BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of : DOCKET NO. 961184-EQ

Petition for approval of early termination amendment to negotiated qualifying facility contract with Orlando Cogen Limited, Ltd. by Florida Power Corporation.

VOLUME 2

AFTERNOON SESSION

Pages 170 through 340

PROCEEDINGS: HEARING

BEFORE: COMMISSIONER SUSAN F. CLARK
COMMISSIONER JOE GARCIA

DATE: Thursday, October 30, 1997

TIME: Commenced at 9:30 a.m.

PLACE: Betty Easley Conference Center
Room 148
4075 Esplanade Way
Tallahassee, Florida

REPORTED BY: JOY KELLY, CSR, RPR
Chief, Bureau of Reporting

APPEARANCES:

(As heretofore noted.)

DOCUMENT NUMBER-DATE
11546 NOV 10 97

I N D E X

MISCELLANEOUS

WITNESSES

EXHIBITS

P R O C E E D I N G S

(Hearing reconvened at 2:10 p.m.)

(Transcript follows in sequence from Volume 1.)

COMMISSIONER CLARK: I'm taking an assessment of the cross examination. It's unlikely we'll finish today, but let's continue on and see what happens. Is there a preference among the parties as to what we do? All right, we'll just see how it goes.

Go ahead, Mr. Keating. You were cross examining Mr. Schuster.

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LEE G. SCHUSTER

continues his testimony under oath from Volume 1

CONTINUED CROSS EXAMINATION

BY MR. KEATING:

Q Mr. Schuster, I'd like to pick up on some questions we had regarding your fuel forecasts, and I believe during the break you've checked on these?

A Yes.

Q Okay. I believe we were looking at your late-filed exhibit, Late-filed Deposition Exhibit No. 3 that's contained in the exhibit, Staff Exhibit LGS-24. And in that exhibit there's a column titled "Premium Supply Cost" reflecting FPC's 9603 forecast or for the years 1997 to 2006. And that exhibit shows that the premium supply cost is 73 cents above what appears to be incremental or spot prices in the other column that's titled "Supply Cost" in each of the years shown. And my question before was does that 73 cents represent the premium for firm natural gas?

A No, it does not. The column that's labled Premium Supply Cost is a column that represents getting gas in the secondary market for transportation. In other words, the Basic Supply Cost column represents buying gas from the pipeline, either available space or space at the time that a pipeline is expanded and new capacity is added. The Premium Supply Cost reflects basically a shortage of transportation and a situation in which we would obtain transportation for gas from another person who holds transportation capacity on the pipeline. Hence the reason for the premium. It represents an alternative scenario for gas transportation costs.

Q Would you be able to estimate the cost-effectiveness of the net present value savings of the buyout based on firm price forecasts? (Pause)

I'm sorry. Let me ask you a different question.

Would it be reasonable to use the 73-cent premium that's shown in that exhibit to convert the spot prices that are relied on, spot price forecast you rely on in your analysis to a firm price?

A No, it would not. Because the 73-cent premium doesn't relate to spot versus firm commodity gas. It relates to the transportation.

What we have used is the supply cost listed in the first column, which is the base case gas forecast. It reflects spot market gas supplied through the marketplace.

Q Would it be reasonable to use the values in the Premium Supply Cost column as a conservative estimate to evaluate the net present value savings of the buyout?

A It could certainly be used as a sensitivity case. I have to apologize again, I was able to determine conceptually what the premium supply cost is, but in order to answer your question properly I would need to know, for example, what the probability of occurring is, and what is really being used internal in the company. I suspect it's being used as kind of a sensitivity analysis considering the possibility that the transportation would be tight.

I don't really see a justification for using that in a base case analysis because under base case status quo conditions you would expect Florida Gas Transmission to expand periodically and accommodate gas demands.

Q If you can please turn to your Late-filed Deposition Exhibit 7 and that's part of a composite exhibit that's identified as LGS-34. It's on page No. 13.

A Yes.

Q Is it correct that that exhibit shows supporting calculations for your determination of the levelized annual carrying cost rates used to determine the placement capacity costs in Florida Power Corporation's cost-effectiveness analysis?

A Yes.

Q Is it also correct that this exhibit provides Florida Power Corporation's financial projections, such as projected debt/equity mix, composite cost of capital, and assumed risk premium on equity, as well as other projections?

A It provides a forecast of those items. This particular forecast was created as part of the May 1995 generation cost forecast. It's information is not fully consistent with the official source of this information, which is the Florida Power Engineering

Economy Manual. And it is also not up-to-date due to the fact it was done in May of '96.

Q Is it correct that according to this exhibit, Florida Power Corporation has projected its debt/equity mix at 50/50?

A For the purposes of this forecast they were projected at 50/50. My recollection is that the Engineering Economy Manual is 45/55.

COMMISSIONER CLARK: Which is 45 and which is 55?

WITNESS SCHUSTER: 55 equity; 45 debt.

Q (By Mr. Keating) Aren't you using the 50/50 debt/equity ratio in your current analysis?

A We are continuing to use the information included in response to Interrogatory No. 15, the exhibit that we're referring to right now, in our current analysis. It does not -- well, it uses slightly different assumptions than those contained in the Engineering Economy Manual.

I've continued to use this particular forecast because the difference between the levelized fixed charge rate computed here and the levelized fixed charge rate computed using the Engineering Economy Manual assumptions is immaterial.

Q I believe that Staff has handed out exhibits

LGS-29, 30 and 31.

COMMISSIONER CLARK: Yes. Mr. Keating, I have them. How would you like them marked as exhibits?

MR. KEATING: I'd like those marked as Composite Exhibit -- what is the number?

COMMISSIONER CLARK: 8 is the next. LGS-29 through 31, which the Staff has handed out, will be marked as Composite Exhibit 8.

(Exhibit 8 marked for identification.)

Q (By Mr. Keating) Mr. Schuster, could you refer to the exhibit identified as LGS-29. (Pause)

A Yes.

Q Would you please review that exhibit for a second and let me know if that exhibit shows in part portions of Florida Power Corporation's monthly surveillance reports for October 1996 and August 1997?

A Yes, it does.

Q This exhibit also contains a summary of those reports prepared by Staff as the last page on the exhibit.

Could you tell me approximately what Florida Power Corporation's current debt/equity mix is as appears on Florida Power Corporation's surveillance reports filed with the Commission?

represented on your Late-filed Deposition Exhibit 7?

A Late-filed Exhibit No. 7 was part of the market-based generation cost forecast that was used in the October 1st filing. It was prepared by a separate department from Purchased Power. We were basically told to use that by management because that was the generation cost forecast being used at that time by the company.

We reviewed the assumptions but it was not our place to change those assumptions or to create a different forecast. It was reasonable at that time

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A Yes, it does.

Q This exhibit also contains a summary of those reports prepared by Staff as the last page on the exhibit.

Could you tell me approximately what Florida Power Corporation's current debt/equity mix is as appears on Florida Power Corporation's surveillance reports filed with the Commission?

A The last page of your exhibit shows 62.07% for August of 1997.

Q What was it in October of 1996?

A 60.55%.

Q How long has Florida Power Corporation's equity ratio been greater than 50%?

A Based on this handout, it runs about 50% in May of 1994.

Q And since that time has it continued to increase?

A Yes, it has.

Q So why didn't you use an equity ratio closer to Florida Power Corporation's actual equity ratio when you projected the original financial values represented on your Late-filed Deposition Exhibit 7?

A Late-filed Exhibit No. 7 was part of the market-based generation cost forecast that was used in the October 1st filing. It was prepared by a separate department from Purchased Power. We were basically told to use that by management because that was the generation cost forecast being used at that time by the company.

We reviewed the assumptions but it was not our place to change those assumptions or to create a different forecast. It was reasonable at that time for the purposes we were using it.

Q And why didn't you use the annual cost of capital rates from these projections to determine the present value of the cost and benefits of the buyout instead of Florida Power Corporation's current rate as they are shown on Late-filed Exhibit No. 7?

A I'm sorry, could you repeat that question?

(Pause)

Q For each of the years on your Late-filed Exhibit No. 7, why didn't you use the annual cost of capital rates on that exhibit to determine the present value of the cost and benefits of the buyout instead of Florida Power Corporation's current rate?

A Are you saying use the annual values in the net present value calculation?

Q Yes.

A Well, there's a different annual value for each year and when you do a net present value calculation you have to select one discount rate to discount the entire cash flow stream. So we used the approved and accepted one, which is the current after-tax discount rate, after-tax cost of capital.

Q Couldn't you use each year's annual discount rate to discount that year's dollars?

A I suppose you could. I've never seen that done before.

Q I'd like to get a late-filed exhibit containing a revision to your Late-filed Deposition Exhibit No. 7 based on a 42%/58% debt/equity ratio. I would also like to get as a late-filed exhibit a revised cost-effectiveness analysis based on these revised levelized annual carrying charge rates with present value determined using each year's annual cost of capital?

COMMISSIONER CLARK: Mr. Keating, I got the last part of that, a revised cost-effectiveness analysis. What was the first part?

MR. KEATING: The first part was a late-filed exhibit containing a revision to Mr. Schuster's Late-filed Deposition Exhibit No. 7 with a late-filed exhibit to be presented based on 42%/58% debt/equity ratio.

COMMISSIONER CLARK: So there are two parts to that exhibit; is that correct?

MR. KEATING: Yes.

COMMISSIONER CLARK: All right. Mr. Schuster, do you understand what he's asked for?

WITNESS SCHUSTER: I'd like to ask him to repeat the second part. I was on the different channel from you. I got the first and not the second.

COMMISSIONER CLARK: Okay.

MR. [illegible]: On the second I would like a revised cost-effectiveness analysis based on the levelized annual carrying charge rates that result from using the 42%/58% debt/equity ratio, and in that analysis I would like the present value determined using each year's cost of capital. (Pause)

WITNESS [illegible]: Let me just ask as a point of clarification, it was in my mind over the last few Q and As, but it never really came up.

We're really talking about two different cost of capital and capitalization concepts here. What's in our Engineering Economy Manual and what is in Late-filed Exhibit No. 7 and what's used in the OCL buyout analysis are capitalization ratios on a financial basis. And by that I mean they are capitalization ratios that are computed straight off the balance sheet for the amount of equity and debt that's outstanding on those financial statements.

What you've referred us to in LGS-29 is a Commission basis cost of capital. And I'm going to -- I want to make sure we're all on the same channel here. Commission basis cost of capital and cap ratios are a completely different concept from financial.

I've never done, once again, an analysis of this type using Commission basis capitalization ratios. We use, for financial analysis purposes, balance sheet capitalization ratios. But with that clarification, I'd be happy to provide the late-filed exhibits. I just want to caution you that the cap ratios you're referring to here may not relate as well to a financial cap ratio as they do to a Commission basis cap ratio.

COMMISSIONER CLARK: Well, you know, I don't understand that. Are you trying to suggest it's inappropriate to use the Commission basis as opposed to, I guess, an overall company basis? Why is it important to make the distinction you just made?

WITNESS SCHUSTER: The distinction is that they are fundamentally different concepts. What you're trying to measure with the cost of capital is the cost of capital for the company in the marketplace, and that depends on what they have on their balance sheet; the equity that they have on their balance sheet, the debt they have on their balance sheet.

So that gives you an accurate cost of capital when you do it on a financial basis based on the financial statements.

If you look at the Commission basis cost of capital it includes, for example, investment tax credits as a component of the cost of capital, which is perfectly fine for computing a Commission basis return and doing things like rate cases and surveillance reports.

The cost of capital and the ratios may be substantially different than they would be on a financial basis, and, therefore, they would be inappropriate to use if what you're trying to do is estimate the company's cost of capital.

COMMISSIONER CLARK: Well, is it inappropriate to use it for the purposes of, I guess, projecting the cost of capital for the company for purposes of avoided cost for this docket? Is it inappropriate to do that?

WITNESS SCHUSTER: If the numbers are close -- and I don't know how close or how much of a difference they would make -- if numerically they were close it wouldn't be inappropriate. Because you would get approximately --

COMMISSIONER CLARK: What if they are not close?

WITNESS SCHUSTER: If they are not close, I would say it would be inappropriate. Because the correct way to do the analysis is on a financial basis, reflecting the actual capitalization of the company and the actual cost of that capitalization in the marketplace.

COMMISSIONER CLARK: Okay.

We'll identify that as Late-filed Exhibit 9.

(Late-Filed Exhibit 9 identified.)

Q (By Mr. Keating) Mr. Schuster, could you turn to the exhibit that's been identified as LGS-30 that was handed out at the break.

A Yes.

Q That exhibit is described as the Attachment to Florida Power Corporation's Response to Staff's Interrogatory No. 16?

A Yes.

Q For the following questions could you please refer to the table that's included in response to that interrogatory?

A Yes.

Q Is it correct that Section 1 of this table shows the calculation of the discount rate that you used in Exhibit LGS-7 to your testimony?

A Yes.

Q And what was that discount rate?

A 8.67%.

Q Does the derivation of this discount rate assume that a mixture of long-term debt and equity will be used to finance a project?

A No, it doesn't. What we're really doing with the 867 is to create a proxy for the customer's discount rate. What -- your question was really true, I mean the project, if you were building a project that required capital investment, it would be made with a mixture of debt and equity. That's the conventional assumption. But in this particular instance we're not talking about an investment; we're talking about determining a proxy for the customer cost of capital or discount rate, and that convention has been to use the after-tax discount rate; in this instance 8.67%.

Q So are you saying in your response that the derivation of this discount rate does assume a mixture of long-term debt and equity?

A Yes, it does.

Q Okay. If you could refer to the line titled "Debt Tax Deduction Component." Does this line represent the savings and income tax due to the deduction of interest expense associated with long-term debt financing?

A Yes, it does.

Q Is Florida Power Corporation proposing to finance the OCL buyout by collecting additional revenue through the fuel and purchased power recovery clause and the capacity cost recovery clause?

A Yes.

Q If Florida Power Corporation's proposal to finance the OCL buyout by collecting additional revenue through the adjustment clause is approved, will Florida Power Corporation issue any additional long-term debt or equity to pay for the buyout?

A No.

Q Then if Florida Power finances the OCL buyout by collecting additional revenues from ratepayers through the adjustment clauses, is there any long-term debt or associated interest expense?

A No.

Q So in your determination of the discount rate on this exhibit was it appropriate to deduct a debt tax deduction component from the composite cost of capital on this table if FPC will not issue any additional debt and will not have any additional interest expense for the contract buyout?

A Yes, it is.

Q Could you please explain why?

A The reason is that that -- that tax adjustment is required in order to develop the correct after-tax discount rate to use in this type of an analysis.

The best example that I can give you is that when you do what's referred to as a levelized fixed charge rate, if you take nonlevelized revenues for a project, or Florida Power in total, and you want to levelize those revenues, it can be proved that the discount rate that must be used to move those revenues from one period to another is the after-tax discount rate. Putting aside what type of a project or an analysis you're doing in a theoretical -- from a theoretical standpoint, you must use the after-tax discount rate to get the right answer.

And that's exactly what we've done in this instance here. We're present valuing what could be described as revenue requirements to customers. We're moving them from period-to-period.

Theoretically, and technically, the correct discount rate to use to move those dollars from period-to-period is the after-tax discount rate.

Q At Page 5 of Florida Power Corporation's protest of the Commission's PAA order Florida Power Corporation stated that the amendment to the OCL contract will provide net savings of over $400 million to Florida Power and it customers, and will mitigate exposure to Florida Power and its customers to potentially strandable costs in the future. Is it correct then that Florida Power Corporation believes that PURPA-related costs will fall within the category of stranded costs?

A I apologize, but I'm going to have to ask you to reask or rephrase that question.

Q At Page 5 of Power Corporation's protest of the Commission's PAA order it was stated that the amendment to the OCL contract will provide net savings of over $400 million to Florida Power and its customers, and will mitigate exposure of Florida Power and its customers to potentially strandable costs in the future.

Is it correct then that Florida Power Corporation believes that PURPA-related costs will fall within the category of stranded costs?

A Yes, I think that's generally a correct statement.

The petition talked about the potential for stranded costs, and I think we were just making that reference in order to be inclusive of that issue and that concern.

I don't think you can say definitively whether PURPA costs would be stranded or not. It depends on the particular contract as to whether or not they were stranded or not. A very economical QF contract might be at or below market and, therefore, not be stranded.

Q Are you aware of legislation, or proposals in any state, that allow recovery of stranded costs?

A Yes.

Q And are PURPA-related costs included in the definition of stranded costs in any of those proposals?

A Yes. I believe they are included in some of those proposals.

Q If in a deregulated environment Florida Power Corporation and other electric utilities are guaranteed recovery of stranded cost, including PURPA-related costs, either through exit fees or transition charges, what risk is there to Florida Power that these costs won't be recovered?

