BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for rate increase by Progress Energy Florida, Inc.	Docket No. 050078-EI Submitted for filing: August 5, 2005

REBUTTAL TESTIMONY
OF
CHARLES J. CICCHETTI, Ph.D.

ON BEHALF OF
PROGRESS ENERGY FLORIDA

R. Alexander Glenn
James A McGee
Progress Energy Service Co., LLC
Post Office Box 14042 (33733)
100 Central Avenue (33701)
St. Petersburg, FL 33733-4042
Telephone: (727) 820-5184
Facsimile: (727) 289-5519

Gary L Sasso
James Michael Walls
John T. Burnett
CARLTON FIELDS
Post Office Box 3239
4221 W. Boy Scout Blvd.
Tampa, FL 33607-5736
Telephone: (813) 223-7000
Facsimile: (813) 229-4133

Attorneys for Progress Energy Florida

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I. INTRODUCTION

Q. Please state your name.

A. Charles J. Cicchetti.

Q. Are you the same Charles J. Cicchetti who filed Direct Testimony in this matter?

A. Yes.

Q. What is the purpose of your Rebuttal Testimony?

A. I respond to the Direct Testimonies of several witnesses for Intervenors who filed Direct Testimony criticizing my Direct Testimony. In particular, I will respond to the Direct Testimonies filed by: (1) James Rothschild (Office of Public Counsel ["OPC"]); (2) Hugh Larkin (OPC); (3) Dr. Philip Porter (Florida Industrial Power Users Group ["FIPUG"]); (4) Alan Chalfant (White Springs Agricultural Chemicals); (5) Michael Gorman (White Springs Agricultural Chemicals); Michael Brubaker (White Springs Agricultural Chemicals); (6) Stephen Stewart (AARP); (7) Michael Culver and Charlie Martin (Commercial Group); (8) Sheree L. Brown (Florida Retail Federation ["FRF"]); and (9) Sidney Matlock of the Commission Staff.

Q. Please summarize your Rebuttal Testimony.

A. There are two primary areas on which I focus in my Rebuttal Testimony. First, I explain that none of the Intervenor witnesses seems to fully understand the underlying concept of the benchmarking model I provide and, therefore, they reject or dismiss the importance and relevance of the annual savings of $396.3 million shown by the model as compared to what one would expect based on utility industry performance. Most fail, for example, to take into account the explicit factors, which I included in the model, that capture the external business conditions that Progress Energy Florida ("PEF" or the "Company") has internalized and overcome for the benefit of Florida's electricity consumers. I will discuss how relative prices and the decline in interest rates fit into this context. Here, I will show that certain of the Intervenor witnesses' simplistic arguments lack merit because they claim –without support-- that PEF's prices are relatively high, PEF cannot be the superior performer that the model shows. I will explain why these Intervenor witnesses' logic is flawed, and that when PEF is compared to its peers on a truly comparable basis, PEF is indeed a superior performer.

Second, I will answer the criticisms that have been leveled against my recommendation that the Commission recognize PEF's superior performance when setting its authorized Return on Equity (ROE). I will explain why good regulation does not punish utilities for superior performance and should, in fact, encourage utilities such as PEF that have more than met their side of the regulatory bargain. In so doing, I will also explain the misconception shared by several of the Intervenor witnesses that revenue sharing is not a substitute policy,

but is complementary. Here, I will also explain some of the errant thinking that some would attach to the recent storm recovery decision and how this may or may not affect future risk.

Q. Do you address any other issues in your Rebuttal Testimony?

Q. Yes. Several Intervenor witnesses have raised issues and presented seriously flawed analysis. I will address those topics as well because they are used in the Intervenor witnesses' Direct Testimony to recommend two quite negative things: (1) reject my proposed recommendation that PEF's ROE be set at 12.8%, which is 50 basis points higher than Dr. Vander Weide's ROE floor; and (2) to propose a major rate reduction for a utility that is a high performer with very real capital requirements to meet system growth. These other issues include: (1) explaining why PEF's parent company's, Progress Energy Inc.'s (Progress Energy's) capital structure is not appropriate for PEF; and (2) explaining why the consumer benefits from allowing Construction Work in Progress (CWIP) in rate base.

Q. How is your Rebuttal Testimony organized?

A. In Section 2, I rebut those Intervenor witnesses who have misunderstood and criticized my benchmarking analysis. In Section 3, I address those Intervenor witnesses who have criticized my proposal to set PEF's ROE to reflect superior performance. In Section 4, I discuss the capital structure and CWIP issues I described briefly in my previous answer. In Section 5, I summarize my conclusions.

II. RESPONSE TO CRITICISMS OF MY BENCHMARKING ANALYSIS

Q. At page 22 of his Direct Testimony, Dr. Philip Porter on behalf of the FIPUG, claims that your opinion that PEF's superior performance has saved ratepayers $125 million cannot be verified because your "proprietary model" and "reported findings are not open to scrutiny." How do you respond to his criticism?

A. Dr. Porter's criticism is misplaced on several levels. First, he misunderstands my Direct Testimony. In my Direct Testimony, I explain the Translog production model that I use to determine the statistical relationship between a typical electric utility's cost of production and the external business conditions that it faces. These conditions include the local prices of labor, capital, finance, fuel, power, and other production inputs. They also include miscellaneous other business conditions such as operating scale and customer mix, load factor, fuel diversity, etc.. The sample includes data on the operations and production costs of 95 utilities over a nine year time period.

None of the data that I use are proprietary. Most were, in fact, drawn from FERC Form 1 filings. In my response to White Springs Agricultural Chemicals Interrogatory Number 29, I provided a list of the variables used in the Translog model for Total Cost, a summary of the formulas and sources for those variables used in the Translog Total Cost model, and a printout replicating the results from the PEF data and parameter estimates. The form of the model and the general econometric methods used to estimate have been widely used for several decades

and are discussed in many textbooks. The econometric model and mathematical logic used, the so-called Translog Production Function and its close cousin, Total Cost Function, are also not proprietary. In fact, this method, albeit complex in structure and its underlying statistical methodology, has been widely used for more than three decades and is included in most advanced econometric textbooks.

None of the above is proprietary in either a legal or pejoratively secret sense. What my firm does claim to be proprietary is the "learned" expertise that we have developed over the years. It is this "learned" expertise that we would not want to share with potential competitors.

Using the Translog Total Cost model, I find that over the last three years for which data was available when I did the analysis (2001, 2002, and 2003), PEF's actual total costs of producing electricity were 12.7%, or $393.3 million per year less than I would expect based upon the electric utility industry's Total Cost of Production Model and given the local business conditions faced by PEF and a normal or industry level of operating efficiency. I also show and discuss the sector-by-sector breakdown of these costs (*e.g.,* labor, capital, fuel, etc.) in my Direct Testimony.

Intervenor witnesses either fail to grasp what I did or they seek to redirect the discussion away from the nearly $400 million advantage that PEF achieved to a separate and distinct $125 million annual savings that PEF and others established through a settlement in the last rate case as part of its merger that formed Progress Energy. In other words, PEF ratepayers benefit from having PEF be their electric supplier as compared to an efficient utility, which is

represented in the Translog Total Cost model. My reference to the $125 million in customer savings is specifically to the indisputable and guaranteed $125 million in annual rate reductions through December 31, 2005 provided to customers by PEF under the settlement agreement reached in 2002. These customer savings should not be in dispute because retail rates were reduced in the 2002 settlement. These are savings that customers have received due to PEF's confidence that it could achieve merger related synergies and efficiencies. Verifying these savings has nothing at all to do with my benchmarking model, which compares PEF to an industry performance standard and does not consider PEF's performance in achieving synergy savings. No one disputes that ratepayers are paying $125 million per year less in rates under the 2002 settlement.

Q. In what other way is Dr. Porter's Direct Testimony incorrect?

A. Dr. Porter implies that the model is some mysterious black box that is not subject to scrutiny. This is also not accurate. The model is based on a rich scientific literature that spans more than thirty years. The methodology that I use is not new or unknown, and the research methods utilized are discussed in many textbooks that describe the theory, applications, and methods used in Translog Production and Total Cost Models. While I consider the accumulation of information and consistency checks related to the vast amount of data that are used in the model to be proprietary, my findings are certainly open to scrutiny. The fact that Dr. Porter chose not to take the time to do so, or simply did not address or interpret the economic theory underlying the analysis, should not enable him to dismiss the

model's results. I devoted 10 pages in my Direct Testimony explaining how the model worked, the data that was used in the analysis, and my findings and conclusions. I also disclosed specific data and model detail in answering interrogatory questions.

The model is based on the well-established theory of production cost, which holds that cost is a function of input prices and one or more measures of operating scale. Cost may also, in principle, be a function of miscellaneous additional business conditions. All business conditions that appear in the model have plausible and statistically significant parameter estimates. In summary, my model is anything but a black box that confounds earnest appraisal.

The Translog form is designed to impose as few restrictions as possible on the shape of these relationships. Alternative functional forms, such as the Cobb Douglas, are simpler but impose more restrictions on relationships.

There is nothing complicated in economists explaining Total Costs as a function of the quantity of inputs used and their respective prices. In the Translog approach, there are some additional constraints that complicate the statistics, none of which are particularly complex ideas. For example, the sum of the various individual costs components is constrained to equal Total Cost. This is usually expressed in percentage terms. Therefore, the sum of the cost components in the estimated regression model is constrained and must sum to one hundred percent.

As I explained in my Direct Testimony, the Translog Total Cost model included various key cost drivers (*e.g.*, labor prices, capital prices, energy and fuel prices, etc.). The model then took into account differences between utilities (*e.g.*,

differences in peak demand, customer growth, percentage of residential customers, etc.). The Translog Total Cost model imposed statistical restrictions for consistency and economic logic. This model is widely used in business, industry, and regulation. In fact, while we have used the Translog Total Cost model in regulatory settings, we more typically use the model in internal benchmarking analyses for utilities that seek a consistent and unbiased assessment of how their performance stacks up against other similarly situated utilities. This offers perhaps the strongest validation of the value and utility of the Translog Total Cost model.

None of the above is a secret to economists, and graduate textbooks in econometrics typically explain the approach in some detail.[1] Before this approach was developed, there were alternate, more rudimentary production cost models, such as the well-known Cobb-Douglas Method. These earlier production and cost models have mostly been replaced by the Translog approach because the latter reflects economic theory.

This is the underlying logic economists use to translate engineering and business decisions that seek to minimize the costs of their inputs in producing the products they sell. There is nothing secretive about any aspect of this approach or statistical methodology. That said, I have applied this logic for a relatively large sample of 95 utilities over nine years to determine a Translog Total Cost model for electric utilities in the United States. This logic establishes the basis for

[1] See for example, Greene, William H, Econometric Analysis, Fourth Edition, Upper Saddle River, N.J., Prentice Hall, 2000; Berndt, Ernest R., The Practice of Econometrics: Classic and Contemporary, Reading, Mass., Addison Wesley Publishing Co. 1991. The actual econometric method is known to practitioners as Seemingly Unrelated Regression with Heteroskedasticity. This method extends the Ordinary Least Squares method to reflect the constraints discussed in the text.

statements that firms such as PEF, which statistically significantly beat this average or expected total cost target, are in fact beating an average or target based upon an approach tied to a foundation of least cost efficiency.

Dr. Porter attempts to dismiss this voluminous and widely accepted body of work by asserting that my model is "proprietary" and "not open to scrutiny," while ignoring that the model uses widely used and accepted econometric formulas. This is not a valid critique. Indeed, we have turned over the statistical model in this proceeding.

