# BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

**In Re: Petition on behalf of Citizens of the State of Florida to require Progress Energy Florida, Inc. to refund to customers $143 million**

**DOCKET NO. 060658**
**Submitted for filing: January 16, 2007**

# DIRECT TESTIMONY OF STEVEN M. FETTER ON BEHALF OF PROGRESS ENERGY FLORIDA


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**IN RE: PETITION ON BEHALF OF CITIZENS OF THE STATE OF FLORIDA TO REQUIRE PROGRESS ENERGY FLORIDA, INC. TO REFUND CUSTOMERS $143 MILLION**

**FPSC DOCKET NO. 060658**

**DIRECT TESTIMONY OF**

**STEVEN M. FETTER**

## I. INTRODUCTION AND QUALIFICATIONS

**Q: Please state your name and business address.**

A. My name is Steven M. Fetter, and my business address is 1489 West Warm Springs Road, Suite 110, Henderson, NV 89014.

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

**A.** I am President of Regulation UnFettered, an energy advisory firm I started in April 2002. Prior to that, I was employed by Fitch, Inc. ("Fitch"), a credit rating agency based in New York and London. Prior to that, I served as Chairman of the Michigan Public Service Commission ("Michigan PSC").

**Q. Please describe your service on the Michigan Public Service Commission.**

**A.** I was appointed as a Commissioner to the three-member Michigan PSC in October 1987 by Democratic Governor James Blanchard. In January 1991, I was promoted to Chairman by incoming Republican Governor John Engler, who reappointed me in July 1993. During my tenure as Chairman, timeliness of commission processes was a major

focus and my colleagues and I achieved the goal of eliminating the agency's case backlog for the first time in 23 years.

**Q. Please briefly describe your role as president of Regulation UnFettered.**

A. I formed a utility advisory firm to use my financial, regulatory, legislative and legal expertise to aid the deliberations of regulators, legislative bodies, and the courts, and to assist them in evaluating regulatory issues. My clients include investor-owned and municipal electric, natural gas and water utilities, state public utility commissions and consumer advocates, non-utility energy suppliers, international financial services and consulting firms, and investors.

**Q. Please briefly describe Fitch's business during your tenure there.**

A. Fitch is the third largest full service credit rating agency in the United States – after its two major competitors, Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's") — and the largest European rating agency. Like S&P and Moody's, Fitch performs credit ratings of corporate obligations, asset-backed transactions, and government and municipal debt. Bond ratings represent the rating agencies' independent judgment based upon financial data provided by the bond issuer as well as additional quantitative and qualitative information gathered from third-party sources.

**Q. What was your role during your employment with Fitch?**

A. I was Group Head and Managing Director of the Global Power Group within Fitch. In that role, I served as group manager of the combined 18-person New York and Chicago utility team and was also responsible for interpreting the impact of regulatory,

legislative, and political developments on utility credit ratings. I was employed by Fitch from October 1993 until April 2002. In April 2002, I left Fitch to start Regulation Unfettered. Shortly after I resigned, Fitch retained me as a consultant for a period of approximately six months.

**Q. Was there any aspect of your experience at the Michigan PSC that particularly relates to your testimony in this proceeding?**

A. Yes. During my six years at the Michigan PSC, my colleagues and I sought to effectuate policies that were fair to all stakeholders and which would encourage regulated utilities to provide customers with reliable utility service in a cost-effective manner. We also sought to ensure that the financial health of the state's utilities would remain sufficient for them to be able to provide reliable service to all consumers, and also that investors would maintain their interest in providing necessary funding on a timely basis upon reasonable terms.

Achieving these goals requires regulators to successfully strike a difficult balancing of interests. Investors provide financing to a utility so that company management can construct and maintain infrastructure adequate to ensure that customers will receive reliable service. In return, regulators must take timely action to provide an appropriate capital markets-based return to investors along with providing reimbursement of company expenditures that are prudently made. A failure to carry out these regulatory responsibilities in a consistent and predictable manner will ultimately be detrimental to both investors and customers, as investors will choose to take their funds elsewhere. Similarly, a regulatory or legislative determination that a utility should financially support certain public policy mandates without receiving timely recovery for

prudent expenditures made in those efforts would undoubtedly lead investors to look to other jurisdictions where they believe their investments will be treated more fairly.

I believe that the circumstances surrounding my regulatory and utility rating experience that I have described above are relevant to the issues before the Florida Public Service Commission ("Commission" or "FPSC") in this proceeding, and I will further elaborate upon these points within the remainder of my testimony.

**Q. Please describe your other prior professional experience related to the utility industry.**

A. During my time on the Michigan PSC, I served as Chairman of the Board of Directors of the National Regulatory Research Institute ("NRRI") at Ohio State University, the regulatory research arm of the 50 state and District of Columbia public utility commissions. In 2003, I was appointed by the President of the National Association of Regulatory Utility Commissioners ("NARUC") to serve as a public member of the NRRI Board – the 20-member governing board includes ten state public utility commissioners. I was reappointed to the NRRI Board for a three-year term in June 2005. I also have served on the Keystone Center Energy Board (a nonprofit public policy board that brings together diverse stakeholders related to the regulated utility industry as well as appointed and elected federal and state policymakers to discuss challenges facing the sector), after having participated in the Keystone Center Dialogues on Financial Markets and Energy Trading and on Regional Transmission Organizations. In February 2002, I was appointed to the Board of Directors of CH Energy Group, Inc. ("CHG"), the parent company of Central Hudson Gas & Electric in Poughkeepsie, New York. I currently serve as Chairman of the CHG Governance and Nominating

Committee, having previously served as Chairman of the Audit Committee and the Compensation and Succession Committee.