A Well, there wouldn't be any risk if that were the case.

COMMISSIONER CLARK: I'm sorry. Would I repeat that question?

MR. KEATING: If in a deregulated environment Florida Power Corporation and other electric utilities are guaranteed recovery of stranded costs, including PURPA-related costs, would there be any risk to Florida Power Corporation that these costs wouldn't be recovered?

COMMISSIONER CLARK: Thank you. And your answer was?

WITNESS SCHUSTER: There wouldn't be any risk. If they were guaranteed, the risk would be zero.

Q (By Mr. Keating) Where stranded costs have been quantified, to your knowledge have they been determined on a specific contract basis or individual generating station basis, or have they been determined on utility-wide basis accounting for the utility's high as well as its low power costs.

A I believe they have been determined on both bases.

Q Has Florida Power Corporation determined what its projected total costs of providing power would be in a restructured industry after recognizing its PURPA contracts and its generation resources?

A Florida Power has attempted to develop estimates of those costs and potentially strandable costs, yes. (Pause)

Q Could you provide as a late-filed exhibit Florida Power Corporation's projections of those costs?

MR. McGEE: Madam Chairman, this raises some concerns, one having to do with the at least potential for sensitive and confidential nature of that material. I wouldn't want to interfere with Staff receiving the information that they really think is necessary to do their evaluation, I'm just questioning whether --

COMMISSIONER CLARK: You're asking for their estimate of their potentially stranded cost? And how is that going to help you in your analysis of the case? Think about whether you need it.

Mr. Keating, do you have more questions?

MR. KEATING: Yes, I do.

COMMISSIONER CLARK: All right. We'll come back to that. Let's finish up and then we'll come back and it will give you an opportunity to talk to Staff. After you have had that opportunity, we'll discuss it.

Q (By Mr. Keating) Mr. Schuster, on Pages 12 to 16 of your direct testimony you discuss the effects of the OCL contract buyout on intergenerational fairness. What do you understand the concept of intergenerational fairnes to mean as it relates to electric utility regulation?

A It has to do with the pattern over time of how costs are recovered from an individual project or a group of projects, up to and including the overall rate structure of a utility.

Q Would you agree that intergenerational fairness involves ensuring that costs befalling one generation of customers are matched with achievable benefits?

A Yes.

Q Considering that the OCL buyout costs are to be recovered over the next five years as the buyout is currently structured, are the costs of the buyout being recovered consistent with the time period within which the benefits accrue?

A No, they are not.

Q Have you reviewed any demographic information on Florida Power Corporation's customer base?

A Yes, I have.

Q Have you reviewed the percentage of Florida Power Corporation customers falling within a particular age group?

A No.

Q During your deposition Public Counsel asked you several questions concerning what would constitute a good deal according to Florida Power Corporation. Do you recall that line of questioning?

A Yes, I do.

Q Do you believe that there's some level of net present value savings below which this buyout would not be a good deal?

A Yes.

Q Do you recall that Mr. Howe asked you several questions about whether Florida Power Corporation was willing to fund the buyout in return for being allowed to retain all of its savings?

A Yes.

Q In your deposition you stated that under this condition you wouldn't consider $10 million of net present value savings to be a particularly good deal; is that correct?

A Yes.

Q And did you also state that you didn't believe that $10 million of net present value savings would be a particularly good deal for Florida Power Corporation's customers with the customers funding the buyout?

A Yes. I believe I answered that question both with respect to the company and the customers as you've described.

Q So if a base case, middle-of-the-road cost-effectiveness analysis demonstrated that the OCL contract buyout was projected to result in only $10 million of net present value savings, would you reccommend to Florida Power Corporation management to pursue that buyout?

A Probably not. But I can't say for certain whether the answer would be yes or no.

In the deposition I was asked to provide ranges, and I think I provided -- said below 10 million it wouldn't be a particularly good deal and it would be questionable. I think I mentioned a range of above 20 million where it becomes a relatively good deal; one that you wouldn't have much question about. And it was -- it wasn't to define a particular number but just to indicate relative to zero NPV, or relative to wherever the number fell, what ranges would appear to be good versus marginal.

Q But since you project the buyout to result in 30 million-plus dollars of net present value savings, you believe this is a good deal?

A Yes, I do.

Q Did your analysis give any consideration to the timing of the savings?

A Yes. What consideration did you give to that matter? We considered it in a number of respects. In the first respect the original offer from OCL was for a five-year buyout that would only take out the last five years of the contract. In recognition of the timing difference, we suggested to OCL a ten-year buyout which would begin to derive savings for the customers five years sooner and we were able to negotiate a ten-year buyout. That was our first recognition of the timing difference.

When we presented the proposal to the Commission for approval, we mentioned and have continued to stress that with respect to the timing it is not ideal. We would prefer to have better timing but because of the nature of cogen contracts, if you're going to make some progress in reducing costs and reducing the burden of these contracts to customers, you don't have as much flexibility as we'd like to have. We have to go out to the back end of the contract in order to strike deals that really make sense; that can provide savings on the order of magnitude of half a billion dollars, as it is in this case.

One additional point: We believe very strongly that intergenerational equity and the timing of the payments should not be considered on an incremental basis. You need to take a step back and look at the layers below that. In particular, the OCL contract has timing differences in the cost to the customer that results in the fact that current customers are not paying their fair share and customers out at the end of the contract are going to pay a substantially higher price for power from this contract. The point we've made again and again is that the buyout represent as incremental adjustment to that contract, which in combination, improves the timing of the overall cost of this contract to customers, and makes it fairer in terms of cost recovery versus benefit than the existing contract does.

Q Could you explain why the OCL contract was priced based on the value of deferral methodology?

A Yes. It basically recognizes an escalation rate in capacity payments similar to what I described when I referred to the May 1996 cost forecast. It recognizes that generation will become more expensive in the future and it adjusts the capacity payment stream to basically, you know -- one viewpoint would say that it represents a market price of generation capacity, going forward in time, rather than a constant cost or a declining cost as would result from traditional ratemaking.

It also is designed to provide an incentive to suppliers to supply their power and keep their capacity in place over the life of the contract.

Q At what rate do the time capacity payments under the contract escalate through time?

A Approximately 6%.

Q Is that the avoided unit's capital cost escalation rate assumed at the time the contract was originally approved?

A Yes, it was.

Q Assuming that inflation stays near today's rate of approximately 3%, if we were to look at the OCL contracts capacity payments in real terms as opposed to nominal terms, that is to remove the effects of inflation, would that tend to flatten out the payment stream over the term of the contract?

A Yes. The payment stream on a real basis deflated for inflation would still increase, but they would increase less than they do on nominal terms.

Q Also looking at that payment stream in real terms, wouldn't the capacity payments made by today's customers more closely match those payments made by future customers?

A They would be closer, but because on a real basis they still increase by approximately 3% per year, the payments at the back end of the contract would be substantially larger than the payments in the near term.

Q Would you agree that costs under the traditional revenue requirements method of recovery are more front loaded than the value of deferral method used in the OCL contract?

A Yes.

Q Then if we were to look at capacity payments under the traditional revenue requirements, under the traditional revenue requirements method in real terms wouldn't the capacity payments made by today's customers still be much larger than those payments made by future customers?

A Yes, they would be.

Q What is the net present value to Florida Power Corporation of the buyout payment streams, the total $49.4 million, in nominal terms?

A You're saying the net present value to Florida Power?

Q I'm sorry, to the customers.

A 40,411,000.

Q So is OCL receiving nominal payments of $49.4 million but in real terms they are receiving

payments of 40,400,000; is that correct?
A Yes, in real terms, according to this calculation.
Q What discount rate was used to determine the net present value of payments, or the $40.4 million?
A 8.67%.
Q Do you recall that in your deposition Staff asked a series of questions regarding Florida Power Corporation's willingness to spread out recovery to buyout payments over more than five years?
A Yes.
Q At the deposition did you indicate there were no specific plans to spread out recovery over a period greater than five years because this has not been discussed with management?
A Yes.
Q Since then have you discussed spreading out recovery of the payments?
A No.
Q What would be an acceptable range of years over which the recovery could be spread?
A Acceptable to who?
Q To Florida Power Corporation.
A I don't know.
Q Would it be acceptable to spread payments --

I'm sorry, would it be an acceptable range -- would 26 years, the term of the contract, be an acceptable range of years over which recovery could be spread?

A No.

Q Why not?

A Well, it depends on your underlying assumptions, but the analysis shows that if the party making the initial buyout payments over five years were to capture the savings from the transaction, they would get their money back in less than 26 years. And that would be under terms that would be transparent to the customer.

If that's the case, to stretch them out beyond the term when you could recover these dollars from the customers, I don't know what purpose that would serve.

COMMISSIONER CLARK: What do you mean beyond the period of time you could recover them from the customers?

WITNESS SCHUSTER: Excuse me, I'm falling back to the prior discussion where it was claimed that if Florida Power funded the initial buyout costs, they could get their money back in approximately 22 years. And putting aside what entity does that, whether it's Florida Power, the customers or whoever, if the mechanics work that way, or approximately that way, and I agreed earlier that you could get your money back before the end of the term of the contract, there would be no justification whatsoever for stretching the recovery out over the full term of the contract. In effect, in order to do that, you would give customers a lower cost due to this contract than even the buyout provides. You would be subsidizing customers for some period in order to delay the recovery of the buyout costs, if I understand Mr. Keatings' question correctly.

COMMISSIONER CLARK: Go ahead, Mr. Keating.

Q (By Mr. Keating) If the recovery of the buyout costs was approved over a period longer than five years, how would Florida Power Corporation finance the buyout?

A I don't know. And let me reiterate that Florida Power pursued this transaction, negotiated it with OCL, had it approved by management and brought it to the Commission for approval by this body.

We have not analyzed or considered or discussed any of the type of alternative structures that you're proposing, so I don't know how it would work or whether it would be acceptable.

COMMISSIONER CLARK: Let me just be clear.

Under the negotiations you had with OCL, it provides for a five-year buyout, you pay them over five years?

WITNESS SCHUSTER: Yes.

COMMISSIONER CLARK: All right.

COMMISSIONER CLARK: Yet for the Tiger Bay, you made an up-front payment of $45 million, right?

WITNESS SCHUSTER: $445 million plus a few extra million, yes.

COMMISSIONER CLARK: Even though you paid it you're going to -- you paid it to the entities you contracted with, you're going to receive that from the ratepayers over a period of time. How come you did it for that one and not for this one? How come you were willing to do it for that one and not for this one?

WITNESS SCHUSTER: For several reasons. First, because the Tiger Bay transaction was one in which there were immediate savings. We could start to pay off that cost immediately and work it down. At the time that the Tiger Bay buyout was approved, we estimated that we could retire the entire cost of the buyout of the contracts by 2008, and we were hoping to do it sooner than that. But the balance that we financed in July of this year has started to come down already based on the mechanics of the stipulation that was signed, and it will continue to be reduced over time to amortize that regulatory asset.

That's not the case with the OCL buyout. If Florida Power were to finance this transaction, they would establish a regulatory asset that would sit there until 2014.

COMMISSIONER CLARK: So the difference being in one the regulatory asset is probably going to go away in 2008 and the other it's 2014.

WITNESS SCHUSTER: Start to go away in 2014. So one of the things we had to do in Tiger Bay was to get ourselves comfortable that our auditors would approve that type of a balance sheet transaction as a regulatory asset. Because of the timing and the circumstances of Tiger Bay, we felt comfortable with that.

OCL is much different and we haven't asked that question and researched it, but I suspect that the answer would not be affirmative. That's the first reason.

COMMISSIONER CLARK: Your auditors wouldn't allow you to treat this as a regulatory asset. Is that what it turns on, whether it gets treated as a regulatory asset?

WITNESS SCHUSTER: I have two or three other reasons I want to explain. But one consideration --

see if the auditors don't approve this as a balance sheet item, we would have to take about a $50 million charge to earnings.

COMMISSIONER CLARK: Okay. For purposes of your financial reporting --

WITNESS SCHUSTER: Right.

COMMISSIONER CLARK: -- you believe they might not allow it as a regulatory asset. What if we approved it as a regulatory asset?

WITNESS SCHUSTER: That may or may not persuade the auditors. So that's point No. 1. Point No. 2 is that in the Tiger Bay transaction we work very hard with the parties to the transaction and the parties to the Commission proceeding to create a stipulation before we came to hearing. We work back and forth; we came up with a structure that we thought all of the parties could agree to. We took it back to our management. We took it back to our accounting department, our tax department, our legal department and made sure it would work and then we brought it to the Commission as a deal that Florida Power was prepared to do and that the other parties to the docket were prepared to live with. We haven't done anything like that here. We only have one deal on the table, and it's the deal that Florida Power and OCL negotiated and brought into this proceeding, hopefully for approval. Well, I thought you said they originally proposed five years and you went back to them and said that's not enough. It sounds like you've done the same sort of negotiating. We did exactly that on the term of the buyout and that happened in early well -- mid-1996 over a year ago. But that was part of the RFP process we conducted last year. Looking ahead to the potential approval of this transaction we felt that a ten-year buyout would save the customers more money, and because it advanced the time period when savings would start, would be more palatable and more acceptable as a proposal; and we had the option to make that change early on and we did. If you would just answer for me why you felt it was not appropriate in this case to do the same thing that you've done in Tiger Bay, just very succinctly. Very succinctly. Okay. Two reasons I mentioned already, is the auditor problem with a regulatory asset outstanding for a long time. The second reason being that we haven't created a stipulation that would have that kind of structure. And the third reason, which I feel is material and it would impact our management, is that this is coming on the heels of Tiger Bay. We have already created a regulatory asset of nearly a half a billion dollars and we have financed that on Florida Power's books.

There's a limit to how much of that you can do. We felt the Tiger Bay transaction was a tremendous opportunity for the customers, and we were willing to get up and step up to the plate and finance that.

COMMISSIONER CLARK: Okay.

WITNESS SCHUSTER: This -- you know, you'd have to stop somewhere.

COMMISSIONER CLARK: All right. Go ahead, Mr. Keating.

Q (By Mr. Keating) Mr. Schuster, what would be the potential benefits to ratepayers spreading costs over a time period greater than five years?

A Well, it would reduce the near term cost of the buyout to ratepayers.

Q If debt were issued to finance a buyout with a recovery over five years, would the payment on this debt appropriately be recovered via fuel and capacity clauses in the ratios recommended by Florida Power Corporation?

A I'm sorry, I'm not understanding your question. If the recovery is over five years there would be no need to issue debt to finance the buyout.

COMMISSIONER CLARK: I thought his question was if it were over ten years? Is that what you asked?

MR. KEATING: No. The question was over five years.

COMMISSIONER CLARK: All right.

Q (By Mr. Keating) I'm sorry, when I say over five years I mean greater than five years. Does that change your answer?

A I apologize. Would you read me -- would you let me have the question one more time.

Q Sure. If debt were issued to finance a buyout, would recovery greater -- over greater than a five-year period, would the payments on this debt appropriately be recovered via fuel and capacity clauses in the ratios recommended by Florida Power Corporation?

A Yes.

Q Would recovering such costs result in greater or lesser net present value savings to ratepayers than recovery over a five-year period?

A Well, assuming that we could finance it at an interest rate less than the discount rate I believe the savings would be greater.

Q If buyout cost recovery was arranged to occur over a period of greater than five years, would customers' rates decrease or would they stay the same?

A Are you asking that in relation to a five-year recovery?

Q Over a period of greater than five years.

A But compared to what?

Q In relation to a five-year period.

A Well, assuming that the transaction is done, recovery over more than five years would result in a smaller rate increment to recover the buyout costs than if the recovery were made over five years.

Q So customer rates would decrease over the next five years, or over the first five years, and then increase with the following years?

A They would be -- they would be lower than if the buyout were undertaken over a five-year period.

Q Okay. Would increasing the recovery period of the buyout costs reduce the possibility for intergenerational inequities to occur by matching the timing of benefits and cost?

A Yes, it would have that effect to a very slight extent. It would reduce the period of time between the occurrence of the cost and the recognition of the benefits.

Q You stated at your deposition that under your proposal the payments to OCL would be matched by ratepayers through fuel clause revenues; is that correct?

A Yes, I did. And let me qualify that.

Florida Power began making payments to OCL pursuant to this buyout transaction at the beginning of 1997, and bearing in mind that this was filed with the Commission last October and the deal was signed prior to that, the original expectation was that we would get Commission approval and begin recovering these costs from customers very shortly after the beginning of 1997.

The agreement has remained in place in spite of the fact that the regulatory approval by this Commission has been delayed from what we originally expected.

Florida Power has continued to make the payments according to the terms of the buyout and we would plan to get back in synchronization after approval.