Additionally, as I stated very clearly in my Direct Testimony, my model shows that since the merger was completed, PEF has demonstrated a 12.7% cost advantage over a utility of normal efficiency facing the same unique characteristics as PEF. Put another way, PEF's actual total cost is less than what the Translog Model, with a high R^2 of about 98.5% (a high degree of statistical accuracy), predicts for PEF. As I explained in my Direct Testimony, this amounts to about a $400 million per year savings relative to other utilities with similar characteristics that also attempt to minimize their total production costs. This is not the $125 million in annual savings related to merger synergies that Dr. Porter discusses.[2] He is confused and incorrectly assumes these two estimates of savings are the same concept.

Q. Dr. Porter also asserts at page 22 lines 12-14 of his Direct Testimony that the

[2] The estimated $400 million in savings for PEF as compared to an efficient utility most likely includes some or all of the $125 million in efficiency related to the merger that customers have received in annual revenue requirement reductions.

PEF could have saved $300 million per year simply by refinancing its $10 billion in debt. Is he correct?

A. Dr. Porter's statement is misleading in several respects. He appears to be comparing the guaranteed annual reduction of $125 million provided in the Company's 2002 rate case settlement to a reduction in utility bond rates dating from 1993. I must point out that Dr. Porter is using Progress Energy's $10 billion in debt, which includes $3 billion in merger related debt, and not PEF's long-term debt. Schedule D-2 shows that PEF's long-term debt for 2004 was $1.7 billion. Thus, Dr. Porter overstates his argument.

Regardless, as I discussed above, Dr. Porter is confused as to the $125 million, which represents guaranteed annual base rate reductions through the end of 2005. These $500 million in savings over four years are quite distinct from the annual cost advantages PEF has achieved and demonstrated in the statistical model, which are about $400 million per year.

Dr. Porter is also rather disingenuous when he takes interest rate reductions over a 12 year period, applies the cumulative total to Progress Energy's total debt, and then compares these purported reductions to annual savings based on a three year analysis of costs, implying that PEF has kept the savings for itself. He is wrong. Corporate debt is issued over many years. Corporate debt is often refinanced, just like home mortgages. The prevailing market conditions at the time of issuance and best practices in finance would establish the terms and costs of refinancing PEF's prior or embedded debt. Dr. Porter seems to ignore this fact.

Furthermore, all utilities included in the Translog Total Cost analysis would have had the same opportunity to refinance, and undoubtedly did refinance over the same very long time period. Some of these savings between rate cases, when new embedded debt costs are reset, are offset by rising costs for other factors of production that also occur between rate cases. One should not, in isolation, look at one expense category (debt) where costs decline, and claim all the savings for ratepayers without also considering the totality of all cost categories, including the categories that increase. The Translog Total Cost model considers the totality of all cost categories, including the categories that increase. And, recall that the statistical model shows that when all cost categories are considered, some decline and some, such as fuel, increase. Nevertheless, PEF's costs are 12.7% below what one would expect of a similarly situated utility. This results in annual cost savings of about $400 million above the savings and increases experienced across the utility industry

Q. At page 12 of his Direct Testimony, Mr. Alan Chalfant criticizes your benchmarking analysis. Please respond to his critique.

A. Mr. Chalfant states that he was "unable to trace the output" of my model, but that he has no reason to expect that the model is "not numerically accurate." He states that he is troubled, however, by my characterization of the results. He references PEF's responses to White Springs' Second Set of Interrogatories, No. 33a to support his contention that my benchmarking analysis, which revealed PEF's costs were 12.7% below what I would have expected for a similarly situated

utility, was "highly dependent on the factors that are selected for inclusion" in the model. It is difficult to fathom exactly what Mr. Chalfant's criticism is.

I provided a list of variables, printouts, and text to describe the sector by sector results. I also discussed how I interpret the output and why I think specific results were found in the analysis. Using regression analyses to determine the interdependence of many variables is commonly accepted and widely used as a reasonable and valued scientific and public policy approach.

In PEF's response to White Springs Second Set of Interrogatories 33a, I explained that the term "efficient" referred to the performance standard of the typical or normal utility in the industry, which is presumed to have the same underlying characteristics as PEF. I could add for clarity that efficient also means "least cost." Based on a statistical model for a utility of typical efficiency, the Translog model estimates what the total costs would be. I then compared these PEF estimates or predictions to PEF's actual costs to determine PEF's relative cost advantage of 12.7% per year over three years.

Q. Does Mr. Chalfant have a more specific critique of your model?

A. No. However, at page 13 of his testimony, he argues that if PEF were truly a low cost supplier, that fact would be reflected in rates and that it would be expected to have lower rates than other utilities in the region. Its rates are lower than TECO's and similar to FP&L's. As for Gulf Power, PEF's location on the peninsula and the resulting transmission constraints implies higher prices for power and generation fuel. Furthermore PEF cannot match the purchasing power of the

mammoth Southern Company and does not have access to its low-price power pool. Note finally that PEF has a much more costly demand mix due to the unusual importance of residential demand in its service territory. For these and other reasons, it is quite possible for PEF to have better performance than Gulf Power despite the higher prices it charges. Mr. Chalfant's attack is strange because the model is based on national, not regional data. He then refers to Mr. Brubaker's testimony that suggests PEF is one of the highest price suppliers in the Southeastern United States. This is a thinly veiled attack on the Translog model's credibility. Mr. Chalfant provides no analysis and fails to explain how and why he would expect other regional utility companies to perform.

Q. How do you respond to Mr. Brubaker's assertions starting at page 5 of his Direct Testimony that PEF is one of the highest cost suppliers in the Southeastern United States?

A. Mr. Brubaker's "analysis" demonstrates the difference between a scientific analysis and a non-scientific one. He considers partial results (*i.e.*, prices for specific customer categories and usage levels). Mr. Brubaker fails to consider: (1) differences in circumstances; (2) uniquely different tariff design and cost allocation; and (3) variation in regulatory and restructuring circumstances.

In the Translog analysis, differences in business conditions are built into the analytic and statistical analyses. Mr. Brubaker and others in this case, make no attempt to determine or to correct their relative price comparisons for these and other very significant differences. For example, virtually all of the other

companies in Mr. Brubaker's southeast sample are much closer to low-cost coal sources.

Consider two utility companies. The first utility is growing rapidly and adding relatively expensive residential customers. Some of this additional cost may be financed out of depreciation expense and some may require new debt and equity. Now consider a second utility that is not growing. That utility has cash flow available from prior investments that are currently being depreciated. The two utilities would have different capital requirements, different costs of service, different current revenue requirements, and different relative prices.

The Translog analysis I provided went to great lengths to identify the many challenges that an efficient utility must face in managing its production costs. I then took the unique characteristics that describe PEF, which I provided to the Intervenors in this case, and estimated the costs that the model predicts for PEF. I then compared this estimate to PEF's actual costs to determine whether PEF had achieved costs that were above or below what the model predicts and I would have expected. Contrast this to Mr. Brubaker's analysis where he simply lines up rows of prices for various services for utilities across a region of the Southeast United States without any regard to or analysis of the varying circumstances facing the utilities he chose to analyze.

There are additional differences in what Mr. Brubaker attempts and what would be a reliable or sensible effort. There are, for example, differences in how utility commissions allocate costs between industrial, commercial, and residential customers. In addition, tariffs are multipart, and differences in customer use can

cause different monthly bills. Again, differences across states and utilities in tariff design and customer use are very commonplace.

The Translog model is a cost analysis. It is not a tariff or specific customer price analysis for a multi-product firm such as an electric utility where voltage, time of use, and other factors vary and affect the unit prices charged. Comparing prices by customer type and use would be more complex and require much more data to attempt to explain a plethora of price differences for specific customer categories across utilities in the United States than what I have done, which is to explain utility cost variations.

Q. What type of circumstances or conditions might affect PEF's relative position with respect to prices in the Southeast part of the United States?

A. Comparing PEF's rates to other electric providers in the Southeast without adjusting for factors that affect prices, tariffs, and cost allocations is not valid. There are significant differences that make any such simplistic comparison inappropriate. For example, every utility has a unique mix of residential and commercial/industrial customers. This mix has an effect on the utility's load factor. The fact that PEF has a significant and growing residential component to its load, coupled with a relatively low industrial percentage component, affects PEF's costs, allocations, and prices.

Location can also be significant and can have very significant and different cost effects on utilities even though all are located in the large Southeastern region of the United States. For example, PEF is located far from

sources of coal and natural gas, and must incur greater transportation costs than utilities in the Southeast that are located closer to the coal and natural gas production. These coal transportation expenses, plus environmental considerations, affect PEF's fuel and purchase power choices. Furthermore, the price for natural gas has increased several-fold over the past few years, making those utilities with access to relatively inexpensive coal and sizeable nuclear fleets less expensive than PEF.

PEF, as do the other utilities located in peninsular Florida, has significant transmission constraints at the Florida border that reduce its access to lower cost generation from outside the peninsula. These are just some of the reasons why PEF's costs and prices are what they are. In the Translog model, these types of differences and consequences, which affect production and Total Cost, are built into the analysis. Mr. Brubaker and others make price comparisons that are extremely misleading because they omit such relevant price and cost differences. This is precisely why the Translog model, which adjusts and corrects for such differences when discussing the total cost level and efficiency of a particular utility, is more sensible and reliable. Mr. Brubaker and others do not attempt to make such adjustments in their analyses of relative prices.

Q. Is there a group of utilities that would make a more appropriate peer group with which to compare PEF?

A. Yes. However, such a comparison is not really necessary or helpful. The Translog model is better suited for making cost performance appraisals for the

reasons I have already discussed. That said, if one were to try to use Mr. Brubaker's relative price analysis, a more appropriate peer group would clearly be the other peninsular Florida investor-owned utilities. I would exclude Gulf Power from this analysis because it is effectively located outside of the peninsula transmission constraint I discussed above and has access to lower-cost wholesale power. Each utility also is in a single state, reducing some tariff differences that are likely across states. Thus, we might sensibly compare PEF's prices to TECO and FPL. In such an analysis, PEF compares quite favorably, especially with respect to the commercial/industrial prices with which Mr. Brubaker and his client are most concerned. This is particularly impressive given that PEF has an unusually large residential component, and PEF has a lower system load factor than either Tampa Electric or Florida Power & Light. For example, in 2003, PEF's load factor (49.5%) was lower than Florida Power & Light (61.3%), Gulf Power (54.2%), and Tampa Electric (56.4%).[3] This is due in part to the greater importance of residential demand.

Q. Have you compared PEF's prices to the two other IOUs located in Florida's peninsula?

A. Yes, I have. The Florida PSC publishes electric industry data every year. The most recent is from 2003 and demonstrates that PEF's prices, especially for commercial/industrial rates compare favorably to the rates of IOUs located in Peninsular Florida.

[3] Statistics of the Florida Electric Utility Industry 2003, published September 2004 by the Division of Economic Regulation, Florida Public Service Commission, page 28.

I will begin with residential prices. Table 1, compares the price of residential service for the three Peninsular Florida IOUs for various monthly use levels.

Table 1
Price of Residential Service
31-Dec-03

Utility	Minimum Bill	100 KWH	250 KWH	500 KWH	750 KWH	1000 KWH	1500 KWH
FP&L	$5.25	$13.07	$24.82	$44.40	$63.95	$85.85	$129.65
TE	$8.50	$16.83	$29.33	$50.15	$70.98	$91.79	$133.44
PEF	$8.03	$15.39	$26.43	$44.84	$63.23	$81.62	$123.43

Source: Statistics of the Florida Electric Utility Industry 2003 (FPSC)

When compared with this more relevant and similar group of utilities rather than, as Mr. Brubaker and others do, all the IOUs in the entire Southeast region of the United States, PEF's residential prices/bills compare favorably, even though PEF's load factor, due to a high residential share, is lower than either Florida Power & Light or Tampa Electric.

Table 2 compares the bills of the three IOUs' commercial and industrial service.