**Q. Have you previously sponsored testimony before regulatory and legislative bodies?**

A. Since 1990, I have on numerous occasions testified before the U.S. Senate, the U.S. House of Representatives, the Federal Energy Regulatory Commission ("FERC"), and various state legislative and regulatory bodies on the subjects of credit risk within the utility sector, electric and natural gas utility restructuring, utility securitization bonds, fuel and purchased power and other energy adjustment mechanisms, and nuclear energy. I have previously filed testimony before the FPSC on behalf of Florida Municipal Power Agency, JEA, Reedy Creek Improvement District and City of Tallahassee in support of their application for approval of the Taylor Energy Center in Docket No. 060635.

My full educational and professional background is attached in PEF Exhibit No. _____ (SMF-1).

## II. SUMMARY

**Q. What is the purpose of your testimony in this proceeding?**

A. My testimony responds to the petition filed by the Florida Office of Public Counsel ("OPC") seeking an order from the Commission that Progress Energy Florida, Inc. ("PEF" or "Company") should refund to customers approximately $143 million, representing allegedly excessive fuel cost recovery charges and related costs associated with its coal purchasing dating back eleven years. My testimony does not address the factual assertions in OPC's Petition or the testimony of Mr. Sansom.

My testimony addresses, and seeks to be helpful to the Commission, concerning: (a) the appropriate standard, as a matter of regulatory policy, that a regulatory body should apply in analyzing such a petition; (b) the importance that the investment community attaches to regulatory finality and certainty in the recovery of fuel costs; (c) the potential impact on utility cost of capital, and ultimately utility rates, that a departure from those basic principles would produce; and (d) when and subject to what exceptions the recovery of fuel costs should be treated as final as a matter of regulatory policy. My opinions are drawn from my background as both a state utility regulator and as a former member of the financial community arriving at independent credit ratings for utilities' bonds and other financial investments.

**Q: What are the standards that you believe are appropriate in this case as a matter of regulatory policy and why?**

A: There are number of concepts which, within this proceeding, I see as being connected.

First, it is a widely-accepted, historic regulatory principle, as well as the practice of utility commissions around the country, that judgments made by a utility's management should not be deemed imprudent if, at the time they were made, they fell within a range of reasonable business judgments. This is so even if the regulator believes it would have made a different decision. Regulators should not substitute their judgment for that of utility management so long as the judgment of management was within a range of reasonable business judgment at the time the judgment was made.

The various public service commissions around the country do not manage the utilities they regulate. That is neither their role nor do they have the time and

resources to do so, even if they wished to. In addition, and even more fundamentally, there is usually no single "right" business judgment on an issue. Management decisions in complex areas are rarely "black and white." Rather, there is a range of decision-making that prudent, equally-informed managements could make. Different, reasonable managers may make different decisions on the same information, yet all those decisions can be reasonable and prudent. Absent a management decision clearly falling outside this range, there is no basis upon which the regulator should substitute its judgment for that of the utility's management. If they do, the regulator effectively takes over management of the investor-owned utility, which is not the regulator's role.

Second, determining whether utility management's judgments fell within the range of reasonable business judgment must scrupulously avoid "20-20 hindsight" review, by which I mean treating circumstances that occurred after a decision was made as if they were known at the time the decision was made. Once the future arrives and is therefore known, it is easy to fall into the trap of thinking it was more predictable than it was at the time a decision was made. But doing so does not meet the principle enunciated above that management decisions should be assessed based on information known to management at the time.

I would emphasize that I am not suggesting that I know of any circumstances that indicate that PEF's coal procurement decisions could be shown to be "wrong" *even if* judged by later events now known. My testimony, as indicated previously, addresses bedrock principles involved in utility regulation around the country. Other witnesses address the bases for the Company's procurement decisions and the prudence thereof.

Third, as a matter of fundamental regulatory fairness, utility regulators should not and do not hold utilities within long-term or "perpetual" jeopardy related to major fuel procurement decisions, at least absent the concealment of material facts. This is particularly so where, as here, the utility has regularly provided information to the regulatory Staff and OPC over the years as to its coal procurement practices, decisions and data, not to mention publicly-available information. As I understand it, PEF and Progress Fuels Corp. provided large amounts of information to the Commission and OPC concerning their coal procurement practices and decisions and all information was available for review and even audit. These included frequent face-to-face meetings with Commission Staff and OPC. The Commission approved those costs for pass-through to customers. In my 20 years of experience I have never seen a regulatory body expose a utility to such long-term uncertainty related to such major costs previously and undisputedly incurred and collected.

There is no need for the Commission to change the existing regulatory process used to authorize the recovery of fuel costs from utility customers. That process is efficient, open and provides a full and adequate opportunity for the prudence of such costs to be scrutinized as needed on a "real-time" basis – *i.e.*, during the authorization of the costs being passed on – while the facts are "fresh" and so that the utility can make appropriate adjustments going forward to the extent, if any, the regulator indicates concern over any aspect of the utility's decision-making. I believe the Commission can take comfort that the process has worked well and continues to work well. Moreover, there is no reason to think that the process requires major revisions to ensure its continued responsiveness to regulatory and utility decision-making.

OPC's suggestion of how the process should work is one that, as discussed herein, would effectively drag the process down to a snail's pace, if not to a halt. OPC effectively contends that the utility has the burden of affirmatively providing "all" information about their fuel procurement decisions without regard to whether questions have been raised or information sought by the Commission or OPC in addition to that normally provided. As I discuss herein, this would place utilities in the untenable position of having to affirmatively provide the Commission with every detail of the utilities' fuel procurement decisions, lest they "guess wrong" about what "issues" the Commission or OPC would later raise as allegedly bearing on prudence.

The only significant shortcoming in the existing state of affairs is ambiguity – perhaps not previously recognized — about the point in the process at which regulatory finality attaches. As this proceeding illustrates, it is undesirable to have a fuel cost recovery process in which there is both no clearly articulated point at which finality attaches and no process and timeframe in place to achieve such finality. Regulatory approval of such major utility costs "subject to prudence review," or similar terms, with no regulatory process in place to conduct such review and establish regulatory finality, is highly undesirable. The appropriate point at which to achieve such finality, subject to certain conditions that I suggest below, is no later than the true-up process, not years later.