Q As a result of any mismatches in the timing of payments to OCL and fuel clause recovery, would there be an interest rate calculation payment to Florida Power Corporation based on the normal mechanics of the fuel clause?

A Yes, there would.

Q What is the interest rate that applies to the fuel clause revenues?

A It's a commercial paper rate. I believe it's probably in the 5 to 6% range. I don't know the exact rate currently.

Q Could you now please turn to the exhibit identified as LGS-31? And that includes your response to Staff Interrogatory No. 7.

A Yes.

Q As requested by Staff you depicted in the graph the annual cumulative net present value of ratepayers' savings associated with Florida Power Corporation's buyouts and settlement agreements for each of the Florida Power Corporation QF buyouts recently considered by this Commission, including Pasco, Lake, Auburndale and Orlando Cogen; is that correct?

A Yes.

Q At your deposition you indicated that it was not appropriate to consider the cumulative net present value of the combined pricing settlement and buyout for OCL; is that correct?

A Yes.

Q Why is that?

A Because -- well, for a number of reasons. It's an apples and oranges mixture.

The OCL settlement, as a result of the pricing dispute, was completed, approved and is now final. The OCL buyout is a completely separate stand-alone deal that is available as an opportunity to Florida Power. I think it's inappropriate to create a total transaction out of two things that have no relationship to each other.

Q So you would consider it more appropriate to consider a comparison of the various QF buyouts without including the pricing settlements?

A I would consider it more appropriate but I feel there are risks even in making that comparison.

Q Reviewing your graph, which of the lines depicting cumulative net present values of the individual QF buyouts shows the greatest combination of risk and return?

A I'm sorry, I don't know how to answer your question.

Q Which of these is riskiest to the ratepayer?

A By what measure?

Q If I could have just a minute. (Pause)

COMMISSIONER CLARK: Well, Mr. Schuster which one is riskier in the sense that the ratepayers might never realize the savings?

WITNESS SCHUSTER: Well, by that measure the project which provides savings to the customer last would be the Auburndale transaction; that's the last line to cross over the zero point.

COMMISSIONER CLARK: But they are not paying as much up front, are they?

WITNESS SCHUSTER: As much as OCL, no, they are not.

COMMISSIONER CLARK: So why I guess -- Auburndale is the one that poses the highest risk to the customers that they will not realize savings.

WITNESS SCHUSTER: Well, yeah, by the measure you described as far as --

COMMISSIONER CLARK: And what was that measure?

WITNESS SCHUSTER: As I understood it for which one do you wait the longest for the savings to occur?

COMMISSIONER CLARK: Well, which one do you think poses the greatest risk that they will not realize savings?

WITNESS SCHUSTER: (Pause) I apologize. The problem I'm having answering the question is the recognition in my mind that the Auburndale, Pasco and

Lake buyouts are embedded in larger transactions where there was a pricing settlement, and the actual cost/benefit stream to the customer is different from what they appear here.

The other concern I have is that these, as I mentioned a couple of questions ago, I don't feel that these are directly comparable because Auburndale, Pasco and Lake were buyouts that were done in combination with energy pricing dispute settlements. And both of the parties to the transactions recognized that it was a package deal and they probably wouldn't have done each piece of the transaction the same way if they had been separated.

COMMISSIONER CLARK: I guess what I -- that response to me suggests that that's a justification for the way the deal was structured; not an answer to which one poses the most risk to the customers in terms of ultimately realizing savings.

Why isn't it Orlando Cogen, because there's more up-front costs they pay and it's later they would realize the benefit. It strikes me that that -- that poses the most risk to them. You apparently don't agree.

WITNESS SCHUSTER: Well, it's not that I don't agree. It's that this is a difficult question.

And that's why I ask the question back, by what measure? Because the way I would look at this is that the -- there's two measures -- just having nothing to go on but this graph, there's two measures I would consider would be risky: One is the degree to which the costs go negative before they turn around, and the second is how positive they are at the end. A third one would be the crossover point.

The project that has the largest cost before it turns around is the Pasco project. Now, it does cross over earlier than OCL, but it's not as great at the end; Pasco stops at about 10 million, OCL goes up to 30.

So if you're weighting -- it depends on how you weight these things. I could say that Pasco is very risky because it has the same cost up front, about 40 million, before it turns around, but it only provides a third of the benefits that OCL does. So it's not a black and white issue in my mind.

COMMISSIONER CLARK: Go ahead, Mr. Keating.

Q (By Mr. Keating) Mr. Schuster, could you refer to the exhibit marked as LGS-24, or previously identified as LGS-24, Page 36.

A Yes.

Q Okay. That exhibit is your Late-filed

Exhibit No. 13 to your deposition; is that correct?

A Yes.

Q Could you tell me which of the -- which of the buyouts as shown on this -- which of the cumulative buyout settlement agreements shown on this graph appears to be the most risky?

A I can tell you which one is the least risky. Excuse me.

Q How do you determine which one is the least risky?

A The Auburndale buyout that just starts good and just gets better.

Seriously -- by this measure, once again I consider it to be a quandry. Here again, even combining the settlements in the early termination, OCL goes the furthest negative but it also goes the furthest positive.

Q So could we analogize what we see here on this exhibit, the line graph of OCL to an aggressive mutual fund? You can get high returns -- there's a lot of risk involved in it. If you've got the risk of very low returns or negative returns or very high returns.

A I would agree with that analogy, with the qualifications that -- the same qualification I raised earlier, that this is an apples and oranges comparison. It's comparing the OCL line represents one transaction from the past that's over and done with in combination with the proposed transaction that we're discussing here today.

I think it's much more appropriate to look at the proposed transaction here today on a stand-alone basis rather than to muddle it up with historical data.

Q Let me go on. If the risk associated with OCL was considered to be greater, as are the rewards, what does that say about the relative level of intergenerational equity between the OCL buyout and the other buyouts? And that is, again, assuming that the risk for the OCL buyout is greater.

A I'm not sure there's -- there's a correlation between those two things, but the risk -- the intergenerational has to do with the timing of the payments and the crossover point. The risk includes that, plus other things. So I would say there's a correlation between risk and intergenerational effects but not a one-to-one correlation.

Q Which of the buyouts do you believe is likely to result in the greatest level of intergenerational inequity?

A Well, I can't really tell that from this Late-filed Exhibit No. 13 because it's combined buyouts and energy pricing settlements.

Q What if we go back, then, to LGS-31, your response to Staff's Second Set of Interrogatories No. 7?

A Okay.

Q Based on that graph, which of the buyouts do you believe is likely to result in the greatest level of intergenerational inequity? (Pause)

A It's difficult to answer that question because each of the buyouts is, as I would judge, intergenerational inequity is actually reducing intergenerational inequity relative to the contracts that the buyouts apply to. All of these buyouts are moving dollars over time periods that compensate for the intergenerational inequity, if you will, of the underlying contract, so they all serve to mitigate intergenerational inequity.

Q So which would you say mitigates intergenerational inequity the least?

A Honestly, I don't know. I haven't looked at these four contracts from that perspective, and I don't know how to measure a degree of intergenerational equity to the precision that your question requires.

Q Would you agree that the extended ratepayers savings associated with the OCL buyout result in the greatest level of intergenerational among these buyouts?

A I didn't catch the very last part of that, intergenerational what?

Q Would result in the greatest level of intergenerational inequity among these buyouts?

A No, I wouldn't. Because I think it's appropriate to view intergenerational inequity, as I mentioned in my summary of my testimony, not on an incremental basis looking just at the buyout payments, but to look at them in combination with the existing contract.

Q What's the effect on risk to ratepayers if part of the buyout costs are funded through existing base rates rather than through the cost recovery clause?

A Would you repeat that question, please?

Q Could you tell me what the effect is on risk to ratepayers if part of the buyout costs are funded through existing base rates rather than through the cost recovery clause?

A The risk to ratepayers would be reduced under your -- the situation you describe because it would effectively result in the nonrecovery of a portion of the buyout costs from Florida Power's perspective.

Q Would you agree that if this buyout is approved, ratepayers would be assuming all of its financial risks?

A Yes, I would, and they would also accrue all of the benefits of the transaction as well.

Q Why shouldn't Florida Power Corporation stockholders also be accountable for the risk involved in this transaction?

A Because the savings from this transaction will reduce customer cost by approximately a half billion dollars in the future.

Our investors are not a party to this transaction; they are not in their posture as investors purchasing power from Florida Power, so they have no participation in this transaction. They shouldn't bear any risk.

Q If the buyout is approved, would Florida Power be willing to make its stockholders accountable for part of the risk?

A No, they would not.

MR. KEATING: Staff has no more questions.

COMMISSIONER CLARK: Thank you. Mr. Keating, you asked for a late-filed exhibit on potential stranded costs. Do you still need that?

MR. KEATING: No. We withdraw that request.

COMMISSIONER CLARK: All righty. Redirect, Mr. McKee.

REDIRECT EXAMINATION

BY MR. McGEE:

Q I just have a couple of questions.

Mr. Schuster, you have been asked several questions premised on the Commission approving something that varies from the proposal that Florida Power has put before the Commission through its petition that we're here on today.

Is there anything that the Commission can approve other than the proposal that we have before us that's reflected in the OCL contract amendment?

A No, there's not. The proposal for the buyout is described in the amendment to the contract, and the terms of that transaction have been agreed to by the parties and that's the only transaction that's available for approval.

Q And does that amendment provide that it will -- that its effectiveness will cease if Commission approval is not given for it?

A Yes.

Q Not given to it, excuse me.

A Yes.

COMMISSIONER CLARK: Let me ask you a question. Suppose we say it's okay but you've got to do a longer buyout period; we'll allow you to recover it over a longer period. You could go back and you could decide that's fine with you, and if OCL agrees to it -- I mean if they get their's in five years and yet we suggest they will be approved if you recover it in rates over ten years, you could decide to do that, couldn't you?

WITNESS SCHOTTER: Yes, possibly we could.

MR. McGEE: My only point was that wasn't the only deal that's on the table.

COMMISSIONER CLARK: I understand that.

Q (By Mr. McGee) Mr. Howe asked you some questions about the risk that OCL incurs because of potential increases in the cost of natural gas, and focusing on the risks that might exist after the current contract expires.

Do you know if the OCL contract gives them the opportunity to reduce their output during off-peak periods and, thereby, minimize the risk that might be associated with higher gas prices?

A Yes. The contract has those types of provisions in it. They are only required to maintain an on-peak capacity factor, so if they found generation to be marginally economic or uneconomic, they could back down during off-peak periods and substantially reduce that exposure.

Q You were also asked some questions on the general subject of intergenerational fairness, in particular a question I believe was from Mr. Howe, where you indicated that customers leaving the Florida Power system within the next 22 years would not receive a benefit from the OCL buyout proposal.

What I'd like to ask you is whether customers who might leave the Florida Power system on or before the end of 2001 when the buyout payments would be completed, whether they would be harmed in any way because of the overall OCL contract including the buyout?

A No. When you take a step back and you look at the OCL contract in combination with a buyout, those costs, as we indicated in a interrogatory response to Staff, are below the cost if Florida Power had provided this capacity through the alternative, that being a coal unit. So even if the buyout transaction were completed, customers in the near term are better off than if the OCL contract had never been signed.

COMMISSIONER CLARK: But they are not better off if -- they will pay more under the amendment in the next five years than they would have under the existing contract?

WITNESS SCHUSTER: Yes, that's exactly true. And that's because the existing contract doesn't recover enough money in the near term commensurate with the capacity that's being provided to our customer base.

COMMISSIONER CLARK: Okay. If you had been providing it.

WITNESS SCHUSTER: Right.

MR. McGEE: I think that's all I have.

COMMISSIONER CLARK: Exhibits.

MR. McGEE: Move the admission of composite Exhibit 1.

COMMISSIONER CLARK: Mr. Howe? Did you want to identify those?

MR. HOWE: Yes. The exhibits within Composite Exhibit 1 that I would object to are Exhibits 1, 3, and 4 as relating to my prior objection.

COMMISSIONER CLARK: All right. That is

noted for the record.

COMMISSIONER CLARK: All right. Exhibit 2.

MR. HORN: I would move the admission of Exhibit 2 and I will withdraw Exhibit 3.

(Exhibit 3 withdrawn.)

MR. McGEE: Can I have one moment? I'm having a little difficulty locating that. (Pause)

We have no objection to the admission of Exhibit 2.

COMMISSIONER CLARK: All right. Exhibit 2 is entered in the record without objection. Exhibit 3 has been withdrawn. Staff, the next exhibits, 4 through 8 of your exhibits.

MR. KEATING: Staff would move for the admission of 4 through 9. 9 is a late-filed exhibit.

COMMISSIONER CLARK: Well, we don't admit it yet.

MR. KEATING: Oh, I'm sorry.

COMMISSIONER CLARK: We'll admit 4 through 8 without objection. And then the late-fileds are subject to objection. Okay.

MR. KEATING: Understood.

(Exhibits 2 through 8 received in evidence.)

COMMISSIONER CLARK: Thank you, Mr. Schuster. You're excused for now.

WITNESS SCHUSTER: Thank you.

COMMISSIONER CLARK: Let's go ahead and take a ten-minute break and then we'll start with Mr. Larkin.

We're going to go a little bit late tonight. It doesn't look like we'll get done today. And then I'd like to start early tomorrow in the hope we can get through before noon. All right, we'll take a break until 10 to 4.

(Brief recess.)

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COMMISSIONER CLARK: Call the hearing back to order. Mr. Howe.

MR. HOWE: Commissioner Clark, Mr. Larkin has taken the stand.

Commissioner, I haven't been doing this very long so you'll see that Mr. Larkin's testimony starts off with an unnumbered page, so --

MR. CHILDS: We'll just strike it. (Laughter)

COMMISSIONER CLARK: That's grounds for striking it.

MR. HOWE: Then we start the next page with 1.

COMMISSIONER CLARK: That gives me

confidence in any numbers that you might have here.

(Laughter)

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HUGH LARKIN, JR.

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

DIRECT EXAMINATION

BY MR. HOWE:

Q Mr. Larkin, would you please state your name and address for record?

A My name is Hugh Larkin, Jr. My business address is 15728 Farmington Road, Lavonia, Michigan 48154.

Q And Mr. Larkin, did you cause to be filed the "Direct Testimony of Hugh Larkin, Jr." consisting of 14 pages, the first of which is unnumbered?

A Yes.

COMMISSIONER CLARK: So it's one unnumbered page and 13 numbered pages.

MR. HOWE: Yes.

COMMISSIONER CLARK: All right.

Q (By Mr. Howe) Mr. Larkin, if I were to ask you the same questions reflected in that prefiled direct testimony, would your answers be the same?

A Yes, they would.

Q Do you have any corrections to be made?

A Not at this time.

Q Mr. Larkin, we also have two exhibits, the Appendix, which consists of the "Qualifications of Hugh Larkin, Jr.," and an exhibit, HL-1. Were those prepared under your direction and supervision?

A Yes.

MR. HOWE: Commissioner Clark, I'd ask we have an exhibit number for identification.

COMMISSIONER CLARK: All right. His Appendix 1 will be marked as Exhibit 10.

MR. HOWE: And can we mark HL-1 then as Exhibit 11.

COMMISSIONER CLARK: I'm sorry. Let's do -- what is it?

COMMISSIONER GARCIA: The attached exhibit.

COMMISSIONER CLARK: HL-1, we'll also make that part of Exhibit 10.

MR. HOWE: All right. Commissioner Clark, we'd ask Mr. Larkin's prefiled direct testimony be inserted into the record as though read.

COMMISSIONER CLARK: It will be inserted into the record as though read.

(Exhibit 10 marked for identification.)

DIRECT TESTIMONY OF HUGH LARKIN, JR.

ON BEHALF OF THE CITIZENS OF FLORIDA

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 961184-EQ

INTRODUCTION

Q. WHAT IS YOUR NAME, OCCUPATION AND BUSINESS ADDRESS?

A. My name is Hugh Larkin, Jr. I am a Certified Public Accountant licensed in the States of Michigan and Florida and the senior partner in the firm of Larkin & Associates, Certified Public Accountants, with offices at 15728 Farmington Road, Livonia, Michigan 48154.

Q. PLEASE DESCRIBE THE FIRM LARKIN & ASSOCIATES.

A. Larkin & Associates is a Certified Public Accounting and Regulatory Consulting firm.

The firm performs independent regulatory consulting primarily for public service / utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorneys general, etc.). Larkin & Associates has extensive experience in the utility regulatory field as expert witnesses in over 400 regulatory proceedings including numerous cases involving water and sewer, gas, electric and telephone utilities.