Table 2
Price of Comercial and Industrial Service
31-Dec-03

Utility	75 KW 15,000 KWH	150 KW 45,000 KWH	500 KW 150,000 KWH	1000 KW 400,000 KWH	2000 KW 800,000 KWH
FP&L	$1,352	$3,542	$11,556	$28,036	$55,846
TE	$1,376	$3,499	$11,565	$28,425	$56,595
PEF	$1,033	$2,820	$9,377	$23,837	$47,663

Source: Statistics of the Florida Electric Utility Industry 2003 (FPSC)

PEF's typical bills compare very favorably with the two other Peninsular Florida IOUs. In fact, PEF's typical bills average about 20% less across these five use levels than the other two peninsular Florida IOUs.

Q. Would it be appropriate to include other non-IOUs located in peninsular Florida in such a comparison?

A. Yes. It would be appropriate to include the Florida Municipals and Customer Owned Utilities that also operate in Peninsular Florida. However, there are some differences between the municipals and cooperatives that give those entities a cost advantage. For example PEF pays income taxes and property taxes, which the municipals and cooperatives typically don't pay, or at least they pay less. PEF also does not typically have access to lower cost municipal financing or the federally assisted financing that is available to cooperatives. Even with these disadvantages, PEF's prices *still* compare favorably to these other Peninsular Florida utilities.

Q. How does PEF compare with Municipal and Cooperative Electric Utilities in Florida?

A. The FPSC also publishes residential prices and commercial/industrial prices for municipal and cooperative utilities in Florida as I explained above. These are not quite directly comparable to the prices published for PEF because the municipal and cooperative utility prices do not have the local taxes, franchise fees, and gross receipts taxes that are embedded in PEF's rates. Table 3 shows the residential

service rates for Florida municipal utilities. Table 4 shows the residential service rates for Florida cooperative utilities. PEF compares quite favorably with these other peninsular utilities, which many recognize have built-in cost advantages not available to IOUs such as PEF.

Table 3
Price of Residential Service
31-Dec-03

Municipal Utility	Minimum Bill	100 KWH	250 KWH	500 KWH	750 KWH	1000 KWH	1500 KWH
Alachua	$8.00	$16.98	$30.45	$52.90	$75.35	$97.80	$142.70
Bartow	$6.60	$15.20	$28.08	$49.58	$71.06	$92.54	$135.52
Blountstown	$3.50	$10.02	$19.80	$36.09	$52.39	$68.68	$101.27
Bushnell	$6.95	$15.70	$28.81	$50.68	$72.54	$94.40	$138.13
Chattahoochee	$4.50	$12.52	$24.55	$44.60	$64.65	$84.70	$124.80
Clewiston	$6.50	$15.29	$28.48	$50.45	$72.42	$94.39	$138.34
Fort Meade	$12.96	$22.70	$37.32	$61.66	$86.02	$110.36	$159.06
Fort Pierce	$5.35	$14.34	$27.81	$50.28	$72.73	$95.19	$140.12
Gainesville	$4.66	$11.87	$22.69	$40.73	$58.76	$79.20	$120.08
Green Cove Springs	$6.00	$15.35	$29.37	$52.75	$76.12	$99.49	$146.24
Havana	$6.00	$15.73	$30.33	$54.65	$78.98	$103.30	$151.95
Homestead	$5.50	$14.45	$27.87	$50.23	$72.60	$94.96	$139.69
Jacksonville	$5.50	$11.77	$21.17	$36.83	$52.49	$68.15	$99.48
Jacksonville Beach	$4.50	$13.54	$27.09	$49.69	$72.28	$94.87	$140.06
Key West	$6.00	$16.22	$31.56	$57.10	$82.66	$108.20	$159.30
Kissimmee	$5.40	$13.97	$26.83	$48.25	$69.67	$91.09	$133.94
Lake Worth	$7.42	$16.44	$29.98	$52.54	$75.10	$97.66	$142.78
Lakeland	$6.35	$15.21	$28.49	$50.63	$72.77	$94.91	$94.56
Leesburg	$8.00	$16.09	$28.22	$48.44	$68.65	$88.87	$129.31
Moore Haven	$8.50	$16.77	$29.18	$49.85	$70.53	$91.20	$132.55
Mount Dora	$4.94	$13.15	$25.47	$46.00	$66.52	$87.05	$128.11
New Smyrna Beach	$5.65	$14.11	$26.80	$47.97	$69.12	$90.27	$132.59
Newberry	$7.50	$16.24	$29.36	$51.22	$73.08	$94.93	$138.65
Ocala	$7.00	$15.35	$27.89	$48.79	$69.68	$90.57	$132.36
Orlando	$7.00	$14.37	$25.43	$43.85	$62.28	$80.70	$122.55
Quincy	$6.00	$15.14	$28.86	$51.71	$74.57	$97.42	$143.13
Reedy Beach	$2.85	$10.70	$22.48	$42.11	$61.74	$81.36	$120.62
Starke	$6.45	$15.06	$27.98	$49.50	$71.03	$92.55	$146.60
St. Cloud	$7.32	$15.02	$26.58	$45.83	$65.09	$84.34	$128.08
Tallahassee	$4.94	$14.87	$29.75	$54.57	$79.37	$104.18	$153.81
Vero Beach	$7.00	$15.72	$28.81	$50.60	$72.41	$94.20	$137.80
Wauchula	$8.62	$18.59	$33.54	$58.46	$83.38	$108.30	$158.14
Williston	$8.00	$17.64	$32.11	$56.22	$80.33	$104.44	$152.66
PEF*	$8.03	$15.39	$26.43	$44.84	$63.23	$81.62	$123.43

*PEF added for comparative purposes

Source: Statistics of the Florida Electric Utility Industry 2003 (FPSC)

Table 4							
Price of Residential Service							
31-Dec-03							
Cooperative Utility	Minimum Bill	100 KWH	250 KWH	500 KWH	750 KWH	1000 KWH	1500 KWH
Central Florida	$8.50	$16.32	$28.07	$47.62	$67.19	$86.75	$125.87
Choctawhatchee	$18.00	$25.15	$35.87	$53.74	$71.61	$89.48	$125.22
Clay	$9.00	$15.92	$26.30	$43.60	$60.91	$78.20	$117.80
Escambia River	$9.00	$17.10	$29.25	$49.50	$69.75	$90.00	$130.50
Florida Keys	$7.00	$15.73	$28.84	$50.67	$72.51	$94.34	$138.01
Glades	$10.50	$18.80	$31.25	$52.00	$72.75	$93.50	$135.00
Gulf Coast	$10.00	$17.81	$29.53	$49.05	$68.58	$88.10	$127.15
Lee County	$5.00	$12.91	$24.78	$44.55	$64.33	$84.10	$123.65
Okefenoke	$10.00	$17.29	$28.22	$46.44	$64.67	$82.89	$119.33
Peace River	$10.50	$19.34	$32.60	$54.70	$76.80	$98.90	$143.10
Sumter	$8.25	$16.37	$28.55	$48.85	$69.15	$89.45	$130.05
Suwannee Valley	$8.73	$16.42	$27.96	$47.20	$66.43	$85.66	$124.13
Talquin	$8.00	$15.60	$27.00	$46.00	$65.00	$84.00	$122.00
Tri-County	$10.00	$18.60	$31.50	$53.00	$74.50	$96.00	$139.00
West Florida	$8.00	$16.53	$29.31	$50.63	$71.94	$93.25	$135.88
Withlacoochee River	$9.75	$17.51	$29.15	$48.55	$67.94	$87.34	$126.14
PEF*	$8.03	$15.39	$26.43	$44.84	$63.23	$81.62	$123.43
*PEF added for comparative purposes							
Source: Statistics of the Florida Electric Utility Industry 2003 (FPSC)							

Q. Did you compare the PEF's commercial and industrial prices to those of municipal and cooperative utilities in peninsular Florida?

A. Yes. The results are shown in Tables 5 and 6, respectively for the municipal utilities and the cooperative utilities. PEF again compares very favorably, with commercial and industrial prices significantly lower than those offered by the municipal utilities, with the exception of Jacksonville, which has slightly lower prices. PEF also has lower prices that the vast majority of the cooperatives for most categories.

Table 5					
Price of Commercial and Industrial Service					
31-Dec-03					
Municipal	**75 KW**	**150 KW**	**500 KW**	**1,000 KW**	**2,000KW**
Utility	**15,000 KWH**	**45,000 KWH**	**150,000 KWH**	**400,000 KWH**	**800,000 KWH**
Alachua	$1,483	$3,957	$13,138	$33,013	$66,003
Bartow	$1,647	$4,283	$14,234	$35,177	$70,335
Blountstown	$1,102	$3,292	$10,959	$29,211	$58,415
Bushnell	$1,616	$4,281	$14,221	$35,553	$71,085
Chattahoochee	$1,321	$4,052	$13,505	$34,340	$68,680
Clewiston	$1,548	$4,305	$14,269	$36,791	$73,547
Fort Meade	$1,746	$4,792	$15,765	$38,750	$77,410
Fort Pierce	$1,451	$3,833	$12,695	$31,795	$63,555
Gainesville	$1,197	$3,128	$10,391	$25,111	$50,161
Green Cove Springs	$1,637	$4,337	$14,399	$30,123	$60,120
Havana	$1,466	$4,385	$14,601	$38,926	$77,846
Homestead	$1,625	$4,337	$14,374	$36,188	$72,341
Jacksonville	$1,016	$2,551	$8,385	$20,450	$40,700
Jacksonville Beach	$1,795	$4,714	$15,677	$38,944	$77,872
Key West	$1,744	$4,712	$15,644	$39,589	$79,159
Kissimmee	$1,473	$3,677	$12,498	$29,371	$58,687
Lake Worth	$1,881	$4,867	$16,106	$39,866	$79,682
Lakeland	$1,363	$3,658	$12,833	$31,178	$61,980
Leesburg	$1,343	$3,469	$11,523	$28,365	$56,713
Moore Haven	$1,544	$3,969	$13,160	$32,360	$64,690
Mount Dora	$1,153	$3,060	$10,166	$25,439	$50,863
New Smyrna Beach	$1,471	$3,934	$13,036	$32,874	$65,714
Newberry	$1,593	$4,000	$13,300	$32,107	$64,199
Ocala	$1,299	$3,409	$11,315	$28,155	$56,289
Orlando	$1,171	$2,995	$9,949	$24,227	$48,551
Quincy	$1,235	$3,305	$10,876	$27,688	$54,228
Reedy Beach	$1,426	$3,585	$11,904	$28,804	$57,588
Starke	$1,608	$4,806	$15,999	$42,649	$85,289
St. Cloud	$1,223	$3,129	$10,395	$25,374	$50,732
Tallahassee	$1,587	$4,137	$13,636	$33,878	$67,716
Vero Beach	$1,392	$3,827	$12,654	$32,429	$64,789
Wauchula	$1,537	$4,885	$16,132	$41,067	$82,069
Williston	$1,609	$4,401	$14,390	$36,290	$72,530
PEF*	$1,033	$2,820	$9,377	$23,837	$47,663
*PEF added for comparative purposes					
Source: Statistics of the Florida Electric Utility Industry 2003 (FPSC)					

Table 6					
Price of Commercial and Industrial Service					
31-Dec-03					
Cooperative	**75 KW**	**150 KW**	**500 KW**	**1,000 KW**	**2,000 KW**
Utility	**15,000 KWH**	**45,000 KWH**	**150,000 KWH**	**400,000 KW**	**800,000 KWH**
Central Florida	$1,389	$3,519	$11,613	$28,050	$56,050
Choctawhatchee	$1,148	$2,924	$9,035	$22,407	$44,784
Clay	$1,142	$3,027	$9,960	$25,185	$48,710
Escambia River	$1,480	$3,910	$12,940	$32,440	$64,840
Florida Keys	$1,112	$3,234	$10,902	$28,242	$56,536
Glades	$1,586	$4,418	$14,125	$22,895	$45,615
Gulf Coast	$1,191	$3,249	$10,802	$27,452	$54,892
Lee County	$1,187	$3,155	$11,055	$26,855	$53,695
Okefenoke	$1,231	$3,020	$9,833	$23,956	$47,811
Peace River	$1,279	$3,293	$10,860	$26,910	$53,770
Sumter	$1,184	$3,040	$10,015	$24,790	$49,530
Suwannee Valley	$1,410	$3,687	$9,346	$22,053	$44,065
Talquin	$1,156	$3,103	$10,530	$23,480	$46,660
Tri-County	$1,360	$3,325	$10,850	$26,300	$52,500
West Florida	$1,264	$3,242	$10,690	$23,070	$46,040
Withlacoochee River	$1,182	$3,086	$10,228	$25,401	$50,777
PEF	$1,033	$2,820	$9,377	$23,837	$47,663
*PEF added for comparative purposes					
Source: Statistics of the Florida Electric Utility Industry 2003 (FPSC)					

Q. The panel composed of Mr. Mike Culver and Mr. Charlie Martin, at page 3 of their testimony, compares PEF's commercial rates to those of other IOUs in the Southeast. Please comment.