The process should remain a streamlined one and not require as a normal or routine matter the utility to affirmatively present as part of its cost recovery showing the details of its procurement decisions, including elaboration of why it did not purchase other fuels from other suppliers. Such a procedure would render the process unnecessarily complex and burdensome with little, if any, benefit to the customer or

the Commission. The existing process provides for appropriate and adequate disclosure, with the Commission and OPC possessing the right to seek additional information from the utility, including an audit of its records.

I do suggest, however, that the effect of the process be better articulated on a going forward basis so that important regulatory goals of efficiency, finality, and fairness to all stakeholders is served. Specifically, I suggest that the Commission declare that the approval of fuel costs upon "true-up" be final, thus establishing a reliable, reasonable point after which the prudence of fuel costs will not be subject to further review, absent concealment of material facts by the utility during the initial approval and true-up process. I further suggest that "concealment" be defined to mean: (a) the affirmative misstatement of facts materially affecting prudence; or (b) the failure of the utility to provide material facts and documents requested by the Commission or OPC during the initial approval and true-up process.

Finally, I discuss why I believe this process does not differ in substance from that which the Commission has implicitly used for years. It is absurd as a matter of regulatory policy to suggest, as OPC implicitly does, that the Commission has approved hundreds of millions of dollars of fuel cost recovery over the decades for all Florida utilities subject to its jurisdiction, yet has never determined the prudence of those costs being passed on to customers.

Although orders authorizing fuel cost recovery have routinely recited that approval is "subject to prudence review," or words to that effect, it appears to me that the existing process actually reflects the prudence review typically employed by other state utility regulatory bodies leading up to a final true-up point. The recital that cost recovery is then subject to "prudence review" is best understood from a regulator's

perspective as reserving the right to revisit those prudence determinations only in the case of concealment of information by the utility.

**Q: Do you suggest by your testimony that the Florida Public Service Commission does not subscribe to the desirability of regulatory finality or the principles prohibiting "second-guessing" utility management judgments or the use of "hindsight review"?**

A: No, I do not. As I indicate later in this testimony, the Florida Commission has long been regarded by the investment community as one that has fostered and maintained a fair and constructive regulatory climate. I know of nothing the Commission has done in this proceeding to indicate that it in fact disagrees with or would not follow any of these principles. I do note that at the December 19, 2006 Agenda Conference several Commission members indicated questions as to what changes, if any, should be made to the approval process for fuel costs in order to achieve finality. I respond to those questions within this testimony. I offer all of the testimony set forth herein because I believe it is important for the Commission's analysis of the claims advanced by OPC.

**Q: Are these principles important to potential investors in utilities?**

A: Very much so. Investors depend on the fact that utility regulators subscribe to the above concepts as a key ingredient in providing capital to regulated utilities at a reasonable cost and upon a timely basis. Each of the principles I have described is important to the creation and maintenance of an environment of regulatory certainty and fairness that is strongly valued by the financial community.

**Q: What is the general perception of the investment community of the Florida regulatory climate as it relates to regulatory certainty and fairness?**

A: Florida is highly-regarded by the investment community as providing a regulatory climate that encourages investment in Florida investor-owned utilities at reasonable cost. However, a departure from the regulatory principles I discuss above would be perceived as adversely affecting Florida's regulatory climate, potentially leading to increased costs of capital for Florida investor-owned utilities, which would translate into increased utility rates.

## III. OPC'S PETITION FOR A $143 MILLION CUSTOMER REFUND FOR ACTIONS DATING BACK MORE THAN A DECADE IS BEYOND THE NORM OF REGULATORY PROCESSES AND AN FPSC ORDER ADOPTING SUCH VIEW WOULD VIOLATE FUNDAMENTAL TENETS OF REGULATORY FAIRNESS

**Q. Can you explain why you feel that the OPC's petition for relief is inappropriate?**

A. Yes I can. The threshold problem arises from its attempt to seek re-examination of decisions made over the course of more than a decade in the past. I have been involved with utility regulation for almost twenty years, first as a state regulator, later as a bond rater, and now as a consultant to utility companies, public service commissions, consumer advocates, and investors. The breadth of my experience has provided a wide-ranging view of utility regulation from virtually all stakeholder perspectives. I cannot recall any petition for relief seeking to re-examine utility management decisions of such complexity, for such a long period of time, and in which so much information was

provided to, and accessible to, the regulator near the time the decisions were being made.

The inconsistency with basic regulatory principles is particularly exacerbated here by the fact that, as detailed in the testimony of Company witnesses, (a) the Company regularly went through fuel cost recovery proceedings at the FPSC with OPC involvement in which no information concerning the Company's coal procurement was concealed or unavailable to the FPSC or OPC; (b) the Company regularly briefed the Commission Staff and OPC on fuel procurement between fuel adjustment proceedings; (c) all of the Company's coal procurement records, detailing its decision-making, were open and accessible to the FPSC and OPC; and (d) the Company made regular, required filings with the FERC and the FPSC setting out in detail its coal procurement costs. To treat as available for re-examination many millions of dollars in costs incurred and recovered under such circumstances is contrary to basic principles of finality as a matter of regulatory policy, and is unprecedented in my 20 years of experience.

**Q: How is the principle concerning substitution of regulatory judgment for management judgment involved here?**

A: It is potentially implicated in any proceeding that purports to judge the prudence of past utility management actions. It is particularly implicated in any proceeding in which those actions involve complex actions as well as actions that span long periods of time, both of which OPC's petition injects into this proceeding. I am aware that OPC insists that it does not seek to have the Commission substitute its judgment for any prudent decisions of the Company's management. However, in my experience, acknowledging the principle and adhering to it are not always the same thing.