Q. HAVE YOU PREPARED AN APPENDIX WHICH DESCRIBES YOUR QUALIFICATIONS AND EXPERIENCE?

A. Yes. I have attached Appendix I, which is a summary of my experience and qualifications.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to provide comments on the proposed Orlando Cogen Limited, Ltd. contract buyout by Florida Power Corporation (FPC). Additionally, I am recommending that Florida Public Service Commission not approve this contract buyout in the format suggested by Florida Power Corporation.

Q. HOW WILL YOUR TESTIMONY BE ORGANIZED?

A. My testimony will cover five subject areas:

I. Cost / Benefit Analysis (purported savings to FPC customers)

II. Discount Rate

III. Intergenerational Inequities

IV. Stranded Cost Issue

V. Alternative Proposal

<u>I. Cost/ Benefit Analysis (Purported savings to FPC Customers)</u>

Q WOULD YOU PLEASE DISCUSS THE COST / BENEFIT ANALYSIS PROPOSED BY FPC AND LABELED AS SAVINGS TO FPC CUSTOMERS?

A. Yes. Both the primary and alternative recommendations of the Staff and the Company have concentrated on presenting to the Commission a comparison which has been labeled as savings to FPC customers. This analysis is essentially a cost/benefit analysis. It is designed to compare the up-front payments made by ratepayers in the amount of $9,881,000 for each of the years 1997 through the year 2001 to a projected future benefit which is projected to have a net positive present value to ratepayers of $75,058,000 (FPC-Exhibit No. 7, Docket No. 961184-EQ).

The calculation of the proposed net present value to FPC customers is, in my view, extremely speculative. The only amount that can be determined to be fixed, known and measurable is the amount that ratepayers will be charged for this buyout. It is clear that, in each and every year, 1997 through 2001, ratepayers will give up through additional charges added to the capacity adjustment clause some $40,411,000 net present value.

In return for these up-front payments, ratepayers are, in theory, to receive reduced fuel and capacity costs starting in the year 2014 which will compensate them for the up-front payment of $40,411,000 net present value. The ratepayers, in theory, are to receive net present value benefits starting in the year 2014 through the year 2023 of $75,058,000 which, according to the Company's calculations, will provide a net present value benefit to the ratepayer of $34,647,000.

The Company does not state how it arrived at the payment of $49,405,000 ($40,411,000 net present value) to OCL for the buyout of the last ten years of the contract. But it is the only dollar amount that can be substantiated. The benefits projected to occur in the years 2014 through 2023 are projections of future costs for both capacity and energy. The Company's net present value calculations have projected both coal costs and gas costs for the years 2014 through the year 2023. It has also projected capacity costs in its replacement case for the year 2014 through the year 2023. Even though the Staff and the Company have focused on these projections, the only conclusion that one could reach about these projections are that they will not be accurate. The likelihood that someone could project even one component, any gas costs, in the year 2023 and state that they were accurate with any degree of reliability would be folly. But these projections not only project the price of gas, they also project the price of coal and capacity in the year 2023. Setting aside for the present the discount rate used by the Company, the likelihood of all three components (i.e., coal prices, capacity costs and gas prices) remaining in the relationship projected by the Company is extremely unlikely.

Q. WHAT DOES THIS INDICATE TO YOU?

A. This indicates that there is the likelihood that one or all three of these components might vary significantly from what is projected. This has the effect of increasing the risk that customers who front the money for this buyout will be harmed. Clearly from a risk reward standpoint the risk that the ratepayer takes is extremely high in that there is no guarantee that one or any of these components will turn out the way the Company has indicated.

Q. ARE THERE ANY OTHER RISKS THAT ARE INHERENT IN THIS TYPE OF TRANSACTION?

A. Yes. It is clear that the Company is aware that some form or level of competition will affect the electric retail industry in the coming years. It is clear that the effect of these competitive changes will impact FPC and other regulated entities long before the year 2014. In fact, the motivation for this type of buyout is to prepare for competitive changes by reducing the cost of capacity and fuel to make the company more competitive. The Company's proposal, however, assumes that regulation will be in effect as it is today in the years 2014 through 2023, and that customers should be willing to accept higher costs today in return for lower costs <u>under regulation</u> in the future. One thing that is clear is that regulation will change and there can be no assurance that capacity adjustment or fuel adjustment clauses will exist 26 years from today.

From the standpoint of risk, both the risk of inaccurate projections some 26 years in the future and the risk that regulation will change or no longer exist, it would be imprudent for the Commission to require ratepayers to front these costs.

II. Discount Rate

Q. WOULD YOU PLEASE DISCUSS THE DISCOUNT RATE USED BY FPC TO CALCULATE A PRESENT VALUE BENEFIT TO RATEPAYERS FROM THIS BUYOUT?

A. FPC has used its marginal cost of capital rate of 9.97% less the tax deductible portion of the debt component of 1.3% to arrive at an after-tax rate of 8.67%. The Company's overall rate of return is predicated upon a secure monopoly franchise to provide energy in its service territory. The debt component, at least in part, is secured by the physical assets of the Company. Thus, this marginal rate of return reflects a monopoly enterprise secured in part by physical assets. It is not an appropriate discount rate to be utilized in analyzing possible future benefits to ratepayers.

Even if one could get by the risk associated with the projections of fuel and capacity in future periods, the discount rate should reflect the risk being taken by the ratepayer and not the cost of capital that the Company receives based on its monopoly enterprise. The payment that ratepayers will make over a five-year period will impose a discount rate on customers more akin to an interest rate on an unsecured loan or a credit card. The rate on these types of payments would range from 13% to as high as 18%. On exhibit HL-1 I have shown the net present value of the Company's case based on a 13% discount rate. As can be seen there is a net negative present value based on a 13% discount rate of ($4,690,550).

Q. **WOULDN'T RATEPAYERS ACCEPT AN 8.67% RETURN IF THEY WERE INVESTING THE MONEY?**

A. It would be unlikely that any sophisticated investor would accept an 8.67% rate of return on his investment considering both the risk and the length of time associated with the Company's proposal. Industrial and commercial customers clearly would not accept a rate of return on their investment as low as 8.67% since their stockholders would demand higher rates of return because of the inherent risk associated with any business other than a monoply. Thus, for the Company to suggest that a 8.67% rate of return is appropriate in calculating the net present value benefit to ratepayers is not reasonable.

If one uses an appropriate discount rate, one that reflects a high risk investment or the rate charged for unsecured loans, clearly there is no benefit to ratepayers. The net present value would be negative.

FPC's argument that ratepayers are better off by making the buyout then they would be otherwise cannot be justified. There is no justification in the Company's case of how it arrived at the payment of $49,405,000 or why that is fair to the ratepayers. There is, however, clear indication that there is substantial risk associated with this buyout and that the discount rate is not appropriate.

Also, the Commission should keep in mind that FPC has no investment in the co-generation facility. The Company's marginal cost of capital affects none of the components, either capacity or energy, of the costs passed through to ratepayers. This is merely a flow through directly to the customers through the fuel adjustment clause and the capacity adjustment clause. Therefore, the use of FPC's cost of capital as a discount rate is inappropriate.

III. Intergenerational Inequities

Q. ARE THERE INTERGENERATIONAL INEQUITIES ASSOCIATED WITH THE COMPANY'S PROPOSAL?

A. Clearly there are. Customers who make payments in the first five years must remain on the system for some 27 years in order to receive the benefits associated with their up-front payments. It is unlikely that many, if any, customers will collect for the payments that they have to make currently in order to receive some future benefit which is subject to the risk of fuel and capacity projections and changes in regulation.

Q. FPC SAYS THAT THIS IS NOT INTERGENERATIONAL INEQUITY, BUT SOMEWHAT MIRRORS THE OCL CONTRACT, WOULD YOU PLEASE COMMENT.

A. It appears that FPC's argument is that capacity payments to OCL are lower in the beginning years and higher in ending years and, therefore, the customers at the beginning of the contract receive some type of benefit because of these lower capacity payments at the beginning. The Company concludes that this is no different than ratepayers making payments at the beginning of the period to receive benefits at the end of the period, an analogy I do not believe is accurate. The capacity payments are lower in the OCL contract to ensure performance. In other words, to ensure that OCL meets its obligations to provide capacity and energy, it is not compensated up-front for the full amount of its investment in capacity. This benefit should flow to the current ratepayers because they are the ones assuming the risk of whether OCL can and will perform its contractual obligations. The higher payments at the end of the contract are justified because, historically, OCL would have performed under the contract for a significant part of the contract term and its performance for the remainder of the contract would be more or less guaranteed by the higher payments. Thus, because the risk is lower, the payment by customers would be higher. This is not comparable to the contract buyout where customers are making payments up front and may not be on the system to receive any benefits at the end of the period. They are taking the risk and receiving no benefit while in the original contract the customers at the beginning are taking the risk of nonperformance and receiving the benefit of lower cash payment for that risk. These are not comparable situations and clearly one is intergenerational inequity (the contract buyout) and one is the payment for risk (current contract costs).

IV. Stranded Cost

Q. BOTH THE PRIMARY STAFF'S RECOMMENDATION AND FPC HAVE CONCLUDED THAT THE BUYOUT HAS ADDITIONAL BENEFITS IN ADDITION TO THE EXPECTED COST SAVINGS. WOULD YOU PLEASE COMMENT.

A. In the Staff memorandum of December 26, 1996, the primary Staff's recommendation states, "The buyout will mitigate potential strandable costs and increase FPC's flexibility in meeting customer needs in the future." The Company states, on page 19 of Mr. Schuster's testimony, that "In the case of the OCL transaction, the effect of reducing future costs from the level of the contract to FPC's projected avoided costs during the buyout period 2014-2023 has, for all intense and purposes, the same effect as eliminating potential strandable costs of a like amount." Additionally, on page 18 of Mr. Schuster's testimony, he states, "FPC's objective is to continue to meet the electric needs of its customers at competitive prices. The Company has recognized that the rising cost of its portfolio of co-generation contracts poses a threat to this objective."

The problem with both the primary Staff's recommendation and the Company's stated objectives is that these costs, if they are strandable costs, have been segregated and placed as a burden upon the ratepayer. In other words, the Company and the Staff have concluded that the co-generation contract in question will be above the cost that the marketplace will be willing to pay for energy in the year 2014. Thus, by eliminating these costs now, the Company can lower its future capacity and energy costs. The problem with this approach is that it burdens the ratepayer with strandable cost without examining the offsetting mitigating assets that the Company owns which should be used in mitigation of strandable cost.

Q. WOULD YOU PLEASE EXPLAIN THAT FURTHER?

A. As an example, suppose that in the year 2014, the first year of the contract buyout, the OCL energy and capacity payments result in an average cost on the Florida Power Corporation System of 11¢ per KWH. Assume however, the other generating plants on the Company's system have an average capacity and fuel price of 5¢ a kilowatt hour including return and all other fixed costs. If the market clearing price on average was 8¢ a kilowatt hour, then FPC would be able to sell all of its native generation at an excess profit of 3¢ a kilowatt hour since its embedded 5¢ rate included a rate of return. The 11¢ power would, of course, only be able to sell at the same market clearing price of 8¢, thus leaving a strandable cost of 3¢ per kilowatt hour. If the Commission approves this contract buyout in the manner that it is currently structured, ratepayers will pick up the 3¢ per kilowatt hour of potential strandable cost in the contract buyout but the Company will earn an additional profit of 3¢ a kilowatt hour on it own assets because the imbedded cost of their plant and energy is cheaper than the market clearing price.

There is no justification for the Company receiving the benefit of the additional 3¢ per kilowatt hour profit on its generating assets since the ratepayer had supported the plant during its entire life. Thus, the more equitable method would be to offset the strandable cost of 3¢ by the excess profit earned by the Company at the same time. The Company would still retain a large portion of this excess profit since KWH from their native generation assets would far exceed the strandable cost from the KWH of this cogeneration contract.

By separating the two transactions, both the primary Staff's recommendation and the Company seek to place the burden of strandable cost on the shoulders of the ratepayer, while keeping any additional profits that the Company's assets might generate for the stockholders. This is inequitable, and the Commission should not embark on such a one- sided policy.

Clearly, if a transaction has the potential of affecting strandable cost, it must be considered in the light of any other positive offsets that the Company might have available to it, such as my example of plant which will generate additional profits at the market clearing price. To do otherwise would burden ratepayers with increased cost and keep increased profits for stockholders.

V. Alternative Proposal

Q. IS THERE AN ALTERNATIVE THAT THE COMMISSION COULD CONSIDER

TO THE COMPANY'S PROPOSAL?

A. Yes, there is. If the Company believes that its proposal is beneficial then it shouldn't matter to the Company whether the ratepayer or the Company make the buyout payments in the years 1997 to 2001.

It would seem to me that, if the Company thought that its projections and its negotiation of the buyout were reasonable and the Commission should rely on them, then the Company should in the alternative be willing to make the up-front payments. Let the Company front the $49 million plus buyout payment and if the Company's fuel and capacity projections are accurate and there is a capacity and fuel adjustment clause in existence in the year 2014, then the Company can recover its up-front payments from the ratepayer through the adjustment clauses. The company will receive a rate of return equal to its current authorized rate of return and at the same time be able to reduce its future capacity and energy costs and achieve its stated goal of offering competitive price to its customers. Since the Company feels its projections ought to be relied on, it should be willing to make the up-front payments and receive a return plus the up-front payments in the years 2014 to 2023.

Q. WOULD FPC SUFFER ANY HARM IF THE COMMISSION WERE TO DENY ITS PETITION?

A. FPC stated, at page 5 of its protest, that "the amendment (to the OCL contract) will provide net savings of over $400 million to Florida Power and its customers and will mitigate the exposure of Florida Power and its customers to potentially strandable costs in the future." FPC, however, has been flowing the costs of the OCL contract through to its customers through the fuel adjustment clause, and its proposal would flow the costs of the buyout to customers. It would appear that FPC cannot be harmed from a denial of its petition because FPC's earnings are not affected under either scenario. If FPC could be harmed by the existence of strandable costs in the future, then it must be presumed that traditional ratemaking will not be applicable in the future. As I have previously explained, FPC should be required to offset strandable costs with those assets that will be able to mitigate stranded costs. If this is the case, FPC's NPV analysis, which are premised on the continuation of traditional ratemaking through 2023, are invalid as a basis for predicting future customer savings.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes it does.

Q (By Mr. Howe) Mr. Larkin, would you please summarize your testimony.

A Yes. My testimony consists of essentially five topics.

The first is I look at the Company's cost/benefit analysis which, in essence is what it is, and I point out that it is comprised of projections that go significantly into the future and project capacity and energy costs, both fuel -- both coal and gas costs, and that it is very difficult, if not impossible, to project any of these with any sense of accuracy.

In addition, I point out that the advent of competition in the electric industry is close; that it is moving forward. And that the likelihood that anyone could project what future customers would be able to obtain energy costs, capacity and fuel costs -- that is extremely unlikely that anyone could predict or project that. So that the cost/benefit analysis is very risky and very speculative just taking the company's projections and the effect of competition.

Then the other component of this cost/benefit analysis is the discount rate. And I feel that it's inappropriate to use the Company's cost of capital as a surrogate for a very risky ratepayer-funded project, and that if you were to look at something comparable it could be an unsecured loan and ratepayers would pay for unsecured loans, anything within the range of 13 to 18%. And once you do that, once you substitute and put in the right discount rate, accepting all of the company's projections and the likelihood of competition, the net present value turns negative, and, therefore, it would not be in the best interest of the ratepayer to invest in this type of project.

The third area is intergenerational inequities. I point out that there was a reason to structure the cogen contract the way it was structured; and that was that there was risk and by putting payments at the end, the risk is mitigated and that the risk taker, that is that group of ratepayers who pay at the beginning, should receive the benefit of the reduction of that price because of the risk. And as that risk mitigates, of course, the price increases and future ratepayers would pay that. That is not at all like the buyout payment.

The buyout payment charges ratepayers in the first five years and waits until the very end, to the year 2014, before any benefits starts to accrue to those ratepayers. So that there is an intergenerational inequity associated with the buyout.

The fourth issue I raise is stranded cost. Both the Staff and the Company have suggested that buying out this contract will somehow mitigate stranded cost. Well, it obviously will, because you'll be charging ratepayers now for something that might be stranded in the future. Of course, we don't know that it will.

But what you do when you do that is that you segregate pieces of stranded cost -- if this is stranded cost -- and you charge ratepayers now without giving them the benefit of those costs that the Company might have embedded in its rates which are below market.

So if this were the only project that the Company had that was stranded cost, the ratepayer would pay the stranded cost, he would alleviate it. The Company stockholders would keep the benefit of all the below market embedded cost, and that's just unfair, and the Commission shouldn't embark on that kind of policy.

And as a last area of my testimony I suggest that if this is such a great deal, let the Company fund it; let them buy out the contract, and then receive back cost of capital and their funds over the same time period that the ratepayer would have received theirs.

And I think that that -- if it is truly as secure as the Company thinks it is, that should be fair to the Company and to the ratepayer.