A. The "analysis" presented by Mr. Culver and Mr. Martin suffers from the same analytic failures and introduces the same omitted variable bias as Mr. Brubaker. It is simply not relevant to compare PEF to a set of utilities that do not face the same load characteristics, transmission constraints, and transportation costs that PEF faces. Mssrs. Martin and Culver find great significance in the fact that PEF's fuel costs are higher than Georgia Power's fuel costs. However, much of the differential is due to location, plant mix, purchasing power, and customer make-up. Located in the Florida Peninsula, PEF lacks the ready access to cheap coal that Georgia Power enjoys. Environmental considerations are also different in

Florida. It is, therefore, not surprising that Georgia Power has lower fuel costs than PEF.

The relevant question is the one that the Translog model has addressed in this proceeding; to wit: how has PEF performed relative to how a typical efficient utility with PEF's characteristics would have been expected to perform based upon utility performance across the U.S. and over nine years. And the answer to that most relevant question in this proceeding is that PEF's Total Costs were 12.7% below what would have been expected. This saves PEF's customers about $400 million per year. The analysis of prices offered by Mssrs. Culver and Martin and Mr. Brubaker do nothing to alter this undeniable truth. PEF has performed very well given its business and operating circumstances. Just limiting the comparison of prices to peninsular Florida also shows a similar result. PEF is a good utility and high performer. In fact, no witness has challenged the results of the Translog statistical benchmarking analysis.

III. RECOGNIZING SUPERIOR PERFORMANCE IN THE FORM OF A HIGHER ROE IS GOOD REGULATORY POLICY.

Q. Why is this discussion of increasing PEF's authorized ROE to recognize superior performance important?

A. PEF is a growing utility that has performed well for its customers. As I explained in my Direct Testimony, there is precedent and many reasons to increase PEF's ROE over that Dr. Vander Weide determined, bringing PEF's ROE to 12.8%.

In this proceeding, Intervenors seek a rollback in PEF's revenue requirements, not the rate relief that PEF seeks, needs, and deserves. In contrast, I urge the Commission to consider both PEF's minimum "needs," as well as PEF's superior performance rationale when it sets PEF's authorized ROE and subsequent revenue requirements and tariffs.

Q. At pages 98-100 of his Direct Testimony, Mr. Rothschild criticizes your recommended upward adjustment to PEF's ROE for superior performance. Please respond to his critique.

A. Mr. Rothschild argues that an upward adjustment for superior performance is "inappropriate, unnecessary, and more than likely would be counterproductive, in that it would provide inappropriate incentives to PEF." Mr. Rothschild apparently thinks that the benefits associated with regulatory lag, where a utility supposedly "keeps" cost savings until rates are reset at the next rate hearing, provides all the incentive that is necessary. And if this "carrot" was not incentive enough, Mr. Rothschild argues that the Commission carries a big stick in the way of prudence disallowances, which provides further incentives for the utility to strive to keep costs down. Presumably, this logic also dictates that Mr. Rothschild is opposed to any type of performance based or revenue sharing ratemaking. I find this all to be quite perplexing because regulation is far less about punishment and discipline and much more about incentives and opportunities.

Regardless, Mr. Rothschild's first conclusion is not relevant for PEF. He falsely implies that PEF "sits on its hands" between rate cases and basks in and

captures returns for shareholders when more cash comes in than had been expected when rates were set initially. This is a naïve and decidedly incorrect depiction of PEF's performance.

PEF does not restrict its spending and investments to the cost-of-service analyses in the last rate case. PEF uses incremental revenue and income to pay for necessary and efficiency improving incremental costs. The Commission monitors PEF's between-rate-case activities through its monthly surveillance reports. PEF neither seeks to keep all nor accepts every last dollar of any upside income between rate cases as Mr. Rothschild's narrow consideration of regulatory lag implies it would attempt to do. PEF uses this so-called regulatory lag dividend to help its customers, add necessary inputs, make additional hook-ups, and improve efficiency.

The fact is that, as I have explained, PEF's total cost record outperforms reasonable and efficient expectations based upon the Total Cost estimates for the electric industry. This means that PEF should receive the proposed upward adjustment in its ROE. The fact that PEF has been a superior performer also means that PEF should not be penalized for using its ingenuity and enterprise between rate cases to beat expectations and to better serve and benefit its customers.

This Commission has recognized that what is good for PEF can often also be good for ratepayers (*i.e.,* revenue sharing). If PEF is provided with additional incentives, rather than penalties, to keep costs down in the future, PEF is more likely to strive harder to attain those harder to achieve cost savings. This

incentive can take many forms, including regulatory adjustments to ROE if it performs in a demonstrably superior manner, as is the case here. I believe strongly that innovation and enterprise are more likely when positive incentives, not after-the-fact disallowances, are used to encourage superior performance.

As I discussed in my Direct Testimony, this Commission has used this positive incentive approach in the past. Most recently in 2002, the Commission adjusted Gulf Power's ROE upward for superior performance. And for symmetry, the Commission has also penalized a utility by reducing its ROE when its performance lagged. This is similar to the approach I championed when I was head of the Public Service Commission of Wisconsin. I believe it was effective then. It can be equally effective now.

Q. What is Mr. Rothschild's basis for asserting that an upward adjustment to PEF's ROE would be counterproductive?

A. I don't know because he never explains what he means. It is hard to imagine why a utility would not have an incentive to make improvements and to keep cutting costs between rate cases when it expects it likely would be rewarded in the next rate case if it does, and can be penalized through a disallowance of an adder if it fails. Mr. Rothschild asserts that with a higher return on capital, it will be more difficult for PEF to "justify making incremental investments that might be designed to reduce expenses." This is not logical or reasonable. Does he mean that only the needy strive to achieve? I assume this is what he means by counterproductive. Mr. Rothschild seemingly fails to consider relevant those

circumstances where successful people or businesses eschew failure and constantly strive to work to keep their advantage. Common sense dictates that if the utility knows that it will be rewarded for superior performance and may be punished for lackluster performance, it would have the incentive to achieve all possible savings. Regardless, PEF's performance has been stellar. I would reinforce this behavior and certainly would not, as some suggest, punish PEF in this rate case.

Q. Mr. Rothschild argues that providing an incentive in the form of an upward adjustment to PEF's ROE would not provide an incentive to work harder to achieve future productivity gains. Do you agree with him?

A. Absolutely not. Mr. Rothschild's argument is premised on the faulty assumption that the "bonus" as he describes it, would go to shareholders, but that it is the employees who implement the cost savings, and those employees are paid by the ratepayers. His logic seems to be that because the employees would not get any additional money, they will not work harder to implement the cost savings. This thinking is wrong-headed on several levels. First, employee salaries are paid by the utility, not by ratepayers. Second, employees who wish to remain employed and advance within the company have various direct and indirect incentives to implement PEF's strategic and business plans. High performing employees, if not compensated reasonably, could also leave the business that fails to value their efforts. That is how all companies function.

Second, the facts belie his assumption. PEF has shown for more than two decades that it uses funds between rate cases to make improvements and to serve its customers. Moreover, PEF has been shown to be a superior performer in a national comparison using the Translog Model and analysis. PEF also has a good record of using employee compensation and training to benefit its workforce.

Mr. Rothschild also argues that to the extent employees are paid bonuses for good performance, ratepayers also pay for this. This is misleading. Mr. Rothschild concludes that a bonus paid to investors would be duplicative and "paid to an entity that does not provide any cost savings." It is difficult to untangle Mr. Rothschild's thought process here. On the one hand, he is opposed to providing investors with a bonus because they did not do the work to accomplish the cost savings. He seems to think that capital is not a factor of production. I had thought that the labor theory of value went down the intellectual drain long before the Berlin Wall fell. Mr. Rothschild is seemingly opposed to rewarding employees who perform in an exemplary manner because it's their job. I find all this to be nonsensical. There is a role for both efficiency and incentives. If a utility knows there is a reward for exemplary service, its management will redouble its effort to do everything possible to achieve that reward. People will lead this charge and apply human capital and financial capital, whichever is the more productive input to get the job done. This is simple human nature and how successful businesses function.

Q. At pages 22-23 of his Direct Testimony, Dr. Porter argues that a "bonus for past performance has little incentive value." Please respond to Dr. Porter's assertion.

A. Dr. Porter's assertion is, apparently, based on the premise that a Commission in the future is not bound to follow the precedent set by a prior Commission. Thus, Dr. Porter reasons that unless there is reason to assume that the Commission will have the same make-up as the Commission that provides the adjustment to ROE, there is no reason to think that the new Commission will also provide the reward. Therefore, there is no incentive. This is hopelessly flawed reasoning. While there is no guarantee that future Commissions will follow the same path as a current Commission, it is my experience that if it "ain't" broken, a new Commission is not likely to "fix" it and tinker with a winning and successful formula. This has often been the situation in Florida, where there has historically been stable and reasonable cost-of-service regulation.

Cost-of-service regulation, by necessity, uses a snapshot of data and assumptions to fix tariffs for a period of time. This is the reality of traditional regulation. In this context, measuring past and current efforts are the only real data available to set future prices.

Monitoring between rate cases is another helpful tool used in Florida. At the next rate case, performance should be and is measured. When there has been superior performance, I believe strongly there should be recognition and, going forward, the adjustment to ROE. At a minimum, there should be no penalty or failure to recognize what has been outstanding efforts. PEF should be recognized

for a job well done, and this should carry on into the future, where the monitoring and future reward cycle of regulation would reasonably, albeit with no guarantee, repeat.

Q. Dr. Porter argues, at page 23 of his Direct Testimony, that regulatory markets are designed to mimic competitive markets, and that perpetuating profits (by giving an adjustment to authorized ROE) ignores competitive processes. How do you respond to this assertion?

A. I concur with Dr. Porter to a point. Regulation can never fully implement the discipline and rewards of a competitive market. Dr. Porter equates regulatory lag to a competitive firm's short-run profits when it successfully innovates. He fails to address how utilities, such as PEF, use such "income" to spend money to meet customer needs between rate cases, particularly in high growth periods. Providing an additional incentive to reward exemplary performance provides additional incentives for the utility to continue to innovate, to continue to capture cost savings between rate cases that will inure to the benefit of customers in the long run. Competitive firms have these incentives in the market. As this Commission has recognized, what is good for the utility is, by extension, good for ratepayers in the long run. Dr. Porter forgets this regulatory dynamic in his zealous efforts to denigrate the regulatory process with a false comparison to the competitive market. Further, the ROE is not being granted in perpetuity. The Commission will revisit it at PEF's next rate case.