PEF's decisions regarding coal procurement had to fall within a range of reasonable behavior, measured by circumstances at the time. Neither the Commission nor OPC made claims of imprudent behavior on the part of the Company when the events at issue in OPC's filing were occurring, even with the extensive information provided to and available to the Commission and OPC at the time. This strongly suggests that the Commission and OPC did not "miss something" at the time, but that, judged under the circumstances existing at the time, PEF's procurement decisions were prudent and fell within a range of reasonable business judgment.

**Q: How is the principle concerning "hindsight" review involved here?**

A: Similar to the principle just discussed, it is potentially implicated in any proceeding that purports to judge the prudence of past utility management actions and especially so in a proceeding involving complex past actions taken over a long period of time. I am also aware that OPC insists that it does not seek to have the Commission employ "hindsight review" in this proceeding. Again, however, in my experience, acknowledging the principle and adhering to it are not always the same thing.

**Q. Can you explain further your mention of 20-20 hindsight?**

A. Yes I can. When I was a regulator, I admit that at times the thought of revisiting a previously-made decision seemed pretty attractive. But upon further reflection, my ultimate conclusion was always that such second-guessing would be wrong. For example, utility management decisions are made based upon the information available and the circumstances existing at the time. While the prudence review process necessarily involves a certain degree of looking back, it is important for regulators to put

themselves into the shoes of the management decision-maker at the time a decision was made, so as to be able to assess whether it fell within a reasonable range of discretion measured by circumstances at the time they were made. It is not appropriate for regulators to attempt to match up what they would have decided was the right course of action at the time with what management actually did. Thus, regulators should not substitute their view for management's view; rather the proper administrative path is for regulators to determine a range of reasonable judgment that provides management with appropriate leeway to run the company without fear that every decision will be penalized after-the-fact.

**Q. Does the openness with which PEF carried out its coal activities impact upon your decision?**

A. Yes, very much so. It is my understanding that PEF management met regularly with Commission Staff and OPC representatives and made ongoing filings charting its current and projected resource supply plans, and made available for the asking any and all information pertaining to fuel procurement decisions.

Ironically, this very proceeding illustrates the availability of that information. As I understand it, this proceeding arose because, although belatedly, OPC requested from PEF a copy of any RFP used in the company's 2004 coal procurement. During that information evaluation, OPC saw that the company had received proposals for Powder River Basin ("PRB") coal at a lower delivered cost than the coal actually purchased, prompting OPC to seek further information as to why the seemingly-cheaper coal was not purchased. In response to these inquiries, PEF provided information as to the cost of PRB coal and information as to why it had not purchased it.

**Q. Why is timeliness such an important matter in regulatory decision-making?**

A. Timeliness is important because the utility business is highly capital-intensive and requires substantial and ongoing infusions of cash from equity and debt investors. The institutional investors providing such capital – pension funds, insurance companies, mutual funds and the like — expect a fair return on their investment received on a timely basis. Accordingly, a major part of an investor's due diligence prior to providing funding to a utility is analysis and assessment of the regulatory environment within which that utility operates. Part of that regulatory analysis by current and potential investors includes, as I learned while serving as chairman of the Michigan PSC and later as head of the Fitch utility ratings practice, close tracking and scrutiny of pending regulatory and judicial proceedings up until the point when all appeals have been concluded and a final enforceable order has been rendered. Acceptance of OPC's claim in this matter would turn the key investment goal of regulatory finality, and thus certainty, on its head.

**Q: Are major changes in the fuel adjustment approval process used by the Commission required in order to adequately address these issues?**

A: No. The existing process is consistent with that used by many state commissions and works well in making all necessary information available to the Commission and OPC on a "real-time" basis, meaning at or near the time the fuel procurement decisions are made and approved for pass-through. There is no need to impose on the utility an affirmative threshold burden, as simplistically suggested by OPC, to in effect present exhaustive and detailed information as to what fuel the utility did not purchase from

each offered source and why. Such information should of course be available to the Commission and OPC in the event they wish to review it, just as it is now.

Fuel decisions for a major utility like PEF can be complex and involve numerous judgments. Requiring the utilities subject to this Commission's jurisdiction to provide as part of its affirmative "case" in fuel adjustment or true-up proceedings a delineation of all the facts and decisions involved in its fuel purchases, including procurement strategies not appropriate for the circumstances, would inundate the Commission with information it rarely, if ever, would need or would have the resources to process.

**Q: But doesn't such a process create a risk that the Commission will make fuel cost recovery decisions without needed information to determine the prudence of the utility's decisions?**

A: No. To the contrary, the process assures the full availability of all information. It merely strikes a reasonable, common sense balance about what information the utility should present affirmatively as a matter of course in seeking cost recovery complemented by the right of the Commission and OPC to seek further information should they wish to have it in any proceeding. The process does not permit a utility to conceal or withhold information if the Commission or OPC believes additional information is necessary for their review and analysis and makes a request for such information.

**Q: Can you elaborate on why such a balance, as you put it, is reasonable from a regulatory perspective?**

A: Yes. Neither this Commission nor any with which I am familiar have required such

exhaustive information as a threshold, routine matter in approving as prudent utility fuel costs. For the regulatory process to work, rather than becoming bogged down in information with little, if any, relevance, regulators must rely on a reasonable balance of information affirmatively *presented* by the utility complemented by additional information which is *available* for further detail or elaboration. This is a reasonable approach for a number of reasons.

For example, the regulator knows that, by definition, the utility's purchase of certain fuel (that for which recovery is sought) means that the utility did not purchase other fuel. The regulator also knows whether information concerning fuel not purchased has been affirmatively presented. Obviously, if the regulator wishes to know more about the utility's decision-making process in not purchasing other fuel, all it need do is ask. Moreover, it can, if it chooses, audit or otherwise obtain from the utility all documents pertaining to a utility's decision-making.