And that concludes my summary.

MR. HOWE: We tender Mr. Larkin.

COMMISSIONER CLARK: Mr. Froeschle.

CROSS EXAMINATION

BY MR. FROESCHLE:

Q Mr. Larkin, good afternoon.

A Good afternoon.

Q I'd like to start with a couple of questions about Part 1 of your testimony, which you've identified as the cost/benefit analysis. On Page 2 of your testimony you state that the only amount that can be determined be to be fixed, known and measurable is the amount that the ratepayers will be charged for this buyout. Is that true?

A Yes.

Q Isn't it also true that the capacity costs under the existing contract are also known with certainty?

A No. If you look at the contract, if you look at -- that section of the contract that deals with capacity payments, it is a calculation and it's a calculation that suggests that it will change as the amount of on-peak power varies, so that it is not something that falls right out of the contract; it has to be calculated. In fact, Page 17 of the contract, subparagraph 8.3 states "At the end of each billing month, beginning with the first full month following the contract in-service date, the Company will calculate the on-peak capacity factor on a rolling average basis for the most recent 12 months. Including such months, or for the actual number of months since the contract in-service date, if less than 12 months, based on the on-peak hours defined in Appendix C, the on-peak capacity factor shall be calculated as the electric energy actually received by the company at the point of delivery, during the on-peak hours of the applicable period, divided by the product of the committed capacity and the number of on-peak hours during the applicable period.

"In calculating the on-peak capacity factor, the company shall exclude hours and electric energy delivered by the QF during periods in which (i) The company does not or cannot perform its obligation to receive all of the electric energy which the QF has made available at the point of delivery, or (ii), the QF payments for electric energy are being calculated pursuant to Section 9.1.1." And I won't read 8.4 which defines the calculations.

So in other words, it's a calculation. It's not a number that where you take the nameplate rating times the capacity factor and you end up with the rate. It varies.

Q Would you agree that the capacity costs are known within a reasonable degree of certainty?

A You can make assumptions that, number one, the Company will be there and it will be performing the function of -- the cogen will be there and will be performing its functions and will be able to deliver. And you could assume that it will deliver a certain amount of energy on-peak, but those are all assumptions.

Q Have you reviewed Mr. Stallcup's testimony?

A I've read it, yes.

Q I'm reading from his testimony now, on Page 8 of that testimony, beginning on Line 4, continuing through Line 7 it reads, "For example, the projected energy costs under the replacement case are determined largely by the future price of natural gas, and are much riskier than the capacity cost under the contract case which are known with certainty." Do you disagree with Mr. Stallcup?

A I do to the extent that I've just stated.

Q I'd like you to turn to Page 3 of your testimony, at Line 6 through 8 you state that the -- to paraphrase, that the projections -- that the only conclusion one can reach about these projections are that they will not be accurate; is that true?

A That's true.

Q Isn't it true that generation planning is done based on projections such as these fuel costs?

A Yes, that's true. But that's not the purpose here. There's not a necessity for this Commission to decide between two alternative choices of a necessary addition of a capacity.

I mean the company -- Mr. Schuster has already admitted that lower prices are coming; that competition is going to bring lower prices. And it seems to me what the Company is saying is that if competition comes, you're going to get lower prices. Give us $49 million to pay off this contract to get lower prices anyway.

So to me the choice for the ratepayer is not -- it's lower prices, having the capacity; lower prices paying 49 million to get it. And that's no choice at all. That's a no-brainer. It's just dumping.

Q Getting back to the question, though, isn't it true that generation planning is done based on projections such as these?

A Yes. As I say, I disagree that this is really a generation planning necessity or hearing.

Q And so projections are made of fuel cost --

A Yes.

Q -- and of capacity costs?

A Yes.

Q And decisions are based -- are made based on those projects; isn't that true?

A That's true if it's a necessity to enter into construction of a plant or purchase, but that isn't the case in this instance.

Q Do you know whether the risk and uncertainty involved in Mr. Schuster's projections for the OCL contract buyout are any greater than the risk and uncertainty involved in the projections used by the Commission for, say, need determinations?

A I haven't looked at that, but I think just the fact that competition is going to change things makes them riskier.

Q Have you looked at the question of whether the risks involved in projections for calculations of avoided costs are any riskier than those that Mr. Schuster has made for purposes of this OCL contract buyout?

A Would you state the question again? I'm not sure I --

Q Have you looked at the question of whether the risks involved in Mr. Schuster's projections for this particular contract buyout are any greater than the risks that would be involved in projections used for calculations of avoided cost?

A It's the same answer I'd give to the other questions that you've asked.

Q Have you evaluated previous Florida Power buydowns or buyouts of purchased power contracts which this Commission has approved with respect to the risks or projections that were made?

A No.

Q Are you suggesting to this Commission that it should no longer use projections to make decisions in this type of a matter?

A I'm suggesting to this Commission that where there is no guarantee that ratepayers will receive a benefit, and it is clear that prices are going to decline because of competition, that they should not accept this kind of buyout.

Q Is it your testimony then that with absolutely certainty, with greater certainty than the calculation of capacity costs under the contract, that rates will go down under competition?

A Oh, I'm fairly certain that they will. I mean, they are moving that way now. I don't know of a state that isn't looking at restructuring or competitive issues.

Q What other states have you reviewed to determine whether those rates are, in fact, coming down?

A Well, I don't know that the rates are coming down. They're not going up as fast, and they are coming down in some places like California.

Q Is it your testimony then that they are going up in some situations?

A No. I said --

Q Not as fast, I believe, was your testimony.

A That's what I said. But I don't think that they're going up period; and in many instances they are coming down. They are either remaining level or decreasing.

Q But not necessarily coming down?

A No, not necessarily coming down.

Q Isn't it true that you're speculating as to what the rates may be under competition?

A Yes. And that's what this whole hearing is about: speculation about what is going to happen in the future. And the only part that isn't speculation is the $49 million you're asking the ratepayer to pay.

Q At Page 3 of your testimony, Lines 19 to 21, you state clearly from a risk/reward standpoint the risk that the ratepayer takes is extremely high in that there is no guarantee that one or any of these components will turn out the way the company has indicated. Is that true?

A That's true.

Q Isn't it true that the components could turn out to, in fact, work out in a way that the ratepayer was better off than was projected; isn't that true?

A No, because competition will eliminate any type of automatic recovery clause. And when that is eliminated, the ratepayer would automatically get that benefit. I mean, inherent in your question is the assumption there wouldn't be any competition. (Pause)

COMMISSIONER GARCIA: Mr. Larkin, let me ask you a question while they are thinking.

Let's say we don't approve this, and competition shows up in the next five years. What happens to this arrangement?

WITNESS LARKIN: Well, if competition shows up -- you mean the contract itself?

COMMISSIONER GARCIA: Yeah. What happens to this arrangement the Company has with the generator in this case.

WITNESS LARKIN: If competition shows up you won't be able to determine what ratepayers will pay for their energy. There will, number one, be no base rates; there will be no automatic adjustment clauses. Customers will be able to choose their supplier and that will be based on price, and that price will include both capacity and energy.

Once that happens, then the portion of the contract that says if we can't collect this through an automatic clause, we are able to abrogate the contract, then the company can abrogate the contract with a co-generator, or as an alternative they can negotiate a price that is market based, and then everybody comes out the way it should come out: The ratepayer hasn't paid any more; the Company is paying market based rates, and the co-generator is getting the value of his energy and capacity based on the current market.

COMMISSIONER GARCIA: You don't think we'd have to address this in some term of a stranded investment.

WITNESS LARKIN: Well, even if you do -- even if you do, the way to address that is to look at all of the stranded costs --

COMMISSIONER GARCIA: Right.

WITNESS LARKIN: -- in comparison to those costs that are aren't stranded.

COMMISSIONER GARCIA: Okay.

WITNESS LARKIN: Let me give you an example.

There will be a price in competition that's called the market clearing price. And that price represents an average of costs or prices that buyers and sellers will be willing to accept or pay in order to satisfy all those that wanted to sell and all those that want to buy.

If that average comes out to be 8 cents, that means some customers will -- who have market power will buy at 5; some customers that have low load factors and want to be on at peak and take all of their energy at peak will pay 9 or 10 cents. But the average will be 8. And at that price anybody will be able to get -- to sell their energy and customers that have -- will be able to buy.

If you have capacity and energy that's

selling at five and you can sell it for eight, and you've recovered all of your costs, you've got a profit that's in excess of the market of 3 cents. And there will be company assets, this Company's assets that will be able to do that.

COMMISSIONER GARCIA: You don't think that the ones who will be taking it at peak, the ones that don't have the market power, will be the ratepayers of this state in some way. Or individuals, in some way, are going to end up paying for this one way or another, and in particular the individual ratepayers or the --

WITNESS LARKIN: Residential ratepayers, or those that don't have -- not if competition becomes the way it should be. And the way it should happen is that there will be aggregators; people that will take small groups of customers or customers with complimentary load profiles and they will aggregate those together. And they will be able to go to Mississippi, or to Georgia, and get power. And as long as the transmission and the distribution system has open access, they'll be able to deliver that. So that if there is stranded cost and any company in Florida says, "Well, I'm going to charge these ratepayers that," the aggregator, through competition, will be able to circumvent that. You'll be able to bring power in that is less than that cost. And so the company will then either have to meet that price -- if he has 11 cents power and they can bring power from Georgia at 8 cents, then he either has to sell at above market energy at 8 cents and eat the 3 cents or he doesn't sell it at all. So it's the piece between 8 and 11 cents that's stranded. And it isn't stranded if he has another piece that has a cost of 5 cents that he's getting 8 cents for; he's whole. But when you take one piece, the 11-cent piece, and say pay for it now, and then five, ten years from now when competition comes he gets to keep the 3 cents and that's unfair to the ratepayer. And what I'm saying to you is do that at the appropriate time.

COMMISSIONER GARCIA: I'm sorry for interrupting. Go ahead.

MR. FROESCHLE: That's okay.

Q (By Mr. Froeschle) I'd like you to turn to Page 4 of your testimony where you begin and end your discussion of competition.

The question was also asked of Mr. Schuster this morning, or this afternoon, or both, regarding competition being the motivation for Florida Power to pursue this buyout.

My question for you is isn't it true that there could be other motivations in addition to the motivation of competition for Florida Power to pursue such a buyout?

A I suppose, but I can't think of any.

Q Isn't it true that as a utility in this state that Florida Power has an obligation to provide electric service to its ratepayers at a fair and reasonable cost?

A Yes, but --

Q Wouldn't it also be fair to say that Florida Power would, in pursuing such an obligation, have a reasonable motivation to seek to lower the cost of its power for its customers?

A Yes, but they could accomplish that by waiting for competition. They could accomplish the same thing by waiting for that price -- marketplace to bring that price to where it should be.

Q Let me ask you this question: If the motivation were to position itself for the onset of competition whenever it may come, and the outcome of Florida Power pursuing this buydown to lower the rates for its customers and, therefore, better position itself for competition, is that objectionable?

A It is when you're charging the ratepayer to meet that obligation. He's going to get the benefit anyway. It makes no sense for him to pay for something that if he didn't have to pay for it he would get in any case.

Q Again, you're assuming that the rates under competition will be lower?

A Not only am I assuming that, your own witness has said the same thing.

Q You're also assuming in your answer that the costs that are involved in this buyout could be avoided by the customers as a result of competition. Isn't that true?

A Yes.

Q Is that ignoring the possibility of a non-bypassable charge that may be legislated at the time competition is brought?

A No, not really, because as I stated to the Commission, that the way to look at stranded cost is to look at it in its entirety, not to bifurcate it and look at pieces of it. And that's what I think is wrong with this mitigation of supposedly future stranded cost.

Q I'd like to turn to your discussion of the discount rate in your testimony.

Isn't it true that the Commission uses a company's marginal cost of capital as a discount rate for net present value analysis of a company's alternatives in a case such as the one before the Commission here?

A Of a company's alternatives. I think that's the key word; not of the ratepayer's alternative.

Q Excuse me, I didn't hear?

A I said of the company's alternative; not of the ratepayer's alternatives. And that's the key.

Q Do you know of any instance where the Commission has used anything other than the company's marginal cost of capital for such calculations?

A I've never looked at it and I don't know that they've ever been faced with a situation where the analysis is taking ratepayer money to fund something through the utility. So I think it's probably -- and I don't know -- that this is an unique situation.

Q Do you know of any instances where the Commission has used a discount rate of 13 to 18% for its net present value calculations?

A No. But I don't think they've ever looked at what the discount rate for the ratepayer is either.

Q Do you know what the effect would be if the Commission were to use such a discount rate of 13%, say, in evaluating the cost-effectiveness of its utility conservation programs?

A They are not interchangeable; they are not comparable analysis.

Q Isn't it true that conservation programs are paid by the customers?

A Yes. But they are paid by the customers to avoid building plants. They are to avoid adding capacity.

Q But they are paid by the customers.

A Well, I assume that they are. I just don't know.

Q Isn't it true that a rate of 13% would render many of these programs non-cost-effective?

A As I said before, I don't think that they are really comparable.

Q On Page 19 of Mr. Schuster's testimony Mr. Schuster calculates a pretax return on investment for the OCL buydown in the range of 14.4 to 16.9%. Are you familiar with that?

A In his rebuttal testimony?

Q That would be on Page 19 of his rebuttal testimony; I believe that's correct?

A Yes, I'm familiar with that.

Q In your opinion would a sophisticated

investor be willing to accept a pretax return on investment in that range?

A Well, if you use Mr. Schuster's theory and apply it to the correct discount rate of 13 to 18% you'd get higher returns than that; you'd get -- and the ratepayer would not accept Mr. Schuster's when he could get a theory -- under his theory, which is, I think, flawed. He would opt to pay off his loans, as I stated, because using that methodology you would have rates of return significantly higher than that. But he arrives at that theory by concluding that because utility bills aren't tax deductible or taxable when they are decreased, that that's equivalent to an after-tax return.

Well, payment on a credit card at 18% is the same thing; equivalent to an after-tax return. So if you gross that up for taxes you'd be up at 22%, so he would opt to do that rather than invest in this buydown. So it's a phony method of trying to justify a rate of return that's not correct.

Q Do you know of any investments available to investors that would offer returns in this range?

A 12 to 14%?

Q 14 to 16?

A There probably are junk bonds that are up that high. You probably could find something that is extremely risky that would get that high, which would probably be comparable to this buydown.

Q I'd like to return to your discussion of intergenerational inequities. How do you define that concept?

COMMISSIONER GARCIA: I'm sorry, I didn't get the question.

MR. FROEHLICH: How do you define the concept of intergenerational inequities?

A It's charging one generation of ratepayers an expense that flows to the benefit of another generation of ratepayers.

Q From where did you get that definition?

A It's my own.

Q Are you aware of any Commission decision in this state where the Commission has defined intergenerational inequity in that way?

A Nope.

Q You are you familiar with any decision where they have defined it in any way?

A No.

Q Could you give me an example of a utility investment or a cost recovery plan that would not have intergenerational inequities?

A Well, in theory all of them do not. In theory, when rates are set, ratepayers currently are charged only the cost of the rates or the service -- the cost for the service that they are receiving. They are not charged something -- for instance, I'll give you -- here's an example.

The Commission doesn't charge current ratepayers, or allow CWIP, construction work in progress, into the rate base currently, and eliminate the carrying charge on that plan, because current ratepayers are not receiving any benefit from it. So CWIP is excluded from rate determination and it carries its own carrying charge. So that current ratepayers, although that plan is being constructed for somebody, the current ratepayers do not pay for it. When it does go into service, then those ratepayers pay the return on and the return of that investment, but at the same time they are receiving service for it; service from that plant.

MR. FROESCHLE: Just one moment.

COMMISSIONER CLARK: Isn't the flip side of that if you don't allow CWIP, you usually have a allowance for funds used during construction and you add it to the capital costs, so it's pay me now or pay me later.

WITNESS LARKIN: Except that if you're accruing CWIP or AFUDC on it and it never becomes used and useful the ratepayer is never charged for it. And in many instances commissions will adjust the capital structure to remove the effects of any debt or equity that was issued specifically for a plant that's coming on line. They don't do it in Florida but there might be instanes. Well, let me give you an example which you've done that I recommended, I felt was right.

In Jacksonville, United Water of Jacksonville had a rate case and they had upgraded the system, either added a new water plant, and they were using the parent company capital structure. But there was also a specific bond issue in Florida to fund that -- construction of that plant. I added that bond issue specifically to the capital structure and rearranged the debt and the equity to give effect to that, which lowered the overall cost of capital. And this Commission said that's right, because that specific issue relates to this project and we should take that into consideration. So there are instances where you adjust capital structures to effect or give effect to that particular project.