Q. Dr. Porter finds it unlikely that customers will benefit from the upward adjustment to ROE. Do you disagree?

A. I do disagree with Dr. Porter. First, customers have been benefiting from PEF's superior performance of beating the industry, other things equal, with a 12.7% per year cost savings. Second, customers will also continue to benefit if PEF is provided with the ROE adjustment I propose to both recognize superior past performance and provide a new incentive to continue to cut costs and develop new, innovative ways to do so. When shareholder, management, employee, and customer interests are aligned, as PEF has done and seeks Commission support to continue, it will be a win for Florida consumers and PEF's customers.

Q. At page 3 of his Direct Testimony, Mr. Chalfant asserts that it is not reasonable for PEF to request a reward for past performance. Do you concur?

A. No. As I set forth in my Direct Testimony, the ROE adjustment I propose will provide an incentive for PEF to continue its cost cutting efforts, which recognized superior performance and would provide ongoing incentives for achieving additional benefits to customers.

Q. Mr. Chalfant asserts that PEF had done no more than the minimum required, as evidenced by the fact that his associate Mr. Brubaker asserts that PEF has some of the highest rates in the region. How do you respond to that assertion.

A. Both Mr. Chalfant and Mr. Brubaker are wrong. In Section 2, I explained why Mr. Brubaker's comparison of PEF's prices to others throughout the Southeast region is flawed and biased because it omits relevant variables. I will not repeat those arguments here. Mr. Chalfant's reliance on Mr. Brubaker's analysis omits the same causal relevant factors and he introduces no credible evidence to back up his assertion that PEF has not performed in an exemplary manner. I again point to PEF's relative price performance compared to other utilities in the Florida peninsula.

Q. At page 4 of his Direct Testimony, Mr. Chalfant asserts that PEF is attempting to extract monopoly rents from its customers through the requested ROE adjustment. How do you respond to this allegation?

A. Mr. Chalfant is mistaken. PEF has no monopoly power. This Commission sets PEF's prices, investment, cost-of-service, and other important policies in a fair and balanced manner. PEF can not increase its profits by selling less and charging more. PEF is requesting an ROE, including the upward adjustment that I have recommended, which is below the ROE PEF is currently earning. PEF is proposing to reduce its current ROE. This is hardly an attempt to extract what Mr. Chalfant describes as monopoly rents. Indeed, the 12.8% ROE proposed would help PEF to continue to grow, add customers, to improve efficiency, and to perform in an exemplary and superior manner.

Q. Mr. Chalfant asserts that because a competitive market provides one-time incentives and rewards, that regulation should do the same. Please respond.

A. PEF is requesting, and I am proposing, the upward ROE adjustment both to recognize its past exemplary service, and as an incentive to continue to achieve even additional savings for its customers. The requested ROE is neither perpetual nor permanent. PEF realizes that unless it continues to provide excellent service and succeeds to continue to control and reduce costs, it may not be rewarded in the future. This is no different than a competitive firm with a good year that seeks to continue to succeed in the future. In fact, this Commission has also penalized poorly performing utilities with a reduced ROE. Thus, I conclude that the adjustment is quite similar to rewards offered in a competitive market to innovating firms. There is no guarantee of future success unless the business continues to work hard, as PEF will likely try to do.

Q. At page 6 of his Direct Testimony, Mr. Chalfant states that underlying your position is the "disturbing concept that PEF is entitled to all the profits that it can achieve." Does this concept underlie your support of PEF's adjustment to ROE?

A. No. I am not even sure what Mr. Chalfant is saying. If he is saying that I think PEF should be able to price its products as if it were an unregulated monopolist, I certainly would disagree. Under the regulatory regime in which PEF operates, it is entitled to a reasonable opportunity to earn its authorized rate of return. This is the underlying premise of regulation. There is nothing in my recommendation

that changes this. I am certainly not proposing that PEF be entitled to, as Mr. Chalfant so colorfully describes it, extract "maximum profit from its customers." Mr. Chalfant needs to be reminded that PEF negotiated a settlement with an annual $125 million revenue reduction savings for the past four years and is now proposing to reduce the authorized ROE to 12.8%, which is less than it is currently earning. This is hardly what I would describe as extracting maximum profit out of its customers.

Mr. Chalfant also argues that under cost-based regulation, PEF has reaped the benefits of its cost cutting by keeping the savings during the time period between rate cases (regulatory lag) and that this provides PEF with all the incentive it needs. As I have explained, utilities, like any business, typically use their cost savings to offset other costs that may be increasing prior to when they, or their regulators, increase retail prices to consumers. The trouble with Mr. Chalfant's concept of regulation is that he thinks that regulatory lag should provide the utility with all the upside it needs. The problem with Mr. Chalfant's view of the world is that, as he states at page 7 of his Direct Testimony, he wants to keep the period of regulatory lag where the utility would keep the costs savings to a "minimum" and would request that the Commission require "new rate proceedings whenever earnings exceed the allowed level..." This concept of many rate cases, even one a year, is not necessarily good regulation. Instead, periodic rate reviews with sensible incentives is often, as it is here, far superior. Draconian ratemaking such as suggested by Mr. Chalfant would, in my opinion, destroy much of the incentive that a utility would have to innovate and save costs

because as soon as it did so and its earnings exceeded its authorized ROE, Mr. Chalfant would support dragging it in to reset its ROE. This may be good for outside consultants. Nevertheless, I think that some sort of sharing method, whether it is a formal performance based or revenue sharing or one such as the ROE adjustment I recommend here provides much superior incentives to a utility to work over several years to perform well and cut costs.

Q. How do you respond to Mr. Chalfant's argument at page 6 of his Direct Testimony that PEF has simply met its side of the 2002 rate case settlement and that no more is required?

A. If PEF had simply met the goals established by the 2002 rate case settlement agreement, I might be more inclined to agree with Mr. Chalfant. But this is not the case. As Mr. Habermeyer testified in his Direct Testimony, PEF has exceeded the goals established in the 2002 rate settlement agreement. This is demonstrated further in Mr. Lyash's Direct Testimony by the extent to which PEF has improved service quality and reliability. Further, my own benchmarking shows that PEF's total costs are about $400 million per year less than what I would expect Total Costs to be for a similarly situated, efficient utility. This is performance that is superior, by any definition of the term superior, and warrants both current recognition and continued incentives in this proceeding.

Q. Mr. Chalfant at page 8 of his Direct Testimony asserts that you are opposed to passing cost saving benefits to customers. Please respond to his assertion.

A. Mr. Chalfant has totally misread my Direct Testimony and he ignores what PEF has done. I do support passing on cost savings benefits to customers. In fact, PEF has done just this by offsetting on-going cost increases since the last rate case as shown in PEF's Surveillance Reports and MFRs, and passing on $125 million annually in rate reductions under the 2002 rate case settlement agreement. There are many reasons, including hard work and success, why PEF has had such infrequent needs to increase its base rates. Since 2002, PEF explicitly has shared past savings with customers, and will continue to do so It is Mr. Chalfant who is greedy in my view. He wants to severely limit PEF's ability to share in the fruits of its efforts, instead he prefers to limit severely any regulatory lag, perhaps using annual rate cases to do so, eschew any formal incentive or sharing plan, and reward PEF with a rate rollback when it requires rate relief.

Q. Mr. Chalfant at page 8 of his Direct Testimony asserts that your proposal to add 50 basis points to PEF's ROE for superior performance lacks a "symmetric set of rewards/penalties." Do you disagree?

A. Yes. There is symmetry inherent in my proposal. Only superior performance would achieve the upward adjustment to ROE. Unless success repeats, the upward adjustment would be lost. The actions this Commission has taken in the past, where it has penalized utilities by reducing the authorized ROE for poor performance is an additional symmetric response.

Q. At pages 9-11 of his Direct Testimony, Mr. Chalfant dismisses your efforts in Wisconsin as not being "similar to what Dr. Cicchetti is proposing here." How do you respond?

A. Mr. Chalfant is setting up a straw person to knock down. Of course, the situation in Wisconsin about twenty-five years ago was different than the situation in Florida today. But the principle was the same: reward utilities that perform well, innovate, and cooperate with regulatory authorities with an upward adjustment to their ROEs. In my concurring opinion I stated that "...utilities which, either by managerial decision or regulatory obligation, achieve certain established targets benefiting the people of Wisconsin, should receive higher rates of return. Meanwhile, those utilities that do not perform as well will receive lower rates of return."[4] Perhaps the language in the Orders is not as explicit as Mr. Chalfant would like. However, I will remind Mr. Chalfant that I was there. I participated in the hearings and held discussions in open meetings with the Intervenors and utilities where I let my position be well known. My stated and well-known intent in Wisconsin was to provide positive, as well as negative, incentives in the form of adjustments to ROE for utilities to provide superior performance, and penalize laggards. I knew then, as this Commission realizes today, that keeping the utility healthy and adding properly incented benefits means that the customers will benefit. Mr. Chalfant's concept that this Commission should haul in PEF as soon as its earnings exceed its authorized ROE, no matter the reason, and yank away all excess earnings for the customers is short-sighted, wrong-headed, and directly

[4] *Application of Wisconsin Electric Power Company for Authority to Increase its Electric Rates,* 1979 Wisc. PUC LEXIS 45, (March 6, 1979).

inconsistent with recent Commission precedent. Mr. Chalfant wants to constantly reset and restart the game. This would be costly and, I believe, would not work as well as reasonable incentives in the form of rewards for superior performance.

Q. Mr. Gorman, at page 35 of his Direct Testimony asserts that your basis for rewarding PEF with an upward adjustment to its ROE for superior performance is "that it has not increased 'base prices' since 1993" and that you have ignored "important external factors that have played a significant role in reducing PEF's cost of service..." Please respond to Mr. Gorman's assertions.

A. Mr. Gorman focused on only the third reason I provided at pages 39 and 40 of my Direct Testimony, and even then he misinterpreted that. In my Direct Testimony I supported a 12.8% ROE because (1) consumers benefit when utilities are financially healthy; (2) other jurisdictions are encouraging sharing productivity benefits and consumers are benefiting; (3) there has been no rate increase since 1993 and in fact, over the past four years customers have received an annual $125 million rate decrease for these base rates; and (4) PEF is adding to its rate base, its dismantlement expenses have increased, and it needs to replenish its storm reserve. In short, PEF has capital needs and deserves rate relief, coupled with a modest upward ROE adjustment to keep it strong and highly motivated to continue to serve customers in an exemplary manner. Rewards and incentives are the American way. These are the grist that keeps our economy humming and the

best in the world. I have no doubt that consumer benefits will easily trump the added cost.

Q. What about the external factors touted by Mr. Gorman?

A. Mr. Gorman asserts that these external factors, primarily the reduction in capital costs, is largely responsible for avoiding rate increases and is beyond management's control. I disagree with Mr. Gorman's assertion. First, Mr. Gorman's mischaracterization of my testimony permits him to focus on only the lack of a rate increase since 1993. I explained above why this was but one factor in support of my support for PEF's requested 12.8% ROE. I also have explained that the same debt reductions apply to all 95 utilities in the Translog Model and PEF still outperformed the expected efficient utility estimate of Total Cost by 12.7%. Specifically, the Translog model shows that PEF has performed in a superior fashion with respect to reducing all inputs but fuel and purchased power, not just those associated with capital. Second, in order to avail itself of the reduced capital expenses, PEF had to achieve a certain level of financial stability. This does not happen by itself. PEF management accomplished this and needs rate relief to complete the job.

Third, I showed in my Direct Testimony that over five years (2002 to projected 2006), PEF's O&M expenses are up 5.64%, which is: (1) less than the CPI (inflation) of 7.34%; (2) less than customer growth of 8.67%; and (3) less than the increase in MWHs sold of 8.73%. In fact, these factors would, in some

fashion, be additive to each other. PEF's operating expense performance is simply very exceptional.