In addition, the utility's decision-making about fuel procurement will often involve managerial judgments that the Commission will defer to, absent imprudence. I do not know any commission that has come up with the formula for a "black and white" quantitative standard as to what constitutes prudence in fuel procurement decisions. This is, of course, wise because any such standard would fail to afford utilities adequate discretion and judgment to make the best overall fuel procurement decisions for the utility and its customers at the time those purchases need to be made. When utilities present information in fuel procurement proceedings, they do so believing they have made prudent decisions. Unless one is going to indulge the unreasonable assumption that utilities are intentionally acting in bad faith, the utilities should have no reason to think that there is anything that they need to "disclose" to the Commission about fuel not

purchased. Their request for cost recovery constitutes the utility's claim that they have purchased fuel prudently, and advises the regulator of the type of fuel, its quantity and what the utility has agreed to pay for it. OPC's view, if accepted, would place utilities in the position of having to second guess their own decisions – decisions that they obviously regard as prudently made — speculate on what the Commission or OPC would regard as imprudent, and also speculate correctly in order to unilaterally provide the appropriate information. The only feasible solution in the face of such an untenable predicament is simply to turn over the fuel procurement process to the regulator, a concept that strikes at the heart of management of an investor-owned utility company.

As a sophisticated, professional regulatory body with its own professional Staff, and with OPC similarly skilled, it is not as if the utility is the only participant in the process with any information or knowledge about fuel markets and other associated matters. Quite the opposite is the case. Those to whom the cost recovery request is presented have substantial expertise in the area. They are qualified and able to conduct further inquiry if they wish. It is the utility's responsibility to provide information in response to those requests. The process should function, and has historically functioned, essentially as a "conversation" between knowlegable participants, not as a one-sided "speech" by the utility to the regulator (and OPC), as a silent, passive audience.

Such an approach best fulfills the goals of regulatory timeliness and efficiency by ensuring that the process addresses and finalizes fuel cost recoveries on a "real-time" or "near real-time" basis. Simply stated, while a utility may maintain written records for longer periods of time than human memory can preserve information, such records are not always an optimal means of reconstructing decisions if a utility is subject to prudence review substantially later than the time when the costs were incurred. This is

particularly the case where judgments were complex or involved the exercise of managerial judgment. The closer to the actual point in time when the costs were incurred that the prudence review occurs, the better the information available and the better the process.

In addition, such "real-time" prudence review can provide a utility with important guidance for future actions if, contrary to the utility's expectations, the regulator concludes that a different decision should have been made, either as a matter of prudence or simply by suggesting other considerations the utility should consider in the future. When such review occurs significantly later, this valuable information is lost, along with the fundamental fairness owed the utility.

**Q: What do you consider to be the appropriate timeframe within which prudence review should occur for fuel procurement decisions?**

A: Prudence review should occur during the regulatory process of authorizing the recovery of fuel costs and should be finalized by the completion of the "true-up" proceeding. This makes sense for the reasons I have just discussed. I would hasten to add, however, that this does not appear to me to be a significant deviation from the Commission's historic practice nor would it impose unreasonable administrative burdens on the Commission.

**Q: Please explain.**

A: It appears to me that, in practice, the Commission has effectively conducted what I regard as prudence review in its historic process of approving cost recovery and then truing up the recovery with actual costs. As I understand it, the utilities engage in

regular dialogue with the Commission Staff and with OPC about fuel procurement decisions, provide data as required by the Commission and the FERC, and make all detailed and additional information available upon the request of either the Commission or OPC. This is what I regard, and what I believe is generally regarded around the country, as the type of process that reflects a regulatory determination that the costs have been prudently incurred, absent affirmative misrepresentations or concealment of material information.

**Q: But, isn't it true that Commission cost recovery orders routinely contain language indicating that the costs are approved, even after true-up, subject to prudence review or words to that effect? Doesn't that indicate that the Commission has not effectively conducted prudence review in the fashion you indicate?**

A: Yes, the orders typically so state. However, that begs the question of what is in fact meant by "subject to prudence review" or similar words.

**Q: Please explain.**

A: I find it hard to believe that the Commission has historically regarded fuel procurement costs, once approved and passed on to the customer, as ***not*** having been subjected to prudence review. This is particularly compelling in light of the fact that, despite this routine statement in orders, the Commission has never established a process by which any other "prudence review" predictably occurs. In fact, as I understand it, no further "prudence review" typically ever occurs.

I am confident that the Commission does not regard itself as having allowed utilities (not just PEF) to recover hundreds of millions of dollars in fuel costs over the

decades, yet would say to those customers, "We have required you to pay these costs for many years, but we have never considered whether they are prudent."

Rather, it appears to me that the Commission has indeed conducted prudence review by the time the fuel costs are ultimately trued-up. No other conclusion makes regulatory sense or squares with the process that has been in place for years. On this backdrop, what makes sense to me is to read the statement that cost recovery is approved "subject to prudence review" to mean subject to revisitation under certain limited circumstances. In my view, the real issue should be what circumstances would support revisiting prior cost approvals, not whether fuel costs long ago the subject of regulatory filings and proceedings and thereafter passed-through to customers were in effect, prudent.

**Q: What circumstances should authorize revisiting prudence review?**

A: As I have already indicated, I believe that sound regulatory policy dictates that such prior approvals should be subject to revisitation only when it can be shown that the utility has concealed materials facts. By that I mean: (a) affirmative misstatement of material facts affecting prudence; or (b) the failure of the utility to provide material facts and documents requested by the Commission or OPC during the initial approval and true-up process.

**Q: Why do you believe this should be the appropriate standard?**

A: I believe this is appropriate for at least three reasons.