Q Isn't it true that in revenue requirement ratemaking current customers pay more than later customers for the same service?

A No. I mean once you set rates, if you set rates now -- suppose you put a new plant in service now, that plant reflects its full value and that is reflected in the rates. Now, the next year that plant has depreciated. Rates aren't reflected downward to reflect depreciation of that plant; if there is a benefit that goes to the company. If rates are never re-established and the plant goes to a complete level of zero over a 30-year period, the ratepayer still pays the same rate unless the Commission requires the company to come in adjust rates, or the company voluntarily comes in to do that.

Q How do you determine how much inequity is too much?

A How much inequity is too much?

Q In intergenerational inequity, how do you determine how much inequity is too much?

A Oh, I don't know. I think it's a judgment the Commission has to exercise. But this is clearly one of those instances where you have somebody pay something the first five years and then they have to wait 15 or 20 years to start getting any benefit back.

Q In analyzing your proposal, wouldn't you agree that you balance the cost to the ratepayers to the benefits they'll receive under whatever you're proposing?

A In association with the risk and the probability that they'll get the benefit.

Q But you would balance those, right?

A You'd look at them and I've looked at them and I think they are not very favorable to the ratepayer.

Q You don't look at the costs alone?

A You don't look at the costs alone. I guess I don't understand the question.

Q You're not looking at the costs in a vacuum; you're balancing, you're weighing them against what the ratepayer is going to benefit from the proposal?

A I guess you would, but in this instance --

Q Let me give you example. In this particular buydown you're saying that there's too much intergenerational inequity?

A I'm saying that there is intergenerational inequity.

Q That there is intergenerational inequity. And what I'm trying to determine from you is where do you draw that line? Where is there too much? Is there some point where it's okay? Some point where it isn't okay?

So with that premise in mind let me ask you this question: If in this example the ratepayers would not benefit by what they were under Mr. Schuster's calculations, but instead would benefit by $5 billion in costs saved at the end of the contract, would that offset what you see as being an excessive intergenerational inequity?

A No. I think that's a separate kind of issue.

Q So you do look at it in a -- you do look at it only as the cost --

A Yes, as whether one group of ratepayers are doing something to benefit another group of ratepayers.

Q So you would completely disregard whatever benefits the ratepayers might gain from the proposal as a whole; you would separate off that cost and completely isolate it from the gain the ratepayers would get?

A Well, I haven't done that, but I think you could. Even if you did, there is no $5 billion that the ratepayer is going to receive at the end. I think it's all pretty shaky.

Q I'd like you to turn to Page 12 of your testimony. And this is your proposal to, I guess, in addition or in differentiation from the one that has been brought to the Commission, you have suggested at line beginning at Line 12 that the Company will receive a rate of return equal to its current authorized rate of return and at the same time be able to reduce its future capacity and energy costs and achieve its stated goal of offering a competitive price to its customers. Is that an accurate statement of your testimony?

A Well, my testimony is a parroting of what I thought the Company was stating it wanted to do. That's an accurate statement of what I said.

Q That is an accurate reading of what you have stated in your testimony?

A Yes. What page -- Page 12, line?

Q Will Lines 12 through 15.

A Yes.

Q What's the basis for that statement?

A I think the Company has stated that that's what it wanted to do; reduce its future capacity and energy costs and offer competitive prices.

Q Well, I believe that this is a discussion of your proposal and your testimony, so it isn't something that the Company has proposed at all. I'm asking you've made this statement in regards to --

A Yes.

Q -- your proposal.

A Well --

Q -- and my question is what is the basis for you're making that statement? Did you perform an analysis?

A I looked at the Company's proposal, and if the Company funded it, they would would be in the same position as the ratepayer.

Q To make that statement, did you perform an analysis of some kind of this alternate plan that you're proposing?

A No. Other than looking at the cash flows in Mr. Schuster's schedule and assuming that the Company funded it instead of the ratepayer, there's no other alternative analysis.

MR. FROMSCHLE: I have no other questions at this time.

COMMISSIONER CLARK: Mr. Childs.

CROSS EXAMINATION

BY MR. CHILDS:

Q Good afternoon.

A Hi.

Q You have discussed Article 20 of the

contract entitled "Regulatory Changes" and I want you to keep that in mind with some questions that I have.
Are you a lawyer?
A No.
Q Have you reviewed this provision of the contract as a lawyer would as to what is required under the contract?
A No. I've reviewed it as a CPA would.
Q Okay.
A Looking at the contract and seeing what effect it would have on my view of the terms of the contract.
Q Kind of like an auditor would?
A Yeah. But I mean -- with you it's -- you know, I went and I looked for this contract or this provision knowing that it was there, knowing that I've seen this in other jurisdictions, and knowing that I've seen other companies and other company lawyers saying that if it is eliminated, this kind of provision would let us out of the contract.
Q And it's typically called a regulatory out provision, isn't it?
A Right.
Q Now, let's go back to my question about you've reviewed this as an auditor would. Did you as

an auditor check what this Commission itself had said about enforcing this kind of a contract provision?
A No.
Q Did you check what the Florida Supreme Court has said about enforcing this kind of a provision?
A No.
Q Would you agree that both this Commission and the Florida Supreme Court has said that once the decision or determination of prudence has been made that this Commission may not direct that further payments not be made?
A Well, I'm talking about the complete elimination of any kind of automatic adjustment clause. I'm not saying that this Commission order them not to make the payments.
Q Well, I think you did?
A If competition comes, there won't be any automatic clauses.
Q Well, so the answer is, then, that you did not conduct a review of what this Commission or the Florida Supreme Court has said; is that correct?
A My answer is that I did not, but such an analysis isn't necessary because it would not be the action of this Commission that would abrogate the contract with the effect of competition on whether the

Commission could enforce the collection from ratepayers who are no longer subject to a specific company providing their energy, force them to make a payment that competition would not make them pay.

Q As an auditor have you ever heard of the contract clause in the constitution of the state of Florida and whether contracts can be abrogated?

A Well, I've heard of --

Q I mean, it's clear you haven't done any review as to whether this provision would affect the obligation to pay in the future; isn't that correct?

A It has to have some effect or it wouldn't be in there. What you're saying to me is that it's in there but it has no effect.

Q Do you know when this contract was signed?

A 1991.

Q Do you know when the Commission -- this Commission addressed that question? That is the question of whether it could eliminate the ability to recover costs for a contract that's previously approved?

A No, but I'm --

Q Well, let me refer you --

A Let me go and give you my answer and it has nothing to do with this Commission abrogating.

Q No, I just asked the witness if he knew what this Commission had done.

I'm going to ask you if you would accept that this Commission address this issue in 1992, and said, "Once the Commission's determination of prudence becomes final by operation of law, the utility cannot, absent extraordinary circumstances, be denied cost recovery of payments made by a QF under negotiated contracts?

A Yes.

Q Do you know what the definition of an extraordinary circumstance was in that holding?

A No, but I would assume that it's probably competition.

Q Pardon?

A I would assume that it's competition.

Q How about material misrepresentation of fact? How about fraud?

A Well, that may be so, but -- I don't see how you're going to force -- or this Commission or the Supreme Court could force ratepayers to pay something --

Q Okay.

A -- that competition would not require them to pay.

Q When is competition going to affect the ability of Florida Power Corporation to recover the payments under this contract?

A We don't know.

Q Have you conducted any study as to the penetration of competition in the state of Florida?

A No.

Q Have you conducted any study as to the availability of generation in the state of Georgia, Mississippi, Alabama or anywhere else within 500 miles of Florida?

A Not a study, but I'm fairly familiar with it.

Q Do you know what the reserve margin is?

A Not offhand.

Q Do you know when it is that they would have to build new capacity if they started to make substantial sales in the state of Florida?

A Well, some are building capacity now or are asking to build capacity.

Q Okay. Do you know how much conservation Florida Power Corporation has as a goal to achieve in the next ten years?

A No.

Q You don't?

A Nope.

Q Do you have any idea as to how much it has?

A How much conservation it has as a goal to achieve?

Q Yes.

A No.

Q Do you know the basis for the determination of Florida Power Corporation's conservation goal?

A No.

Q Would you accept that this Commission reviewed and evaluated the cost of building and operating generation in the future?

A I know they do that on a regular basis.

Q So if competition is coming, then the first thing we ought to do is eliminate all conservation, wouldn't you agree?

A I don't know. That might be an end result.

Q Well, I mean you're asking -- under your theory you're asking -- conservation is asking current customers to pay a cost with the potential which you find to be unrealistic of deferring the need for capacity in the future. So shouldn't you, therefore, to be consistent with your approach, not pursue any further conservation?

A That might be likely. But what we're

looking at right here, right now is this buyout. And what the issue is is whether the ratepayer should be asked to pay $49 million for something they're not sure they will get; that is so far in the future that no one knows what the costs will be; that no one knows whether competition will, in effect, eliminate all of the automatic adjustment clauses and abrogate this contract.

Q Well, do you know that about any of the conservation that Florida Power Corporation has?

A No. But competition -- or conservation isn't the issue in this case.

Q No, sir. But if this Commission makes a decision on the basis that you urge, which is that competition should be recognized and, therefore, the potential for future payback is not there, then this Commission is going to have to take that into account in any determination for conservation, isn't it?

A It ought to. But that's only one of the issues that I raise. I raise the issue of --

Q But that's all I'm asking about right now.

A Okay.

Q I want to pursue on generation planning. I think that you were asked some questions about generation planning, as well.

Would you agree that under the circumstances that if competition is coming in the state of Florida that the last thing any electric utility should do is to make any commitment to build new capacity to be -- provide service under regulation?

A No.

Q Okay. Well, when do we get out of this dead band of knowing when a utility ought to look to an obligation to serve or serve its customers, and when I want ought to react to the competition that you identify is coming?

A Well, I would qualify your question by saying that if they want to remain competitive, and they see that there is a need for capacity, that they would build the capacity because they want to be competitive. They want to be able to serve; not because they have an obligation to serve the customer under regulation.

Q So they shouldn't build capacity because of any obligation?

A They should build capacity looking towards whether competition will compensate them for that capacity.

Q Well, that's an altogether different type of analysis, isn't it?

A Well, it's an answer to your question. Your question is an altogether different question from whether we're dealing with this contract or not.

Q Well, the analysis that one would do to decide whether to build capacity for competition or whether to build capacity for continuing regulation involves an altogether different type of analysis. Wouldn't you agree?

A Well, no. I mean, if you're building it for regulation, you're saying, "I have a demand. The demand must be served. I'm the only party that is authorized to serve it. I'm obligated to serve it. I should build the capacity." On the other hand, I'm a competitor. I see a demand. I want that customer. I should build the capacity. It seems to me there's just the same analysis.

Q How about using your discount rate of 13%, and then tell me how a utility in Florida would justify building anything other than a combustion turbine in the near term?

A Well, my discount rate has nothing to do with a monopoly utility who can recover all of its cost through --

Q Wait a minute?

A Let me finish. Let me finish.

MR. CHILDS: Commissioner, I --

COMMISSIONER CLARK: Mr. Childs, I think you have been interrupting him, frankly.

MR. CHILDS: I think that if he can answer the question, he can then explain. He doesn't answer.

COMMISSIONER CLARK: Okay. That's fair enough.

Mr. Larkin, you have to say yes or no and then you can explain. But don't interrupt each other, please.

MR. CHILDS: All right. I'm sorry.

A What was the question?

Q (By Mr. Childs) The question is if we use your discount rate of 13%, how would we justify -- we, being the Commission and the electric utilities and others -- building anything in state for -- in the way of generation other than a combustion turbine?

A You wouldn't, but then you wouldn't use my discount rate.

Q I beg your pardon?

A I said you wouldn't because you wouldn't use that discount rate.

Q You would not.

A No. Now, let me finish. I gave you a yes or no answer. I said you wouldn't use it, and you wouldn't use it because this is a monopoly, and as long as it's a monopoly it will get a monopoly return on that, and then that's the discount rate you use.

My discount rate reflects the ratepayer's cost of capital, which is significantly higher than the utility's. And what you want to do is to interchange the two and you can't do that.

Q Yes, sir, that is exactly what I want to do. And I want to return to the question that -- you answered it, as I understand it, that because it is a monopoly, and that is the utility, that you would use -- one would use the monopoly cost as the discount rate.

Don't you recognize that any plant that is built by an electric utility would have a useful life that would extend beyond the period that you say competition would be initiated in Florida?

A Well, yes. But not only I say competition will be in effect in Florida, but the Company itself says that. But why that is so is because you want now to put that in the rate base and you want now to ask the ratepayer to pay it, to automatically include that in base rates. You can use any discount rate you want. You can use 13%, you can use 113%; just don't come in here and say put this into the rate base. I don't care what discount rate you use.

But inherent in your question is would anybody build a plant using a 13% discount rate and come to this Commission and ask them to put it in rates? I mean, that's inherent in your question.

Q That's right.

A Okay. And my answer to you is, no, this Commission would not probably accept that.

Q All right.

A But you can use any kind of discount rate you want when competition gets here, and you can build plants and take the risk. But when you use a discount rate, you're asking the ratepayer to take that risk and that's when it becomes important.

Q So I take it, then, that your position or your answer is, is that because of competition that is coming in the state of Florida, that a utility would be unwise to evaluate a generation alternative on the basis of a 13% discount rate?

A Well, it depends under what assumptions; that they are going to come to this Commission and ask that they be required to put it in rates, or that they will find their own way of selling that supply? Qualify the question.

Q Let's try this. I'll try to narrow the assumptions. You're familiar with the -- with what is commonly called the front-end loading, for example, of the capacity-related cost associated with a coal unit?

A In this contract?

Q No, sir, in general, for regulation?

A Front-end loading of the capacity cost.

Q The revenue requirements -- revenue requirements on a coal unit because of the effect of depreciation -- or any plant, they are higher at the front end than they are at the back end; isn't that true?

A That's true, but they are not front-end loaded. That's just a fact of life.

Q Okay. They are higher at the front end than they are at the back end. And you would accept, as well, that coal, would you not -- a pulverized coal unit or fluidized bed coal unit is much more expensive to build than a combined cycle unit, would you not?

A Yes.

Q In fact, what's the ratio, 3-to-1, 4-to-1?

A I don't know.

Q Okay. So it's the fuel cost, is it not, the fuel cost differential between a combined cycle unit and a pulverized coal unit that over time has to provide the cost differential to justify building, say, a combined cycle unit as opposed to a coal unit, would you agree?

A Say that again? It's the fuel cost over time?

Q It's the fuel cost differential between a pulverized coal unit and a combined cycle unit. Once we know the differential in capacity costs, that tells the decision maker what type of unit to build?

A It's the technology in a combined cycle, combined -- the fuel cost per million Btus is higher, gas over coal. But it's the technology and the present value of both revenue streams, the capital revenue stream for the coal plant plus the coal, and the capital revenue stream of the combined cycle plus the fuel compared under present value that tells you what choice to make.

Q All right. And when you present value that, typically, how long does it take for there to be a turnaround under current conditions between building a coal unit and building a combined cycle unit?

A I don't know. I haven't looked at it.

Q What would you assume would be cheaper to build , to the customer, say in the first ten years, a coal unit or a combined cycle unit?

A Well, it depends on the price of fuel.

Q The price that we have today.

A Well, I assume that it probably would be cheaper for a combined cycle unit.

Q Right. In the first ten years. Okay.

Now, have you done any review of this Commission's site certification determination of need proceedings?

A No, and none is required in this -- for this kind of analysis for this docket.

Q Do you know what the standard is that this Commission applies in a determination of need proceeding?

A No, and none is required for this analysis in this docket.

Q Well, how do you know if you don't know what the standard is?

A Because I know what the analysis is, and the analysis should be in this docket and no other party has raised that issue.

Q Beg your pardon?

A No party has raised that issue. It's not even an issue in had case.

Q What issue?

A Site analysis or site approval.

Q Well, I'm raising it as to your comment about what discount rate to use.

A I don't see how it relates to the discount rate in this analysis.

Q That's obvious.

Have you done any review of the Commission's rules on setting the value of deferral for either standard offer contracts or negotiated contracts?

A No, and I don't think any is required.

Q Do you know what the rule says about setting value of deferral payments; that is the rule of the Florida Public Service Commission?

A No, I don't, but there is no reason that it affects the ratepayer's discount rate.

Q Do you know what discount rate is used in the Commission's rules relating to value of deferral?

A No, I don't, but it is not the ratepayer's discount rate.

Q Okay. Will you identify what orders or rules of this Commission, by reference to title or where cited that you reviewed in preparing your testimony?

A I reviewed the documents that were filed in this case.

Q Okay. So that means, then, that you don't recall what rules or orders of this Commission you reviewed?

A No. What I said is I reviewed the documents that were filed in this case. If there were rules filed, then I reviewed those and I don't believe that there were any.