It is irresponsible for Mr. Gorman to imply that the savings associated with reduced finance costs would have happened regardless of how PEF was being operated. Mr. Gorman's assertion that avoided rate increases were due to merger savings and "not the result of superior management performance, but rather were created by the effect of the merger" is also patently absurd. Who does Mr. Gorman think was responsible for accomplishing the merger, for implementing the merger, and overseeing that the promised benefits were not only achieved, but exceeded? The answer, of course, is that these benefits, and using proceeds earned during rate cases to pay for customer growth, inflation, sales, growth, etc., is what PEF has done. PEF has a superior outcome as a direct result of management efforts, not the efforts of elves in the night.[5]

Q. Mr. Stephen Stewart testifies at page 9 of his Direct Testimony that AARP's position is that the Commission should deny PEF's request for an upward ROE adjustment. Please respond to his statement.

A. Mr. Stewart prefaces his testimony with the admission that he does not consider himself to be an expert on return on equity issues and that he is not offering an opinion as to the required ROE. Rather, at page 9, he offers AARP's opinion, even though that organization is also not an expert in these matters. Nevertheless, their "position" warrants a response.

[5] With all due respect to the Brothers Grimm.

Mr. Stewart observes that PEF has received an incentive for its past performance through its revenue sharing plan. This is true. But that plan is coming to an end. My proposal replaces the incentives provided under revenue sharing with new revenue requirements with a new incentive. If PEF continues to perform in a superior manner, future Commissions can determine the appropriate ROE.

Mr. Stewart avers that the Commission's "traditional equity awards are more than adequate to compensate the utility's shareholders, especially given the continuing reduction of risks they are exposed to." Mr. Stewart explains that "a very large percentage of their revenues are subject to 100 percent cost recovery through rates." Whether traditional equity awards are "adequate" is somewhat beside the point. I consider them typically to be the floor or a starting point because this is the *quid pro quo* for providing safe and reliable service. I propose that the Commission offer something more to reward PEF for superior performance and to provide incentives to PEF to maintain this high level of performance and cost cutting, efforts that will strengthen the utility and benefit the customer, a truly symbiotic relationship.

In addition, the pass-through of certain costs is always the subject of a prudence review in which there can be and often are disallowances of full recovery. Furthermore, some regulatory authorities like to mix pass-through mechanisms with cost-of-service regulation in order to focus their regulatory scrutiny on the parts of cost-of-service they deem the utility is best able to affect or control. In this combined fashion, regulators seek the greatest "bang" for their

regulatory "buck" because their efforts focus on things that are more amenable to incentives, performance, and scrutiny to alter outcomes. Further, PEF does not get the immediate recovery of its expenses. The storm expenses incurred in October 2004 offer a good example. The Company will not fully receive recovery of its allowed costs (only about 90% of its total storm-related costs) until 2007.

Mr. Stewart also fails to describe fully the risk faced by shareholders under various pass-throughs. Many of these are not fully automatic, but are subject to prudence review by the Commission, which often reduces the amount of dollars recovered. In the recent storm docket case, the Commission did not allow all costs that PEF sought to be passed through in a surcharge. The allowed cost recovery was about 10% lower than the costs that PEF claimed. I do not wish to reopen the nuances of that case here. Regardless, Mr. Stewart is mistaken when he thinks that there is a guarantee of full recovery. Therefore, there is risk to shareholders associated with approval and prudence hearings.

Q. At page 22 of her Direct Testimony, Ms. Sheree Brown argues that PEF's actions have not yielded $125 million in annual benefits to customers. Is this true?

A. No, it is not true. The inescapable truth is that for the past five years, PEF's customers have enjoyed base rates that reflect $125 million per year in reduced revenue requirements that were reached in the 2002 Settlement. That is the fact, notwithstanding Ms. Brown's assertion that these reductions were cost deferrals,

not savings. The fact is that customers have paid $125 million per year less since 2002 than the base rates that they had been paying and which were lower still than PEF's then cost-of-service filing would have supported. If PEF failed to perform, its shareholders would have paid for these reductions. Regardless, the customers benefited and PEF performed in a superior fashion.

Q. Does Ms. Brown dispute the fact that PEF has successfully reduced operating expenses?

A. No, she readily admits that "the Company has successfully reduced certain operating expenses." This is supported by the testimony submitted by various Company witnesses and buttressed by my own benchmarking analysis.

Q. At page 23 of her Direct Testimony, Ms. Brown claims that the $45.9 million in revenue sharing benefits received by PEF's customers is not attributable to PEF's cost-cutting efforts. Do you agree?

A. Ms. Brown misrepresents what I said. I never stated in my testimony that the revenue sharing benefits were attributable to PEF's cost cutting efforts. The revenue sharing plan was part of the 2002 rate case settlement agreement and was separate from the $125 million in rate requirement reductions that were attributable to cost savings

In addition, Ms. Brown asserts that the rewards of PEF's cost cutting efforts have "accrued to shareholders," not customers. Apparently, in Ms. Brown's world, all revenue associated with cost-cutting is earmarked for

shareholders while a portion of the revenue associated with customer growth and weather goes to customers through revenue sharing. Alas, in the real world, there is no such differentiation of the revenue stream and Ms. Brown cannot credibly make this argument. Ms. Brown ignores PEF's enviable record of holding base rates below inflation for twenty plus years, with no increases since 1993 and a reduction in 2002. The cold hard facts are that PEF entered a settlement in 2002 that pledged and provided to its customers both an annual $125 million rate reduction and worked to add an additional $45.9 million in revenue sharing benefits.

Q. At page 23 of her Direct Testimony, Ms. Brown disputes that your proposed ROE adjustment will provide an incentive to PEF to continue its cost cutting efforts. Please respond to her.

A. As I have said repeatedly, good regulation both recognizes good performance and provides incentives for utilities to continue cost cutting efforts. The ROE adjustment will provide such recognition, plus an incentive. This means that PEF will want to do everything it can to ensure that it will continue to receive this type of performance recognition from the Commission in the future, as well as future incentives. In essence, the adjustment replaces the revenue sharing mechanism that is expiring at the end of 2005. Thus, I disagree with Ms. Brown's assertion at page 26 of her Direct Testimony that a proposed 12.8% ROE will not change the directions of utility's incentives.

I have some employees who work under a specific formula for determining their quarterly bonuses. The metrics used are transparent, quantitative, and fairly rigid. I have other employees who I simply award a bonus for superior performance, which I know when I observe their contributions. There are no formulas and no guarantees. I am convinced that both approaches work. At times, I am troubled about potential formula gaming, or working in a fashion to achieve a number under the first approach.

I also worry that I may not always fully recognize the efforts that go into superior performance. I push myself to make certain that I do not take superior performance for granted. In a small but relevant way, what I do in my firm is a useful insight into what I am proposing for PEF. The Commission can adopt formulas, as have other regulators, to reward performance. Alternatively, the Commission can accept my recommendation and add 50 basis points to PEF's ROE. I am fully convinced that PEF will treat such recognition as a strong incentive to maintain and improve its superior performance status and will continue to beat expectations.

Further, the ROE adjustment I proposed will strengthen the company financially, which as this Commission recognized in the storm docket, is essential to providing ongoing and future benefits to PEF's customer. I cannot stress strongly enough my mantra when sitting as a commissioner: "what is good for the utility is good for the customer," especially a utility that is growing and adding infrastructure.

Q. Ms. Brown argues that regulatory lag between rate cases provides the utility all the incentive that is required. Do you agree?

A. No, I do not. This is especially so when there are Intervenors who will reflect Mr. Chalfant's clamoring for a speedy rate hearing as soon as the utility's earnings exceed its authorized ROE, no matter the reason for the increase. And that is precisely the problem that creates disincentives for the utility under cost-of-service regulation with frequent rate cases. I also believe that a utility that uses regulatory lag income to offset costs is quite different than one that simply seeks to enrich shareholders by pushing all gains into ROE during lags, and in the process, forces a new rate case sooner. PEF is not this sort of utility. PEF is a high performer and deserves recognition as such.

Q. At pages 27-28 of her Direct Testimony, Ms. Brown discusses the revenue sharing plan in effect for Georgia Power and attempts to distinguish that plan from the recommended ROE. Please comment.

A. To a certain extent, she is correct. The Georgia Power plan is a formal plan with a clearly established neutral band around a set ROE, and varying sharing allocations when earnings increase above the neutral band or fall below it. Ms. Brown's primary critique of my proposal is that, unlike the Georgia Power plan, the adjustment is one-sided. However, Ms. Brown fails to recognize, as I explained above for my different employee bonus approaches, that at PEF's next rate hearing, the Commission could, as it has done with other utilities in the past, impose a penalty and reduce authorized ROE if PEF fails to meet expectations.

This provides the symmetry along with the others I discussed above that Ms. Brown finds lacking. Thus, I conclude that her concerns are not valid.

Q. Ms. Brown asserts at page 25 of her Direct Testimony that because a large percentage of PEF's total operating costs are covered by cost recovery clauses and adders, that the incentive to reduce costs is reduced and risk is reduced. Please comment.

A. What Ms. Brown fails to take into account is that many of the largest pass-throughs, such as fuel and storm costs, are subject to prudence reviews by the Commission. If costs are found to be excessive or inappropriate, those costs will not be passed through to customers. The threat of a prudence review and potential disallowance, coupled with Surveillance Report monitoring, gives the Commission a great deal of authority to protect customers. It also provides the necessary incentives for PEF to keep costs down. This regulatory approach does not eliminate or reduce risk to the level implied by Ms. Brown. Moreover, this Commission has crafted a regulatory regime in which it focuses much of its attention on base rates. Utilities do not have guaranteed returns. They do not control world energy markets, the financial markets, or mother nature. PEF has real risks *and* a duty to serve. That said, PEF has also been and seeks to remain a superior performer.

Q. At page 4 of his Direct Testimony, Commission Staff witness Mr. Sidney W. Matlock avers that PEF's performance since 2000 or 2001 in the area of

distribution reliability does not warrant adding 50 basis points to its ROE as you have recommended. Please respond to this assertion.

A. First, my recommendation to add 50 basis points to PEF's ROE was not based solely on how PEF had performed with respect to the three measures of distribution reliability (SAIDI, CAIDI, and SAIFI) that Mr. Matlock analyzes in his Direct Testimony. Rather, I based my recommendation on several factors. These include the recent improvements that PEF has made in attaining merger related synergies and implementing cost cutting measures. Included within my analysis were the distribution reliability indices on which Mr. Matlock focused. I also compared PEF's actual cost performance for the three years 2001 to 2003 to the electric industry's performance. I showed that PEF's costs were nearly $400 million per year less than expected based on the industry model.

I also based my conclusion and recommendation on customer satisfaction survey results, improved employee safety, reduced residential base rates, reduced installation costs for new services, an FPSC report that stated that PEF had improved on seven of eight performance metrics, impressive transmission reliability, better than national average fossil steam unit availability, low forced outage rates, high ranking nuclear units, etc. In nearly all these criteria, PEF performs very well, which Mr. Matlock ignores. I realize that Mr. Matlock specializes in distribution reliability, but my recommendation was based on far more than the three distribution related reliability metrics he analyzed.

Q. Nevertheless, Mr. Matlock does not seem to be overly impressed with PEF's

improvement in the three areas of distribution reliability that he analyzed. Do you share his assessment of PEF's performance?

A. No, I do not. Mr. Matlock's analysis begins in 1992 and compares the three distribution reliability indices over time. Other than to include one year (1993) that is rather a statistical anomaly, during which PEF had unusually low numbers for the three reliability metrics, I cannot imagine why Mr. Matlock wanted to analyze 11 years of data. Reviewing the period subsequent to 1993 shows a decade of PEF improvement. For example, consider a child that had a great second grade report card. I would certainly be impressed by ten or so years of constant improvement up through high school graduation and I would be less focused on what might or might not have happened in the second grade.