First, it recognizes that the process by which fuel costs are recovered is an interactive dialogue as I have previously discussed. It does injury to the process of

fuel cost pass-through if prior conclusions can be revisited at any time, absent a utility affirmatively having concealed information during that process.

Second, absent specific rules (of which there are none) about what must be affirmatively presented in a fuel cost recovery proceeding, the magnitude of the dollars at risk would leave utilities no practical choice but to "dump" every detail of their fuel procurement decisions into the cost recovery dialogue and process, thus inundating the regulator with information rarely, if ever, actually needed.

Third, it provides utilities and the investment community a reasonably concrete basis upon which to determine whether millions of dollars in prior fuel cost recoveries can be safely assumed to be final.

**Q. Why is regulation so important to an investor's decision to provide capital to a utility company?**

A. Regulation has always garnered the attention of Wall Street, but, years ago, seemingly only during the days leading up to a commission's rate case decision. This began to change around the time that Fitch hired me in 1993 to serve in the role of analyst of regulatory, legislative, and political factors that could have an impact upon a utility's financial strength. When California announced its ultimately ill-fated restructuring plan in 1994, the entire financial community, especially Fitch and its rating agency competitors S&P and Moody's, took much greater notice of regulators and how they carried out their responsibilities, not only with regard to rate-setting, but even more importantly the manner in which they undertook to change the way the utility industry had operated for over 100 years.

S&P highlighted the continuing importance of regulation to the financial community in two recent reports. In a report entitled "New York Regulators' Consistency Supports Electric Utility Credit Quality," S&P offered general thoughts on the importance of regulation that apply within but also far beyond the borders of New York State:

> Regulation defines the environment in which a utility operates and greatly influences a company's financial performance. A utility with a marginal financial profile can, at the same time, be considered highly creditworthy as a result of supportive regulation. Conversely, an unpredictable or antagonistic regulatory environment can undermine the financial position of utilities that are operationally very strong.
>
> To be viewed positively, regulatory treatment should be timely and allow consistent performance over time, given the importance of financial stability as a rating consideration. Also important is the transparency of regulatory policies...[1]

Earlier, S&P had discussed how changing circumstances within the utility industry have elevated the importance of regulatory policies:

> In recent years, [S&P's] emphasis on the decisions by state commissions has been less pronounced simply because so many jurisdictions have been working through multiyear restructuring transition periods. During this time, rates were frequently frozen, and companies and customers have been adjusting (albeit with limited success) to the opportunity that customers have to choose alternate power suppliers.
>
> But the confluence of the approaching end of these transition periods and the growing need in certain regions of the country for significant resource additions is quickly returning the regulatory arena to center stage. In assessing the regulatory environment in which a utility operates, [S&P's] analysis is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory scheme to be considered supportive of credit quality, commissions must limit uncertainty in the recovery of a utility's investment. They must also eliminate, or at least greatly reduce, the issue of rate-case lag that may prove detrimental if a utility needs rate relief.[2]

[1] S&P Research: "New York Regulators' Consistency Supports Electric Utility Credit Quality," August 15, 2005.

[2] S&P Research: "U.S. Utility Regulation Returns to Center Stage," April 14, 2005.

**Q. Where does Florida regulation fit within the view of the financial community?**

A. Based upon my knowledge of and interaction with Florida regulators over the past twenty years, Florida regulation is perceived by the financial community as being very constructive and sensitive to the concerns of both equity and debt investors.

**Q. Isn't such positive status for the FPSC good for investors and not so good for consumers?**

A. No, not at all. Actually the opposite is true. The lower the regulatory risk within a jurisdiction, the lower the cost of capital a utility has to pay to attract needed investment. Those lower costs then get factored into the rates that customers pay. So a positive investment climate is good for all stakeholders within the process.

## IV. POTENTIAL NEGATIVE IMPACT ON FLORIDA'S CONSTRUCTIVE REGULATORY ENVIRONMENT

**Q. Can you briefly describe the credit ratings process?**

A. Credit ratings reflect a credit rating agency's independent judgment of the general creditworthiness of an obligor or the creditworthiness of a specific debt instrument. While credit ratings are important to both debt and equity investors for a variety of reasons, their most important purpose is to communicate to investors the credit strength of a company or the underlying credit quality of a particular debt security issued by that company.

Corporate credit ratings analysis considers both qualitative and quantitative

factors to assess the financial and business risks of fixed-income issuers. A credit rating is an indication of an issuer's ability to service its debt, both principal and interest, on a timely basis. Ratings can also be used by contractual counterparties to gauge both the short-term and longer-term health and viability of a company.

**Q. Can you provide a brief discussion on why credit ratings are important for regulated utilities and their customers?**

A. Yes. It is a well-established fact that a utility's credit ratings have a significant impact as to whether that utility will be able to raise capital on a timely basis and upon favorable terms. As respected economist Charles F. Phillips stated in his treatise on utility regulation:

> Bond ratings are important for at least four reasons: (1) they are used by investors in determining the quality of debt investment; (2) they are used in determining the breadth of the market, since some large institutional investors are prohibited from investing in the lower grades; (3) **they determine, in part, the cost of new debt, since both the interest charges on new debt and the degree of difficulty in marketing new issues tend to rise as the rating decreases**; and (4) they have an indirect bearing on the status of a utility's stock and on its acceptance in the market.[3] [Emphasis supplied.]

Thus, the lower a regulated utility's credit rating, the more the utility will have to pay to raise funds from investors to carry out its capital-intensive operations – and, as noted by Dr. Phillips, credit ratings can also affect the amount of money that utilities can raise from equity investors at any point in time. In turn, the ratemaking process factors the cost of capital for both debt and equity into the rates that consumers are required to pay.

3 Phillips, Charles F., Jr., The Regulation of Public Utilities, Arlington, Virginia: Public Utilities Reports, Inc., 1993, at p. 250. See also Public Utilities Reports Guide: "Finance," Public Utilities Reports, Inc., 2004 at p. 6-7 ("Generally, the higher the rating of the bond, the better the access to capital markets and the lower the interest to be paid.").

