quarterly adjustment mechanism would ensure dollar-for-dollar recovery of fixed payments without having to receive approval from regulators for changes in fuel costs. This is superior to base tariff treatment, where variations in volume sales could result in under-recovery if demand is sluggish or contracting. For utilities in supportive regulatory jurisdictions with a precedent for timely and full cost recovery of fuel and purchased-power costs, a risk factor of as low as 30% could be used. In certain cases, Standard & Poor's may consider a lower risk factor of 10% to 20% for distribution utilities where recovery of certain costs, including stranded assets, has been legislated. Qualifying facilities that are blessed by overarching federal legislation may also fall into this category. This situation would be more typical of a utility that is transitioning from a vertically integrated to a disaggregated distribution company. Still, it is unlikely that no portion of a PPA would be capitalized (zero risk factor) under any circumstances.

The previous scenarios address how purchased power is quantified for a vertically integrated utility with a bundled tariff. However, as the industry transitions to disaggregation and deregulation, various hybrid models have emerged. For example, a utility can have a deregulated merchant energy subsidiary, which buys power and off-sells it to the regulated utility. The utility in turn passes this power through to customers via a fuel-adjustment mechanism. For the merchant entity, a 70% risk factor would likely be applied to such a TAP or tolling scheme. But for the utility, a 30% risk factor would be used. What would be the appropriate treatment here? In part, the decision would be driven by the ratings methodology for the family of companies. Starting from a consolidated perspective, Standard & Poor's would use a 30% risk factor to calculate one debt equivalent on the consolidated balance sheet given that for the consolidated entity the risk of recovery would ultimately be through the utility's tariff. However, if the merchant energy company were deemed noncore and its rating was more a reflection of its stand-alone creditworthiness, Standard & Poor's would impute a debt equivalent using a 70% risk factor to its balance sheet, as well as a 30% risk-adjusted debt equivalent to the utility. Indeed, this is how the purchases would be reflected for both companies if there were no ownership relationship. This example is perhaps overly simplistic because there will be many variations on this theme. However, Standard & Poor's will apply this logic as a starting point, and modify the analysis case-by-case, commensurate with the risk to the various participants.

Adjusting Financial Ratios

Standard & Poor's begins by taking the NPV of the annual capacity payments over the life of the contract. The rationale for not capitalizing the energy component, even though it is also a nondiscretionary fixed payment, is to equate the comparison between utilities that buy versus build--i.e. Standard & Poor's does not capitalize utility fuel contracts. In cases where the capacity and energy components of the fixed payment are not specified, half of the fixed payment is used as a proxy for the capacity payment. The discount rate is 10%. To determine the debt equivalent, the NPV is multiplied by the risk factor. The resulting amount is added to a utility's reported debt to calculate adjusted debt. Similarly, Standard & Poor's imputes an associated interest expense equivalent of 10%--10% of the debt equivalent is added to reported interest expense to calculate adjusted interest coverage ratios.

Key ratios affected include debt as a percentage of total capital, funds from operations (FFO) to debt, pretax interest coverage, and FFO interest coverage. Clearly, the higher the risk factor, the greater the effect on adjusted financial ratios. When analyzing forecasts, the NPV of the PPA will typically decrease as the maturity of the contract approaches.

Utility Company Example

To illustrate some of the financial adjustments, consider the simple example of ABC Utility Co. buying power from XYZ Independent Power Co. Under the terms of the contract, annual payments made by ABC Utility start at $90 million in 2003 and rise 5% per year through the contract's expiration in 2023. The NPV of these obligations over the life of the contract discounted at 10% is $1.09 billion. In ABC's case, Standard & Poor's chose a 30% risk factor, which when multiplied by the obligation results in $327 million. Table 1 illustrates the adjustment to ABC's capital structure, where the $327 million debt equivalent is added as debt, causing ABC's total debt to capitalization to rise to 59% from 54% (11 plus 48). Table 2 shows that ABC's pretax interest coverage was 2.6x, without adjusting for off-balance-sheet obligations. To adjust for the XYZ capacity payments, the $327 million debt adjustment is multiplied by a 10% interest rate to arrive at about $33 million. When this amount is added to both the numerator and the denominator, adjusted pretax interest coverage falls to 2.3x.

Table 1 ABC Utility Co. Adjustment to Capital Structure

	Original capital structure		Adjusted capital structure	
	$	%	$	%
Debt	1,400	54	1,400	48
Adjustment to debt	-	-	327	11
Preferred stock	200	8	200	7
Common equity	1,000	38	1,000	34
Total capitalization	2,600	100	2,927	100

Table 2 ABC Utility Co. Adjustment to Pretax Interest Coverage

		Original pretax interest coverage (x)		Adjusted pretax interest coverage (x)	
Net income	120				
Income taxes	65	300		(300+33)	
Interest expense	115	115	= 2.6x	(115+33)	= 2.3x
Pretax available	300				

Credit Implications

The credit implications of the updated criteria are that Standard & Poor's now believes that historical risk factors applied to TAP contracts with favorable recovery mechanisms are insufficient to capture the financial risk of these fixed obligations. Indeed, in many cases where 5% and 10% risk factors were applied, the change in adjusted financial ratios (from unadjusted) was negligible and had no effect on ratings. Standard & Poor's views the high probability of energy delivery and attendant payment warrants recognition of a higher debt equivalent when capitalizing PPAs. Standard & Poor's will attempt to identify utilities that are more vulnerable to modifications in purchased-power adjustments. Utilities can offset these financial adjustments by recognizing purchased power as a debt equivalent, and incorporating more common equity in their capital structures. However, Standard & Poor's is aware that utilities have been reluctant to take this action because many regulators will not recognize the necessity for, and authorize a return on, this additional wedge of common equity. Alternatively, regulators could authorize higher returns on existing common equity or provide an incentive return mechanism for economic purchases. Notwithstanding unsupportive regulators, the burden will still fall on utilities to offset the financial risk associated with purchases by either qualitative or quantitative means.