Mr. Matlock states in his Direct Testimony that, with the additional nine years of data, "one may approximate changes in performance since 1992, and see the recent changes in a clearer context." I do not know what he means by this. There is no need to "approximate" changes in performance; the data speaks for itself. As far as seeing recent changes in a clearer context, I do not see how PEF's performance 11 years ago is particularly relevant to analyzing whether PEF has been meeting its recent performance targets, which it has done. I would focus on a decade of improvement, not one distinct year.

Q. At page 4 of his Direct Testimony, Mr. Matlock lists three "revealing" things about the PEF's 2004 levels of SAIDI, CAIDI, and SAIFI. Please comment on Mr. Matlock's revelations.

A. Mr. Matlock's first point is that greater improvements were achieved in "earlier periods" than over the years 2001 through 2004. Mr. Matlock does not define with any clarity what this earlier period is. Nevertheless, let's assume that his earlier period begins in the year that the reliability metrics were at their highest (*i.e.,* worst levels). Without question, Mr. Matlock is correct that all three distribution reliability metrics improved more between 1995 (1996 for SAIDI) and 2000 than they did from 2001 to 2004. This is understandable. During the earlier period, PEF was able to make greater improvements picking the low hanging fruit. As SAIDI, CAIDI, and SAIFI scores improved, it became progressively harder and harder to improve. Nevertheless, PEF did continue to improve, as Mr. Matlock admits. For example, consider SAIDI scores. In 1996, PEF's SAIDI score was 130.42. By 2000, it had dropped to 100.60, a drop of almost 30, or a 23% decrease from the 1996 score of 130.42. In 2001, PEF's SAIDI score was 89.70 and by 2004 had dropped to 77.00. This is a decrease of 12.7, representing a 14.1% decrease from the 89.70 posted in 2001. As Mr. McDonald stated in his Direct Testimony, this is a very strong industry performance.

One can always manipulate the numbers by choosing a starting date from which to measure the change. If we were to begin measuring the improvement of SAIDI for the period 1992 (the beginning of Mr. Matlock's data) to 2000, one would see that SAIDI in 2000 (100.60) was virtually identical to the SAIDI in 1992 (103.89). Measured against that earlier time period, PEF's performance in the 2002 through 2004 time period is outstanding.

What is important is that for the most recent, and therefore most relevant period, PEF has performed in an exemplary fashion in reducing its SAIDI, CAIDI, and SAIFI scores. Mr. Matlock does not dispute that PEF's distribution reliability metrics have improved during this period.

This is simply like the student that jumps from a "C" to and "A." After that, moving to an "A+" may be more difficult. When improvement is accomplished, as PEF has done, it should be recognized.

Q. Mr. Matlock's second point is that the "2002 through 2004 improvements were a continuation of improvements that began in 1995 or 1996 following sharp declines in performance after 1993." Please comment.

A. I agree with Mr. Matlock. PEF has sought to continually improve and has succeeded, even as it gets more difficult to make incremental improvements in what is already excellent service quality that is well thought of by its customers and is a strong industry performer. PEF should be rewarded for its efforts to continually improve its distribution service quality and reliability. I cannot imagine why Mr. Matlock is criticizing steady improvement in distribution reliability over an almost ten-year period.

Q. Mr. Matlock's third point is that little overall improvement has taken place over the entire period between 1992 and 2004. Please comment.

A. Again, the numbers contained in Mr. Matlock's Exhibit No. __ (SWM-1) show that this is not true. For example, Exhibit No. __ (SWM-1) shows that SAIDI has

dropped to 77.00 from 103.89, almost a 26% decrease from the 103.89. That indicates to me a substantial improvement over the entire period.

Of course, I realize that Mr. Matlock's point is that if we look at the decrease from 1992 to 1993 and compare the 1993 number (78.55) to the 2004 number (77.00), there has not been much of a decrease. This analysis, however, reveals very little useful information. One could just as easily arbitrarily pick the SAIDI from 1996 (130.42) and compare that to the 2004 number (77.00) and tout the incredible job PEF has done in improving distribution reliability. Of course, this would be as meaningless as what Mr. Matlock did. My point is that between 2002 and 2004, the only relevant time period, PEF has undeniably reduced its numbers for SAIDI, CAIDI, and SAIFI.

More important, as I stated above, I did not base my recommendation to add 50 basis points to PEF's ROE solely on its improvement in its distribution reliability. These improvements made up only a part of the reasons behind my recommendation. Nothing in Mr. Matlock's testimony should dissuade the Commission from awarding PEF an additional 50 basis points to its ROE for its outstanding performance.

Q. Have you reviewed the ROE recommendations made by the various Intervenor Witnesses?

A. Yes. Mr. Rothschild is recommending an ROE of 9.1%, Mr. Gorman is recommending an ROE of 9.8%, Dr. Porter states that "an appropriate return on

equity for PEF is less than 9 percent", although he does suggest that 10% is an upper bound, and Mr. Stewart adopts Public Counsel's 9.1% recommendation.

Q. How do these ROE recommendations compare to ROEs that have been recently been granted across the country?

A. The ROE recommendations from the Intervenor witnesses are shockingly low. Regulatory Research Associates (RRA) publishes a summary of major rate case decisions. The latest version covers the period January 1990 through December 2004, and reports more than 700 cases where an ROE was authorized. Of these, one base rate proceeding for Jersey Power & Light (Final Order for Docket No. ER02080506, issued May 17, 2004) provided for an ROE of 9.5%. However, if the utility resolved certain reliability issues, its ROE could increase to 9.75%. I found two additional cases out of more than 700 where the authorized ROE was set at 9.75%[6]. Both utilities were located in New Jersey, a state where the electric industry has been restructured, generation divested, and a periodic state level generation auction established. Florida is <u>not</u> like New Jersey. I conclude that Intervenor witnesses' ROE recommendations are far too low based on what virtually every other regulatory decision reported in RRA found to be a just and reasonable ROE. In addition, PEF is significantly growing, adding new generation, and is a strong industry performer. PEF should be authorized an ROE of 12.8%.

[6] PSE&G, Docket No. D-ER-02050303 (July 9, 2003); Rockland Electric, Docket No. D-ER-02100274 (July 16, 2003).

IV. OTHER FLAWED ARGUMENTS MADE BY INTERVENOR WITNESSES

Capital Structure

Q. Beginning at page 9 of his Direct Testimony, Mr. Rothschild argues that PEF's capital structure should be the same as its parent company. Do you agree?

A. No. Mr. Rothschild seemingly ignores one of the important reasons why Progress Energy's (the parent company) capital structure contains almost 58% debt. He should recall that the parent company's capital structure reflects the cost associated with the merger. As I testified in 2002, the merger synergies that provide customers with annual savings that yielded a settlement worth $125 million per year for PEF's customers did not come without a cost. The costs to achieve the merger were borne by the parent company in increased debt. This debt will be repaid to the parent through dividends paid by PEF to Progress Energy.

Mr. Rothschild's approach conveniently looks at only one side of the equation; the merger savings and ignores how these were paid for at the parent company level. The transaction costs necessary to achieve the merger were real. The resulting cost savings were also real. It is not reasonable to use this resulting thick debt percentage and to all too conveniently overlook the fact that PEF's dividends to Progress Energy will repay the costs expended to achieve the synergy benefits. Mr. Rothschild's proposed capital structure coupled with his low ROE recommendation would severely hamper the utility's ability to pay for these merger related costs. This would be unjust and unreasonable because it

would falsely support the notion that there are "free lunch" merger benefits that can be had without cost.

Q. At page 22 of his Direct Testimony, Mr. Rothschild disagrees with your statement that as the debt-to-equity ratio increases, the return on debt will begin to increase as bond ratings are lowered, increasing overall rate of return; and that the financial risk of firm is higher as debt-to-equity ratio increases. Please respond to his criticism.

A. Mr. Rothschild admits that my statements may be true for a stand-alone entity. For a wholly-owned subsidiary such as PEF, Mr. Rothschild contends that rating agencies will not consider PEF's equity ratio when setting bond ratings, but will consider only the equity structure of PEF's parent company. This is definitely not true for mortgage-backed debt, which is often used to finance infrastructure. Mr. Rothschild's assertion that rating agencies are unconcerned with the debt-to-equity structure of the regulated utility subsidiary that has pledged to repay debt is unfounded. He offers no support for his bald statement that it is only the parent company's capital structure that matters. Ironically, Mr. Rothschild's (and others') draconian ROE recommendations in this case would make it virtually impossible for PEF to dividend sufficient amounts to the parent company to reduce the debt portion of its capital structure. This would create a Catch-22 where Progress Energy can never improve its bond rating because PEF will be limited in the amount it can dividend up to its parent to reduce the parent's, and in Mr. Rothschild's view PEF's, cost of debt. None of Mr. Rothschild's

recommendations would benefit customers in the long-run as the Company's bond rating would decline, its cost of debt would increase, and customers would pay more for energy.

Q. At pages 22-23 of his Direct Testimony, Mr. Rothschild attempts to justify his recommended lower equity percentages in PEF's capital structure by arguing that passing on all storm damage costs to ratepayers reduces risk for shareholders, and lower risk justifies higher debt ratios. Please respond to Mr. Rothschild's contention.

A. First, I must take exception to Mr. Rothschild's characterization that PEF recovered all its storm damage cost. What PEF will recover over two years is the storm damage cost recovery approved by the Commission. In the recent storm damage docket, PEF's actual recovery was not 100%, but closer to 90%, and there have been deferrals of recovery. While a substantial percentage has been approved, it is not the 100% claimed by Mr. Rothschild.

In fact, the Commission pushed about $54.9 million into a capital account potentially to be recovered in this rate case. In addition, the Commission disallowed about $26.3 million in O&M expense recovery. Further, the Commission recognized these deferrals and disallowances combine to reduce PEF's 2004 ROE from 13.48% to 12.66%, or a loss of 82 basis points in shareholder value. Without reopening the storm recovery case, this is not a 100% recovery of storm costs.

Forcing shareholders to pay for and to defer collections with or without a return on the prudently incurred costs related to the four hurricanes that devastated PEF's service territory in 2004 does not reduce risk to shareholders to the extent implied by Mr. Rothschild. On-going prudence reviews also increase uncertainty and add to shareholder risk.

PEF did not receive an automatic pass through of these storm related costs. Rather, it underwent a time-consuming and contentious hearing on whether its expenditures were prudent and incremental. PEF was, consequently, at risk if the Commission had decided that certain of the costs were not prudent. Lost in the shuffle were the more than $11 million in sales PEF lost as a result of these storms. Shareholders have eaten storm costs for a variety of reasons. Thus, I disagree with Mr. Rothschild that storm damage risk was eliminated for the past storm.

Q. But did not the Commission itself state that shareholder risk was reduced because of the storm damage recovery clause?

A. The Commission did state in its order that it would be cognizant of the fact the ratepayers bear the risk of storm damage recovery when it determined the Company's ROE in this proceeding. However, the Commission also recognized that it retained its authority to review the prudence and reasonableness of the charges incurred, including whether specific charges were properly allocated to the storm damage reserve. This also adds an element of uncertainty to the storm cost recovery. Importantly, the Commission also observed that it continues "to be

supportive of the financial integrity of PEF and, by extension, the long-run interests of its ratepayers."[7] My point is that if the Commission follows Mr. Rothschild's recommendations with respect to PEF's capital structure and ROE, PEF would be severely harmed, and by extension, the long-run interests of its ratepayers would suffer.