Thus, a utility with strong credit ratings is not only able to access the capital markets on a timely basis at reasonable rates, it also is able to share the benefit from those attractive interest rate levels with customers through lower utility rates.

**Q. Please describe the factors used by the rating agencies.**

A. The most important qualitative factors include regulation, management and business strategy, and access to energy, gas and fuel supply with recovery of associated costs. On the quantitative side, financial performance continues to be a very important element in credit rating analysis. Credit rating agencies and fixed-income analysts utilize key analytical ratios to understand the credit profile of a utility.

**Q. Since regulatory response to the OPC petition will be such a key factor in this case, can you share your thoughts on the importance of "regulation" within the credit ratings process?**

A. Yes. Regulation is a key factor in assessing the credit profile of a utility because a state public utility commission determines rate levels (recoverable expenses including depreciation and operations and maintenance, fuel cost recovery, and return on investment) and the terms and conditions of service.

Since the announcement of California's restructuring plan in 1994, regulation has become an even more important variable as the nature of a utility's responsibilities in providing energy services to customers has undergone dramatic change. In some states, industry restructuring was the result of plans formulated by the state legislature. In other states, the regulators, rather than the legislators, have determined the nature and

pace of restructuring. And, of course, in states like Florida, restructuring has not moved very far forward at all.

With such divergence among the states, before major energy investors will be willing to put forward substantial sums of money, they will want to gain comfort that regulators understand the economic requirements and the financial and operational risks of a rapidly-evolving industry and that their decision-making will be fair and will have a significant degree of predictability.

For these reasons, rating agencies look for the consistent application of sound economic regulatory principles by the commissions. If a regulatory body were to encourage a company to make investments based upon an expectation of the opportunity to earn a reasonable return, and then did not apply regulatory principles in a manner consistent with such expectations, investor interest in providing funds to such utility would decline, debt ratings would likely suffer, and the utility's cost of capital would increase.

**Q. Can you discuss how Florida's current positive regulatory climate affects PEF's credit ratings in a manner that lowers the rate impact on the Company's customers?**

A. Yes I can. S&P views the Company's credit profile as improving, citing in July 2006 Florida's "historically supportive regulation" as a beneficial factor. S&P cautioned, however, that a weakness was the need for "[s]ignificant rate increases for rising fuel costs," and noted that the consolidated utility's outlook could be lowered to Stable if "under recovered fuel costs [at the Progress Energy Carolina affiliate] are unfavorably

resolved."[4]

Moody's cites Florida's "constructive regulatory environment," but similarly cautions that "[a]ny change in the regulatory environment which could limit recovery of fuel costs" could change the rating in a downward direction.[5]

Fitch agrees that Florida represents a "historically favorable" state regulatory environment, but also warns that its "Stable Rating Outlook incorporates Fitch's expectations that ... fuel and operating costs will be recovered from customers on a timely basis."[6]

**Q. You have described unanimity among the three rating agencies with regard to how they look at Florida regulation and their shared concerned about current fuel cost recovery. Can you offer a view as to how they would react if the commission were to validate the OPC's theory about coal procurement and costs?**

A. Yes, I can. In a word, they would be stunned. The major current concern of the financial community about the utility industry is the rapid run-up in fuel and purchased power costs and whether companies will receive timely and complete recovery for prudent actions related to those challenges. The idea that a state public utility commission, especially one so favorably viewed by investors, would take the unprecedented step of putting into play fuel costs going back as long as a decade ago, with the potential of a $143 million disallowance, is inconceivable. These were not steps taken behind closed doors that are just now coming to light. PEF has carried on

4 S&P Research Update: Progress Energy's, Units' 'BBB' Ratings Affirmed; Outlook Revised To Positive," July 25, 2006.
5 Moody's Credit Opinion: "Progress Energy Florida, Inc.," September 1, 2006.
6 Fitch Press Release: "Fitch Upgrades Progress Energy and Utility Subsidiaries; Outlook Stable," November 3, 2006.

its coal procurement processes with all information accessible to Commission Staff and OPC. If the FPSC were to reopen the matter, it would create a regulatory environment within which no issue is ever finally resolved. If that were to occur, I would expect that investors would react to such uncertainty by requiring higher returns on equity and higher interest payments on debt issuances, potentially for all of the state's utilities. Those costs would then get factored into the rates that utility customers have to pay. Even worse, investors might just choose to forgo higher returns in the more volatile environment and just take their funds and invest in other states – where fairness, consistency and predictability would be more certain.

**Q. Does this conclude your testimony?**

**A.** Yes, it does.

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**Education** University of Michigan Law School, J.D. 1979
Bar Memberships: U.S. Supreme Court, New York, Michigan
University of Michigan, A.B. (Communications) 1974

April 2002 – Present
**President – REGULATION UnFETTERED – Henderson, NV/Rumson, NJ**

Founder of advisory firm providing regulatory, legislative, financial, legal and strategic planning advisory services for the energy, water and telecommunications sectors; federal and state testimony; credit rating advisory services; negotiation, arbitration and mediation services; and skills training in ethics, negotiation, and management efficiency.

- Service on Boards of Directors of: CH Energy Group (Chairman, Governance and Nominating Committee; Member, Audit; Previous Chairman, Audit and Compensation Committees), National Regulatory Research Institute (at Ohio State University), Keystone Energy Board, and Regulatory Information Technology Consortium; Member, Wall Street Utility Group and American Public Power Association; Participant, Keystone Center Dialogue on Financial Trading and Energy Markets.

October 1993 – April 2002
**Group Head and Managing Director; Senior Director -- Global Power Group, Fitch IBCA Duff & Phelps -- New York/Chicago**

Manager of 18-employee ($15 million revenue) group responsible for credit research and rating of fixed income securities of U.S. and foreign electric and natural gas companies and project finance.