Q Okay. Will you identify me by category of costs, what costs there might be in a Commission determination of most cost-effective alternative that can be substantiated with a greater accuracy than can the accuracy of cost estimates in this case?

A Repeat your question. I'm not sure I caught it all.

Q Will you identify me what category of costs in a Commission determination of most cost-effective alternatives can be substantiated with any greater accuracy than can the category of costs that are at issue in this proceeding?

A I don't know that there are any, but as I pointed out in my testimony, it is the ratepayer that's paying these costs; it's not the companies. And it is not an analysis where the Commission must make a choice. There is not a --

COMMISSIONER CLARK: Mr. Larkin, would you listen to the question again and answer it and then --

WITNESS LARKIN: I think I did, but maybe I didn't.

COMMISSIONER CLARK: I don't think you did.

WITNESS LARKIN: Can I hear the question again or can I hear my answer?

MR. CHILDS: Yes. And I guess -- I think that -- I've read your testimony and I think everyone else has and I think -- I'd ask, Commissioner, that it seems to me that an explanation of an answer is acceptable, but that counterpunching is very time-consuming.

COMMISSIONER CLARK: I guess that's concerning me, too, and I would expect that Mr. Howe will, in fact, conduct your redirect.

Q (By Mr. Childs) I want to return to that --

A Okay. You were going to reask the question?

Q (By Mr. Childs) Yeah, I'll try it. Would you identify for me what category of costs in a Commission proceeding for the determination of most cost-effective alternatives can be substantiated with any greater accuracy than can the cost categories that are at issue in this proceeding?

A And I said I don't think there are any.

Q Okay.

A And then I continued to say I don't think that that's an issue in this case. So I've answered your question.

Q Okay.

A And I went on to say -- I went on to explain why I didn't think that was the case.

MR. CHILDS: Commissioner, really, with all due respect, I object to the gratuitous, "I don't think it's an issue in the case." I think that's for you to decide, and I don't think that when the witness has said, "I haven't reviewed the rule; I don't know what it says and I'm not familiar with the proceeding," to then add, "but I don't think it's an issue in the case." And I would -- I think that's objectionable to answer it that way.

MR. [illegible]: Commissioner Clark, if I might respond.

Mr. Larkin is answering within the context of this case that he has reviewed. And what Mr. Larkin had said was it isn't -- hasn't been raised in this proceeding. He hasn't seen it. That's an accurate statement.

Mr. Childs is trying to introduce all kinds of extraneous matters. And as long as he wants to go down these avenues, I think he's going to have to deal with the appropriate answers that apply.

Now, I have not been objecting because, you know, there has been no reference to anyplace in Mr. Larkin's direct testimony that these questions apply, but I'm confident that Mr. Larkin, with his expertise, can handle the attorney. And I think he's been answering truthfully. And when he says, "It isn't an issue in this proceeding," I think he's answering within the context of the proceeding that he knows that he's in, the issues he has reviewed, the issues he has testified to and that's a valid answer.

MR. CHILDS: Commissioner, Mr. Larkin has repeatedly attempted to make a point that the estimates in this case are not accurate and he testifies to that under direct.

And I'm attempting to inquire of the witness as to whether there are any other proceedings where this Commission routinely addresses matters such as here; that the accuracy can be can determined with any greater degree of certainty. And the fact that the witness is unaware and has decided not to review these other Commission proceedings, I don't think it's grounds for him to offer his opinion that it's not at issue here. But I will continue.

Q (By Mr. Childs) At what point would Florida Power Corporation be permitted to sell, if possible, the capacity out of its contract with OCL and not provide that power to its customers pursuant to regulation in this state?

MR. [illegible]: Objection. Commissioner Clark, I guess I'm going to start objecting to questions that go outside Mr. Larkin's prefiled direct testimony. If Mr. Childs can identify --

COMMISSIONER CLARK: All right. You're objecting to it because it's not part of his prefiled. I got that.

Go ahead, Mr. Childs. What part does it cover?

MR. CHILDS: Well, he has testified to you repeatedly that with the coming of competition that you should, in fact, let Power Corp just wait and take what happens and be struck with the contract. And so I'm trying to inquire of him if that's the proper way to react with one's contract, why they can't operate a little earlier and simply sell it and keep the revenue, if any.

COMMISSIONER CLARK: Okay. Where in his direct testimony is it?

MR. CHILDS: Well, it is with respect to his -- I don't have the reference of the direct, but I have the reference to what he said in the summary where he spoke about the effect of competition, and that because competition was coming, in the state of Florida, that you should not -- that is, you, the Commission, should not be addressing this issue now, because in the future there wasn't going to be any opportunity for recovery of costs. So I'm inquiring if that's the case, why can't they sell it now?

MR. HOWE: Well, Commissioner Clark, the objection remains because there's nothing in that statement that implicates the issue of how will Florida Power Corporation sell this capacity to others? It's not an issue in this docket.

MR. CHILDS: I think it's -- it is the issue. They want to make a point to you that -- I guess, that Power Corp is supposed to stay with this contract and then just kind of go down the drain; that when the retail customers go away they are stuck with the contract.

COMMISSIONER CLARK: You're exploring what the obligation is for them to continue to provide power under this contract if, in the future, ratepayers don't have to pay for it under the contract.

MR. CHILDS: Right.

COMMISSIONER CLARK: All right. Go ahead

and answer that, Mr. Larkin.

WITNESS LARKIN: Repeat the question again.

Q (By Mr. Childs) Well, do you think that Power Corp -- let me premise it this way. Do you think that Power Corp has an obligation to mitigate their potential losses under this contract?

A Yes. In a hearing or in a position where the below market cost has been used to offset the above market cost. And I said that to the Commission.

Q Do you know whether the cost -- are you finished?

A No. I said that there will be a time when competition will come and there might be stranded costs, and those can be reviewed and analyzed against those below market costs, and if there's a difference, then that cost can be recovered from ratepayers. But don't segregate the cost now and charge ratepayers for part of it.

Q Okay. Are you familiar with the review by this Commission of the contract when it approved it?

A Other than what I've read in the orders, no.

Q Did you review the order approving the contract?

A I reviewed -- probably not the original order, just the order that -- where there was a suit regarding the O&M costs.

Q Do you know what the standards are, if any, of this Commission for the review and approval of negotiated contracts for qualifying facilities?

A I didn't review those.

Q Do you consider that irrelevant?

A I think it's irrelevant to this analysis, yes.

Q How would you know?

A Because this analysis is one of cash flow. This analysis is one of risk; this analysis is one of choosing the right discount for ratepayers.

Q Okay.

MR. CHILDS: I have an order that I want to pass out at this time, Commissioners. It's Order No. 24734. (Pause)

COMMISSIONER CLARK: Is this the whole order, Mr. Childs?

MR. CHILDS: It is unless an error is made in copying.

COMMISSIONER CLARK: All right.

MR. CHILDS: It's supposed to go through Page 21.

COMMISSIONER CLARK: All right. Do you want us to take official notice of this order?

MR. CHILDS: I do.

COMMISSIONER CLARK: All right. We'll take official notice of Order 24734 issued in Docket 910401-EQ.

Q (By Mr. Childs) Now, a couple of questions. Would you agree, Mr. Larkin, that this contract with OCL was based upon the avoidance or deferral of a coal unit by Florida Power Corporation?

A The capacity and energy charges are based on that calculation.

Q Well, does that mean that you agree that the approval of the contract was based upon the deferral of a coal unit?

A That that was the avoided cost, yes, but I did not look at whether they would have actually built a coal unit or not.

Q They didn't?

A I said I did not look at whether that would have been required or not.

Q Would you turn to Page 8 that is in the left-hand side of the page of that order.

A Yes.

Q Now, the second -- would you agree that this reference to Rule 25-17.0832 in the discussion here under approval of contracts that the Commission, in fact, identified the three standards or four standards that it used for approval?

A Well, there are three paragraphs there.

Q Would you agree or agree subject to check, that the Commission, in fact, applied those standards?

A I'll agree that they are in the order here. I don't know how they were applied or if they were applied.

Q Okay. Well, turn back to Page 3, if you would, please. In the middle of the second paragraph with the words -- it says, if you can find it, "on a present worth basis," do you have those words?

A Yes.

Q Let me read that. It says, "On a present worth basis, using FPC's planning assumptions, the 450 megawatt of coal capacity has total fuel and capacity costs very close to the 300 megawatt coal and 150 megawatt combustion turbine option." Are you familiar with those options?

A These particular options?

Q Sure.

A No.

Q Are you familiar in general with those kinds of options and the cost characteristics of those kinds of options?

A I'd say in general, yes.

Q All right. And continuing it says, in the order, "FPC's projections indicate that beginning in 2008 a coal unit's total avoided cost, capacity and fuel, fall below the combustion turbine's total avoided cost on a net present value basis."

Now, would you agree -- this order was entered in 1991. Do you know from what point in time that analysis was made, that is whether the analysis as to the comparison on a net present value basis began in 1991 or some later date?

A It began in 1991 looking forward?

Q Yes.

A Oh, I don't know.

Q Would you look to that chart that Mr. Howe has put up?

A Yes.

Q That's up there. Would you agree that this sentence that I just read out of the order reflects that in comparing the cost of a coal unit or a combustion turbine that this Commission recognized that the same sort of situation as is shown on that chart would occur as to the cumulative net present value, and that is that there would be a negative cost until the year 2008? (Pause)

A I think that the sentence indicates that one unit would have a different net present value and one would exceed the other in the year 2008. That's got nothing -- it's not even remotely similar to that chart.

Q Well, compare -- this chart that has to do with --

MR. CHILDS: This chart, Mr. Howe, is this chart that's up there, is that Exhibit 3 or 2, so I have a reference?

MR. HOWE: Exhibit 2.

Q (By Mr. Childs) Exhibit 2, that exhibit --

COMMISSIONER CLARK: Hang on a minute. I believe it's Exhibit 3. Yeah, I have Exhibit 3, Schuster's Exhibit 7.

MR. HOWE: I'm sorry, Commissioner, I had understood that you had given me a composite number for both charts and that Exhibit 3 was the --

COMMISSIONER CLARK: You're right. Excuse me.

MR. HOWE: -- one I withdraw dealing with the tax rate.

COMMISSIONER CLARK: You're exactly right. So that chart up there is part of Exhibit 2. Thank you.

Q (By Ms. Childs) Well, let's test that for a minute, Exhibit 2, Mr. Larkin. That's identified as being based on Mr. Schuster's Exhibit 7, is it not?

A Yes.

Q And Mr. Schuster's Exhibit 7 is an evaluation of the costs including the payment for buyout of continuing the contract with OCL or building and operating a combined cycle unit, would you agree?

A Yes.

Q So at least for the period of ten years that's analyzed, we have the comparison of one generation alternative to the other?

A Part of the analysis compares one generation alternative to the other.

Q That is the --

A But there's no payment.

Q I'm not there yet. I asked you about the ten years. Would you agree that for the last ten years that the comparison is between the generation alternative of the contract with OCL and the building and operating of a combined cycle unit?

A For the last ten years?

Q Correct.

A Yes. For the ten years that would be bought out, yes.

Q Right. And that the difference, if any, is that this analysis assumes that there would be a payment in each of the first five years of the analysis?

A Yes.

Q All right. Now, when one considers or one compares the present value of one generating unit against another, you would get two revenue streams, would you not?

A Yes.

Q And then based upon a cumulative present value calculation, you would either have a negative or positive for each year?

A That there would be a negative or a positive -- one would be greater or less than the other.

Q Sure.

A Yeah.

Q And you have to start at the beginning, and when you start at the beginning and calculate net present value and continue on a cumulative net present value basis, you're positive or negative when you begin, correct?

A Yes, comparing two revenue streams.

Q That's right. And this says, does it not, this statement out of the order says that comparing the two that the projections indicate that the coal units avoided costs fall below a combustion turbine's total avoided cost on a net present value basis and that begins in the year 2008?

A Okay.

Q So do you accept that?

A I accept that that's what it says.

Q So before the year 2008, when you compared the goal unit to the combustion turbine, wouldn't you agree that of necessity the coal unit had to have a negative net present value compared to the combustion turbine?

A It was higher priced.

Q And that's exactly what you would expect, isn't it?

A I don't know. I didn't do an analysis and that's not involved in this case.

Q Okay. So for that first year, starting in 1991, if we were to chart the cumulative net present value, comparing the coal unit to a combustion turbine, using the format of Exhibit 2, we would see negatives through the year 2008, would we not?

MR. HOWE: Objection. Exhibit 2 doesn't show a comparison between two alternatives.

MR. CHILDS: Sure it does.

MR. HOWE: It portrays one proposal.

MR. CHILDS: Well, it does compare two alternatives and the witness has already acknowledged that for the last ten year of the comparison.

Q (By Mr. Childs) Doesn't it?

A Yes, but that doesn't -- that's not the whole comparison.

Q Oh, everybody knows that this has a five-year payment, Mr. Larkin.

A Yeah, but you're trying to mix apples and oranges, and you're trying to come out with a conclusion that doesn't make any sense.

Q Well, I'll move on as to the comment.

This Commission routinely has to face the decision of what generating alternatives to select, does it not?

A Yes. But this isn't -- yes, but this case is not one of those cases.

Q Is this case, that is the one addressed in Order 24734 one of those occasions?

A I don't know. I haven't reviewed it, but I assume that it is.

Q Assume what?

A That it is.

Q So you haven't reviewed the Commission's rules on setting prices for purchases from qualifying facilities; is that correct?

A Yes.

Q You haven't reviewed any of the orders adopting those rules; is that correct?

A That's correct.

Q You haven't reviewed any of the orders setting avoided costs for purchases from qualifying facilities?

A That's correct, and I don't think they are relevant.

Q You haven't reviewed any tariffs containing prices for purchases from qualifying facilities?

A That's correct, and they are not relevant.

Q I don't think that's -- have you -- do you know whether there are any tariffs?

A For qualifying facilities?

Q For purchases from qualifying facilities?

A Well, they are probably not tariffs that -- they automatically flow through the fuel adjustment clauses and the capacity clause.

Q I beg your pardon?

A They flow through the fuel adjustment clause and the capacity clause. There aren't any tariffs that I know of.

Q Okay. You haven't reviewed any proceedings of this Commission in determination of need of -- in determining need as it relates to the comparison of generation alternatives?

A That's correct.

Q Okay. Will you accept that this Commission does use the utility's after-tax cost of capital in evaluating generating alternatives for that utility?

A I will accept that, but I don't think it's appropriate in this case.

Q Would you accept that this Commission used the after-tax cost of capital of Florida Power Corporation in evaluating this particular contract?

A Yes.

COMMISSIONER CLARK: Which particular contract?

MR. CHILDS: It's the contract between -- I mean the contract between Florida Power Corporation and OCL --

COMMISSIONER CLARK: Okay.

MR. CHILDS: -- that is addressed in this Order 9 -- excuse me, 24734.

COMMISSIONER CLARK: Well, is it the same contract that's being bought out or being amended in this proceeding?

Q (By Mr. Childs) Do you know, Mr. Larkin, if the contract addressed in this order is the same as the one being bought out?

A No, I don't know that, but I assume that it was.

Q Will you accept that it is?

A Yes.

Q You're not aware of any other contracts between Florida Power Corporation, are you? (Pause) And OCL?

A I was just looking for the name, but I don't see the name in the -- in the order.

Q Okay. Well, turn to Page 18 of the Order, if you would. Do you have that?

A The last page I have is 11. You said there's a Page 18 or a 12?

COMMISSIONER CLARK: It's a chart, right?

MR. CHILDS: It's a chart.

WITNESS LARKIN: Oh.

Q (By Mr. Childs) Says Page 18.

A Okay. I've got it.

Q Doesn't this reflect that the contract payments were compared to the avoided cost of Florida Power Corporation? (Pause)

A Where are you looking at?

Q I'm looking at the title, "Comparison of Contract Costs and Avoided Costs."

A But it doesn't say what corporation. It doesn't say Florida Power Corp.

Q Isn't that what this order is about?

A I assume that it is, but I, you know --

Q I thought you accepted that subject to check.

COMMISSIONER CLARK: Mr. Larkin, look at the title of the docket on the front.

WITNESS LARKIN: Yes, I see that on the docket, but that doesn't mean this comparison in the back has got anything to do with what's -- you know, it could be any kind of comparison.

Q (By Mr. Childs) Could it?

A I assume that it has to do with Florida Power Corp, but it's not labeled as such, and it doesn't say on any of the headings that it's Florida Power Corp's avoided cost. But I'll accept that, subject to check.

Q Well, let's then back up to Page 9 under cost-effectiveness. Would you look at the first sentence there? "The analysis provided by FPSC with its petition indicated that the present value of its payments to each of the QFs for firm capacity and energy will be no greater than the present worth of the value of the year-by-year deferral of FPC's avoided costs."