Further, the Commission is actually addressing ratepayer risk, more than shareholder risk, when it increases the storm reserve. This is because storms are uncertain and potentially costly. The Commission, in effect, has recognized the 2004 storms as a potentially new source of future ratepayer uncertainty. Spreading legitimate ratepayer costs over many years, such as building up reserves in years with less storm damage than the amounts collected for storm reserves, seems like a better regulatory approach to insure customer pricing stability and a greater degree of ratepayer certainty than waiting to recover all future "big storm" costs in the two years or so subsequent to when the storms occur. At the very least, smaller volume customers would seem to prefer this Commission-approved insurance approach rather than to be forced to pay temporarily higher rates when the next severe storms hits and PEF's customers have their own storm costs as well.

CWIP.

Q. At page 25 of his Direct Testimony, Mr. Larkin states that Construction Work in Progress (CWIP) should not be included in rate base. Do you

[7] In re Petition for approval of storm cost recovery clause for recovery of extraordinary expenditures related to Hurricanes Charley, Frances, Jeanne, and Ivan, by Progress Energy Florida, Docket No. 041272-EI, Order No PSC-05-0748-FOF-EI (July 14, 2005).

concur?

A. No. Mr. Larkin's point of view is short-sighted and will, in the long-run cost consumers more in terms of higher consumers' revenue requirements. Historically, there was a long debate about whether CWIP should be included in rate base. That debate, I had thought, was previously settled and CWIP had been found to be better for consumers than AFUDC.

Mr. Larkin in this proceeding is clearly anti-CWIP. He is, however, ambiguous when it comes to the alternative (AFUDC), which is most often used when construction schedules, as they are here, are mostly longer than one year. PEF's CWIP balance has about $145.8 million in generation related dollars alone according to PEF's MFRs (Schedule B-13).

After dismissing CWIP, Mr. Larkin proceeds to discuss AFUDC as an alternative. On page 30, lines 6-7, he states that the Commission "may require the accrual of AFUDC." Here, Mr. Larkin appears to remove CWIP, but remains silent on future AFUDC recovery. I will discuss why CWIP is more preferable for consumers than AFUDC. I also think that this Commission, despite Mr. Larkin's ambiguity, should continue to recognize that carrying costs during construction are real and part of the just and reasonable cost recovery of prudent investment costs.

In essence, when a utility is building a generating plant or transmission line, the cost of the asset will be placed into rate base when the plant is placed in service, or is considered "used and useful." While the asset is being constructed, the utility will incur financing charges on the money it borrows to construct the

asset. If CWIP, or the carrying cost during construction that may spread over several years, is not permitted to be recovered, the constructions costs, along with these carrying costs incurred during construction, are added to rate base in the form of AFUDC when the project is placed into service. This increases the amount on which the utility may earn a return and recover depreciation over the life of the facility. If CWIP is permitted in rate base, the utility will earn a current return in rates on the funds used in construction. The effect is beneficial to both the utility and its ratepayers because, as a rule of thumb, each one dollar deferred and added to rate base, costs customers about three dollars in higher future revenue requirements.

Q. How is it beneficial?

A. CWIP is beneficial to the utility in that it helps the utility to maintain its financial integrity. PEF is facing strong customer growth and must undertake substantial construction projects to meet this growth and new environmental requirements. In determining whether to include CWIP in rates, the Commission should consider things like slippage in coverage, the need for outside financing, and the quality of earnings. These things all tip the scales in favor of allowing CWIP in rate base. It is simply less costly to pay now when it can be affordable to do so than paying much more later. The utility benefits because allowing CWIP increases the certainty of recovery, provides cash flow to support the construction, and reduces the need to borrow more debt and/or raise more equity.

Q. How do ratepayers benefit?

A. Ratepayers benefit because, even though they pay somewhat increased rates in the early years of the project, costs are significantly reduced in later years. If, as Mr. Larkin recommends, the finance charges are added to the cost of the asset, when the asset is eventually placed into rate base, it will be more expensive for the ratepayer than if it were gradually placed into rate base under CWIP. By spreading the costs over the construction period and the life of the facility, the effect on rates is minimized and, as I explained, the rule of thumb is about three dollars in the out years less than when CWIP is collected in the current year.

Q. Please explain why CWIP is less expensive for ratepayers.

A. By delaying the collection of interest expense to some future date under AFUDC accounting, customers will likely pay for both a return of and on the AFUDC at future rates of return. There is little doubt that the future revenue requirements will increase as both the rate base and quite likely the underlying authorized rate of return on rate base are increased with higher future finance costs than today's low interest charges by delaying and capitalizing the collection of interest during the construction period.

In the long-run, Mr. Larkin's argument to prohibit CWIP would increase ratepayer costs. Additionally, CWIP allows the cost of the project to be absorbed through a series of small rate increases. AFUDC results in an increased project cost and a large rate increase when the project is placed in rate base. Disallowing cost recovery of real carrying costs would be the worst outcome because it would

undermine a utility's financial integrity and strength, forcing consumers to pay dearly. The choice is between "pay now" or "pay more later." I think that the pay more later approach advocated by Mr. Larkin harms both the utility and the ratepayer and should be rejected.

Q. Does this come down to a question of customers' discount rates and intergenerational equity?

A. Yes. These are both important, but mostly separate matters. Construction often takes time and any deferral of finance costs is a real cost. The fact is that it is simply cheaper to pay sooner than to finance the deferral of prudent cost, or worse simply wishing them away.

This raises the intergenerational issue and the related "used and useful" standard. Consumers today are often people building homes, adding to them, adding to their families, and working, building, and expanding their businesses. All of these current activities require electricity now and in the future. Few consumers would accept a deal where power was here now, but it may not be available in the future without some form of rationing.

Of course, PEF plans and builds ahead so that there will not be any future rationing. This means that customers today benefit from prudent investments under construction. Customers today, in effect, benefit because PEF plans and builds for future needs. There is no free lunch here. Current customers benefit, "use", and find "useful" PEF's plants, transmission, and distribution when these assets are under construction.

Once this is recognized, we can and should embrace the mantra that it is cheaper to pay now, rather than later.

Q. Please explain the logic you use to conclude that an asset can be used and useful before it is placed in rate base?

A. In a very real and important sense, current construction being undertaken by PEF represents a used and useful investment for today's customers, who either care about tomorrow for themselves, the value of their current estates and property, or for their children and heirs. It is today's level and pattern of use that causes a utility to need to add capacity. Current customers are responsible for this growth just as surely as the "newcomers." This is a fundamental economic principle. To allocate otherwise is to practice a vintaging form of price discrimination.

It is also the case that "not building" today would cause problems for present and future customers who would both expect reliable and relatively affordable service tomorrow, and the next day, etc. Postponing the news that today's use is causing tomorrow's plants to be built today encourages greater use today, more construction, and higher prices tomorrow. The latter is directly related to AFUDC accounting, increased financial risks, reduced cash flow/quality of earnings, and increased growth in sales.

Q. Why is this important for PEF?

A. PEF is a utility faced with a rapidly expanding customer base that will require substantial new investments in the near future in generating plants, transmission,

and distribution. Additionally, environmental upgrades are required under federal law. If CWIP is not permitted, PEF will be responsible for the carrying charges on these investments until the projects are placed in rate base. This will put financial pressure on PEF, and ultimately will cause customers to pay more for the plants than they would have if the carrying charges had been phased into rate base during construction through CWIP.

Q. At pages 50-51 of her Direct Testimony, Ms. Brown recommends removing $82.1 million in CWIP from rate base. Please respond to her recommendation.

A. Ms. Brown bases her recommendation solely on the fact that PEF can maintain the EBIT times interest coverage necessary for an A rating even when CWIP is removed from rate base. Thus, reasoning that CWIP is to be included in rate base solely to maintain the utility's financial integrity, Ms. Brown concludes that it is not necessary to include the $82.1 million in CWIP. As I discussed above in response to Mr. Larkin, this is a short-sighted approach. There are more factors than financial integrity in play with CWIP. Most important is how customers will be required to pay for the "real" construction period finance costs. Removing the $82.1 million in CWIP will, as Ms. Brown correctly notes, have the short term effect of reducing PEF's revenue requirement. However, in the long-run, ratepayers will pay more for the assets that are eventually placed into rate base, as well as more for PEF's financial costs. In fact, the rule of thumb for IOUs is about $3 more for each $1 deferred for a 30-year cost recovery. More would be

added here if PEF's debt is also downgraded. These are bad things for customers. Consequently, Ms. Brown's recommended adjustment to CWIP should be rejected.

V. CONCLUSION

Q. Please state your conclusions.

A. My conclusion and opinions remain the same as stated in my Direct Testimony. I restate them here. First, it is crucial that PEF's outstanding job since the merger in achieving merger related savings and other cost cutting efforts that make PEF a superior performer be recognized. The effects of these efforts are demonstrated by both the internal and external statistical benchmarking analyses. PEF has improved when measured against its pre-merger performance or against its peer companies across the nation. This effort continues and PEF should receive both recognition and incentives to finish the tasks ahead.

Customers have already reaped the benefits of the merger through a settlement in 2002 that yielded a $125 million annual base rate reduction. Customers also received $45.9 million in revenue sharing benefits. PEF needs rate relief now primarily to account for new customer requirements, including generation being placed in rate base and to restore and expand the storm reserve fund. Both will yield consumer benefits. I find the Intervenor witnesses improperly try to ignore the savings already provided to ratepayers. Worse, their collective testimonies would, in effect, penalize PEF for building new generation, improving reliability, and adding customers. More importantly, Intervenor

witnesses seem to "forget" about the costs that were incurred by Progress Energy that enabled PEF to achieve these merger related savings for its customers. These transaction costs need to be repaid. This would enable the parent company to reduce its debt and improve its debt equity structure, improving its ability to improve its bond rating, which Intervenor witnesses think would improve PEF's ability to improve its bond rating. I remain firmly convinced that this Commission should continue to provide appropriate incentives that encourage PEF to continue its exemplary cost cutting such as establishing PEF's ROE at 12.8%. Similarly, the Commission should be applauded for its recognition that a financially strong PEF will, by extension, inure to the long-term benefits of ratepayers. In addition, there should be explicit recognition that building more generation, improving infrastructure, and reducing future price volatility risk by expanding the storm reserve fund all benefit consumers. These benefits exceed the costs. However, these are real costs and PEF needs rate relief to achieve these and other benefits.

With that overarching policy matter firmly in mind, I conclude that the 12.3% ROE recommended by Dr. Vander Weide is a reasonable floor, to which the Commission should add 50 basis points to reward PEF for its superior performance and encourage PEF to continue its efforts. Thus, I conclude that an ROE of 12.8% is appropriate.

Further, in keeping with the general regulatory flavor of providing an incentive for the Company to continue along its current path, I support Dr. Vander Weide's recommended 45/55 debt to equity ratio. Further, I conclude that PEF's

approach to include purchase power costs as part of the debt component should be implemented here because these costs are analogous to debt that would be incurred if PEF financed and built power plants to provide the power received under these purchase power contracts.

It is important to keep in mind the fact that PEF is located in a traditional state that has eschewed deregulation. As my statistical analysis demonstrates, PEF is a superior performer with respect to cost levels and also needs to invest in infrastructure to serve its expanding, primarily residential, customer base. PEF, as others have shown, has also improved the quality of its service and its reliability performance. PEF should be rewarded with an authorized ROE at the higher end of the range of reasonable ROEs. Further, PEF's superior performance should be recognized by adding 50 basis points to the ROE authorized by the Commission. This should be coupled with a 45% debt, 55% equity capital structure.

By doing these forward looking things, the Commission can help ensure that PEF is able to attract capital at reasonable prices to finance its infrastructure improvements. By so doing, the Commission will be providing long-term customer benefits that will last 30 years or longer. Such regulatory treatment will also ensure that savings associated with the merger, other cost cutting benefits, and safety and reliability improvements will continue to be made. In adopting such a reasonable regulatory treatment, the Commission will provide benefits to both customers and shareholders, a symmetry that is required for the continued success of the Company and the welfare of its customers.

Q. Does this conclude your Rebuttal Testimony?

A. Yes.