- Led an effort to restructure the global power group that in three years time resulted in 75% new personnel and over 100% increase in revenues, transforming a group operating at a substantial deficit into a team-oriented profit center through a combination of revenue growth and expense reduction.

- Achieved national recognition as a speaker and commentator evaluating the effects of regulatory developments on the financial condition of the utility sector and individual

companies; Cited by Institutional Investor (9/97) as one of top utility analysts at rating agencies; Frequently quoted in national newspapers and trade publications including The New York Times, The Wall Street Journal, International Herald Tribune, Los Angeles Times, Atlanta Journal-Constitution, Forbes and Energy Daily; Featured speaker at conferences sponsored by Edison Electric Institute, Nuclear Energy Institute, American Gas Assn., Natural Gas Supply Assn., National Assn. of Regulatory Utility Commissioners (NARUC), Canadian Electricity Assn.; Frequent invitations to testify before U.S. Senate (on C-Span) and House of Representatives, and state legislatures and utility commissions.

- Participant, Keystone Center Dialogue on Regional Transmission Organizations; Member, International Advisory Council, Eisenhower Fellowships; Author, "A Rating Agency's Perspective on Regulatory Reform," book chapter published by Public Utilities Reports, Summer 1995; Advisory Committee, Public Utilities Fortnightly.

March 1994 – April 2002
**Consultant -- NYNEX -- New York, Ameritech -- Chicago, Weatherwise USA -- Pittsburgh**

Provided testimony before the Federal Communications Commission and state public utility commissions; Formulated and taught specialized ethics and negotiation skills training program for employees in positions of a sensitive nature due to responsibilities involving interface with government officials, marketing, sales or purchasing; Developed amendments to NYNEX Code of Business Conduct.

October 1987 - October 1993
**Chairman; Commissioner -- Michigan Public Service Commission -- Lansing**

Administrator of $15-million agency responsible for regulating Michigan's public utilities, telecommunications services, and intrastate trucking, and establishing an effective state energy policy; Appointed by Democratic Governor James Blanchard; Promoted to Chairman by Republican Governor John Engler (1991) and reappointed (1993).

- Initiated case-handling guideline that eliminated agency backlog for first time in 23 years while reorganizing to downsize agency from 240 employees to 205 and eliminate top tier of management; MPSC received national recognition for fashioning incentive plans in all regulated industries based on performance, service quality, and infrastructure improvement.

- Closely involved in formulation and passage of regulatory reform law (Michigan Telecommunications Act of 1991) that has served as a model for other states; Rejuvenated dormant twelve-year effort and successfully lobbied the Michigan

Legislature to exempt the Commission from the Open Meetings Act, a controversial step that shifted power from the career staff to the three commissioners.

- Elected Chairman of the Board of the National Regulatory Research Institute (at Ohio State University); Adjunct Professor of Legislation, American University's Washington College of Law and Thomas M. Cooley Law School; Member of NARUC Executive, Gas, and International Relations Committees, Steering Committee of U.S. Environmental Protection Agency/State of Michigan Relative Risk Analysis Project, and Federal Energy Regulatory Commission Task Force on Natural Gas Deliverability; Eisenhower Exchange Fellow to Japan and NARUC Fellow to the Kennedy School of Government; Ethics Lecturer for NARUC.

August 1985 - October 1987
**Acting Associate Deputy Under Secretary of Labor; Executive Assistant to the Deputy Under Secretary -- U.S. Department of Labor -- Washington DC**

Member of three-person management team directing the activities of 60-employee agency responsible for promoting use of labor-management cooperation programs. Supervised a legal team in a study of the effects of U.S. labor laws on labor-management cooperation that has received national recognition and been frequently cited in law reviews (U.S. Labor Law and the Future of Labor-Management Cooperation, w/S. Schlossberg, 1986).

January 1983 - August 1985
**Senate Majority General Counsel; Chief Republican Counsel -- Michigan Senate -- Lansing**

Legal Advisor to the Majority Republican Caucus and Secretary of the Senate; Created and directed 7-employee Office of Majority General Counsel; Counsel, Senate Rules and Ethics Committees; Appointed to the Michigan Criminal Justice Commission, Ann Arbor Human Rights Commission and Washtenaw County Consumer Mediation Committee.

March 1982 - January 1983
**Assistant Legal Counsel -- Michigan Governor William Milliken -- Lansing**

Legal and Labor Advisor (member of collective bargaining team); Director, Extradition and Clemency; Appointed to Michigan Supreme Court Sentencing Guidelines Committee, Prison Overcrowding Project, Coordination of Law Enforcement Services Task Force.

October 1979 - March 1982
**Appellate Litigation Attorney -- National Labor Relations Board -- Washington DC**

**Other Significant Speeches and Publications**

- Perspective: Don't Fence Me Out (Public Utilities Fortnightly, October 2004)
- Climate Change and the Electric Power Sector: What Role for the Global Financial Community (during Fourth Session of UN Framework Convention on Climate Change Conference of Parties, Buenos Aires, Argentina, November 3, 1998)(unpublished)
- Regulation UnFettered: The Fray By the Bay, Revisited (National Regulatory Research Institute Quarterly Bulletin, December 1997)
- The Feds Can Lead...By Getting Out of the Way (Public Utilities Fortnightly, June 1, 1996)
- Ethical Considerations Within Utility Regulation, w/M. Cummins (National Regulatory Research Institute Quarterly Bulletin, December 1993)
- Legal Challenges to Employee Participation Programs (American Bar Association, Atlanta, Georgia, August 1991) (unpublished)
- Proprietary Information, Confidentiality, and Regulation's Continuing Information Needs: A State Commissioner's Perspective (Washington Legal Foundation, July 1990)