A Yes.

Q Does that help you conclude that this is FPC?

A Oh, yeah.

Q Would you turn to Page 10?

A But --

Q Excuse me.

A It does say of the QFs, so --

Q Sure.

A -- there's more than one QF.

Q Right. Let's turn to these sheets, sir, which is a summary of contracts. It lists all the QFs, doesn't it?

A Yes.

Q That's Page 13?

A Yes.

Q And there's a sheet for each one of those?

A Yes, I see that.

Q And the one I asked you about was Orlando Cogen, Limited, L.P., on Page 18.

Now, would you turn to Page 10 of the order?

And look at the top paragraph. It says, "At the time the petition for approval was filed, FPC was in the process of updating the K factor associated with its avoided costs." Do you know what the K factor is?

A It's a term that has to do with the cost of capital.

Q Doesn't it have to do with comparing the total revenue requirements to the installed cost of a facility?

A It may. I don't recall right offhand.

Q Well, let's help you then. I'm going to suggest that we look at the rule, and I'm going to circulate a copy of it.

MR. HOWE: Commissioner Clark, I'm going to object to any introduction of a rule. I believe Mr. Childs is going to try to attempt to introduce the rule the Commission has dealing with cogeneration. And as I pointed out earlier in my opening statement, the Commission has a rule that a petitioning party must cite to the rules and orders which entitle them to relief. There is no recitation of such a rule in Florida Power Corporation's petition, in its protest of the PAA, or in any direct testimony we have had so far. So I would object to any attempt to introduce a rule through my witness in an attempt to create a claim that is not in the record.

COMMISSIONER CLARK: Hang on just a minute.

(Discussion off the record.)

COMMISSIONER CLARK: Mr. Howe, I understand -- I think it's okay to ask him about the rule, whether or not they have appropriately put it at issue is a different issue.

MR. HOWE: Commissioner Clark, Mr. Larkin has already stated that he has not reviewed -- Mr. Larkin has already stated that he has not reviewed any rule. And so asking him to look at a rule that he has not reviewed, I doubt can be anything other than an attempt to get a rule in the record.

COMMISSIONER CLARK: Well, I view this as testing a basis on which Mr. Larkin has made his opinion that this is not cost-effective to the ratepayers, and I think Mr. Childs is entitled to test that.

MR. HOWE: But he has stated he has not reviewed any Commission rule on the subject.

COMMISSIONER CLARK: But we're talking about avoided cost and I -- Mr. Childs, why are we looking at the rule?

MR. CHILDS: Well, I think we're -- first, we're looking at the rule because this witness is testifying as to the discount rate to use. And contrary to Mr. Howe's characterization, the witness said, when I suggested referencing and want to reference the rule, that he didn't recall what was in the X factor. I'm not trying to get -- I don't think you can do that. I mean, the rule is a rule, whether you put it in evidence or not, that doesn't create a basis for relief.

Q (By Mr. Childs) Do you have that rule in front of you?

COMMISSIONER CLARK: You were going to give us all a copy.

MR. CHILDS: Yes.

COMMISSIONER CLARK: Did you give Mr. Howe one?

MR. CHILDS: Yes.

WITNESS LARKIN: Yes.

MR. CHILDS: And while that is being distributed, what I'm referring to is as 25-17.0832. If you'll look to the top of that document on the right, you will see that there are different pages. I'm looking at Page 332. And I'd like to have this marked. I think you can rely upon your rules, anyway, but for reference I'd like to -- we don't need that.

Q (By Mr. Childs) Do you have that rule in front of you?

A Yes.

COMMISSIONER CLARK: I'm sorry. What do you want me to do?

MR. CHILDS: I withdrew my request that you mark it.

COMMISSIONER CLARK: Okay.

Q (By Mr. Childs) Would you agree, Mr. Larkin, that the K factor is defined there in the formula on the left-hand side of that page?

A Yes.

Q Now, would you agree that in the calculation of the carrying charges for determining the K factor that the utility's cost of capital is used?

A It doesn't say that under the K factor.

Q Okay. Would you see the reference to a little term "r", small "r" on the right-hand side, defined as the annual discount rate being the utility's incremental after-tax cost of capital?

A Yes.

Q What does the incremental after-tax cost of capital mean to you?

A It means the next group or the next issue of debt or equity or a combination of that would be incremental.

Q What issue of what?
A The next incremental issue of capital.
Q Does that mean all capital?
A I would assume so, yeah.
Q All sources of capital?
A Yes.
Q Okay. (Pause.)

MR. CHILDS: Excuse me one moment.

I have another document that I'd like to circulate at this time.

The first page is entitled, "Comparison of OCL Contract Buyout to Coal-Fired Generation," and this was from Mr. Schuster's Document 5. I don't remember what exhibit that was. And on the second page is from page -- I'm sorry, don't do that. We've copied the wrong page. Just look at the first page.

COMMISSIONER CLARK: All right. Just look at the first page.

MR. CHILDS: Take the second page off.

COMMISSIONER CLARK: All right.

Q (By Mr. Childs) Now, if you, Mr. Larkin, would look at the page comparison of OCL contract buyout to coal-fired generation, and, also, then, go back to Page 18 of Order No. 24734, I'd appreciate it.

MR. CHILDS: And while he's doing that,

Commissioner, would you please mark this sheet for identification?

COMMISSIONER CLARK: We'll mark it as Exhibit 11, "Comparison of OCL Contract Buyout to Coal-Fired Generation."

(Exhibit 11 marked for identification.)

MR. CHILDS: Okay.

MR. HOWE: Excuse me, Commissioner Clark, As I understand, this is already in the record as part of Mr. Schuster's exhibit.

MR. CHILDS: Yeah, I just thought it was a whole lot easier to have it marked for identification to refer to, rather than saying it's one of the pages of something else. Is that okay?

MR. HOWE: Yes.

COMMISSIONER CLARK: Wonderful, we have agreement.

Q (By Mr. Childs) Have you looked at these two sheets now Mr. Larkin?

A I glanced at them.

Q All right. Look at Column 2 on the sheet entitled "Comparison of OCL Contract Buyout."

A Yes.

Q Does that look like what one would expect to see in terms of the revenue requirements for a power plant?

A You could have a revenue stream that flowed like that, but I wouldn't know that without calculating it. So the answer is it may be, but I don't know.

Q Okay. Now, would you know that the net present value on this sheet is 194,677,293?

A That's what it's labeled as.

Q Would you then look to the net present value that's identified on Page 18 of Order No. 24734 and agree that the net present value is almost exactly the same?

A I can't read it.

COMMISSIONER GARCIA: Would you repeat the question?

MR. CHILDS: I'm asking him, Commissioner, to look at the sheet, "Comparison of OCL Contract Buyout to Coal-Fired Generation," the number for net present value of 194,677,000, et cetera, and compare that to the net present value shown on Page 18 of Order No. 24734, and ask him if he would agree that they are almost exactly the same.

A Well, there are several net present value numbers on that page.

Q (By Mr. Childs) Okay. Look at the one

under contract capacity credits, dollar by year?

A Yes.

Q Isn't that almost exactly the same?

A Well, 194 million is the same, but the rest of the numbers aren't.

Q Well, we're what, $200,000 off out of 200 million?

A I don't know.

Q You don't know?

A No.

Q Okay. Now, going back to the chart which has been marked as Exhibit 11, it's obvious there that the numbers are larger in the earlier years than the later years. If this chart represents the revenue requirements for a coal unit, the capacity costs, doesn't this reflect that there's a sure disparity in the payment streams that customers are expected to pay?

A No.

Q All right.

A Because you don't know what's put into rates, and this is a calculation of a revenue stream. The numbers put into rates may be the first number or the second number, 94, 95. Ratepayers -- the rates may not change for ten years, so ratepayers would pay

25 or 28 million dollars for ten years, even though the revenue stream changes.

Q Sure. That could happen. And here we could have $28 million put in rates for these customers, and they pay for that ten years until rates are changed, right?

A Right.

Q How is that treated for recovery of capacity costs under a contract with a qualifying facility?

A Whatever the capacity payments are they are recovered.

Q There's a direct pass-through, right?

A That's correct?

Q So we don't have this problem of recovering $28 million for ten years, right?

A That's correct. But your question was what are ratepayers expected to pay for a coal generating unit.

Q I asked you about several other proceedings, and I think you said that you were not familiar with them as, for instance, conservation. Do you know when this Commission evaluates conservation programs whether it assumes that the costs are recovered from customers?

A I don't know that, but I would assume that they do.

Q Would you assume that, really, in any financial evaluation of alternatives for a utility that one would assume that the costs are recovered from the customer?

A Yes.

Q Okay. So if the Commission were looking at Column 2 as an estimate of the coal generation annual capacity cost, in trying to make a comparison of that against the OCL contract annual capacity cost, it would assume that both of those cost strings were being recovered from customers, would it not?

A Well, it could assume that, but that wouldn't be the case.

Q But it would assume that in making its decision?

A Yes.

Q All right. Now, your testimony is that capacity payments are lower in the OCL contract to ensure performance, but you have testified that you have no knowledge of the Commission rules or orders relating to cogeneration. Would you agree?

A Yes.

Q Would you agree then that your statement about they are lower in the OCL contract to ensure performance is then not based upon any statement of this Commission in the approval of capacity costs?

A Well, that was my opinion as to why they did it that way.

Q But your opinion is based upon not looking at the relevant data?

A No, my opinion is based on what I read in Commissioner -- statements by the Staff or in somebody's testimony.

Q But your counsel just objected to any reference to the rule because you hadn't read that?

A No, I didn't said I read a rule, I said --

Q Hadn't read that?

A Yeah. Well, I said that was based on what I read in somebody's testimony.

Q Well, where is that?

A Well, it was probably in Mr. Schuster's testimony?

Q I don't know.

A As a quote from the Staff.

Q Wouldn't you think it was -- are you looking?

A Yeah. Go ahead. Go ahead.

Q Then you say, "In other words -- in your testimony -- "to ensure that OCL meets its obligations to provide capacity and energy, it is not compensated up front for the full amount of its investment and capacity." On what do you base that?

A I think it's either in one of the orders or it's my conclusion from what I read in the orders.

Q But when I asked you about an order, I think you said you didn't recall having read any addressing this subject; isn't that correct?

A Well, it's in one of the orders related to this case.

Q Have you ever heard the discussion of PURPA and what cost information one may obtain from a qualifying facility under PURPA?

A I know what PURPA is and I'm familiar with PURPA.

Q Well, would you agree, sir, that it is not permitted to look to the investment that a qualifying facility makes in its generating capacity in determining what to pay it?

A Yes.

Q And it's against the law?

A Yes. I understand.

Q Okay. Then what investment in capacity was OCL not being compensated for?

A Well, in case their capacity costs were greater than the avoided cost, or if it didn't perform, or there was some other problem with the unit.

Q Now, you also state that, in talking about the structure of payments for -- on the value deferral, that customers at the beginning are taking the risk of nonperformance and receiving the benefit of lower cash payment for that risk, that's at Page 8?

A Yes.

Q What do you base that on?

A Again it was my analysis of the statements that were in the original documents.

Q So if we look through here, and we don't find anything that addresses this, then you will be in error?

A No. I said it was my analysis.

Q Object. Well, I asked you what orders you'd looked at, and I asked you what rules you'd looked at and I think you didn't identify any.

A Yes. No, I told you I looked at the documents involved in this case and it's in this case.

Q Well, where specifically is there a statement that customers at the beginning are taking the risk of nonperformance?

A No, that's -- I told you that was my

analysis of that statement.

Q That's your analysis?

A Yes.

Q But you said your analysis was based on not knowing the basis for the structure of the payments.

A No. I told you my analysis was based on the statements in the orders.

Q No, I'm sorry. I thought you said your knowledge did not reflect what was the basis, for instance, the computation of K, correct?

A Computation of K?

Q K. K factor we just talked about it in the rule.

A Yes.

Q You didn't know that?

A I didn't know what the basis of the K factor was in the original contract.

Q Well, then why don't you tell me how one calculates the value of deferral?

A I told you -- you were asking me what is the basis of my statement, and I said that there were statements in this order, in this docket that indicated that the deferral was set up the way it was in order to ensure performance. And my analysis of that is that is a risk defining -- that's how one compensates for risk by back-end loading the payments. And I said to you that I got that out of one of the orders in this case.

Q Okay. Would you agree, subject to check, that this Commission's rules do not support that statement?

A I would not -- I told you -- well, my analysis of the statement that there is risk associated with it --

Q Okay.

A -- is based on what is in one of the orders. And I don't know --

COMMISSIONER CLARK: And you would not accept, subject to check, that the rule says otherwise?

WITNESS LARKIN: I will accept that, subject to check, that it says otherwise.

Q (By Mr. Childs) Okay. Would you turn to your Document HL-1?

A Yes.

Q Where you did the calculation based upon an alternate rate of return, I guess that's a discount rate of 13%?

A Yes.

Q And you calculate a negative net present value of $4,690,000 -- is that thousand dollars?

A Million.

Q Four million?

A 4,690,000.

Q I can't read whether the last mark is a comma or a period. It goes too many places.

A It's a period.

Q You're familiar with the calculation of internal rate of return?

A Yes.

Q Would you agree that this revenue stream, that is the one under Column 2, when discounted at your -- excuse me, when you compare that to the payments up front, produces an internal rate of return of approximately 12.2%?

A It may, but that's not the proper analysis. The proper analysis is the discount of the ratepayer's payment because the ratepayer is the one that is making the rate of return.

Q Sure. But when you calculate --

A The ratepayer is making the payment.

Q I beg your pardon?

A The ratepayer is making the payment.

Q Sure, the ratepayer, under your assumption, is making the payment of five payments of $9,881,000, correct?

A Correct.

Q And then in return on your sheet you show -- you show savings starting in the year 2014 and continuing through 2023?

A Right.

Q And that totals the $472 million?

A That totals to --

Q Approximately?

A Well, I don't know what it totals to, but that is not the net present value.

Q No, I'm not asking that.

A It totals to a number that would be --

Q But when one compares the payment for the five years to the revenue or the savings, my question is wouldn't you agree that that equates to a return to the customer of approximately 12%?

A It may, as they say, but what the proper calculation is, is to use the discount rate that that ratepayer would pay or avoid had he kept the money himself. And I haven't made that calculation because I don't think it's appropriate.

Q Well, I want to pursue that for a minute. You have assumed that 13% is the appropriate rate of return, correct?

A Discount rate, yes.

Q And -- discount rate. And using 13%, you calculate net present value of negative 4.6 million.

A Yes.

Q And all I'm asking you is what is the actual rate of return that the stream of benefits provides?

A You mean what it will be if it comes out to zero?

Q You could state it that way. What rate of return would make the net present value come out to zero?

A Yeah. It would be about 12.9%, but that is not -- what's included within that assumption is that the ratepayer is actually going to get all those dollars, and that his discount rate is 12.9%. If his discount rate is higher than 12.9%, then it's a bad deal for him, and that's why I used the 13% rate of return.

What you want me to do is substitute something else, assume that all other projections are correct, and that he's going to get every dime that you show here, which is not correct, and that he gets some rate of return that you think is 12.9%.

Q I just asked you for --

A It's a calculation, but I disagree with it.

Q I just asked you for the mathematical result.

A Yeah.

Q I didn't ask you to make any of those other assumptions, did I?

A But that's inherent in your question.

Q Okay. How many customers of Florida Power and Light borrow at 13%?

A Oh, I don't know.

MR. HOWE: Object to the form of the question. I believe you mean Florida Power Corporation.

Q Well, let's do a survey. I mean, have you looked at what any customers in the state borrow at?

MR. HOWE: My question was you said Florida Power and Light, I understood.

MR. CHILDS: Yes.

MR. HOWE: Did you mean that?

MR. CHILDS: Yes.

MR. HOWE: Okay.

WITNESS LARKIN: Florida Power and Light?

Q (By Mr. Childs) Yes.

A I don't know what -- what I did was go to a bank. And I got the bank's rates, and I asked, and I looked at those rates and I took the lowest rate for an unsecured loan.

Q How about Gulf Power?

A There may be customers that borrow at 13 to 18%. How many, I don't know.

Q You don't know. Aren't there significant differences in the customer makeup in the state of Florida?

A Sure.

Q And did you ask for rates in the Florida Power Corporation service territory?

A No.

Q You didn't?

A No, and I don't think it's relevant.

Q Do you know how many customers in Florida Power Corporation's service territory borrow are at 13%?

A No.

Q Do you know how many customers in Florida Power Corporation's service territory that do borrow also attempt to save for retirement?

A There probably are a lot.

Q And do you know what rate they might expect?

A Relevant to this kind of risk, it would be high.

Q On their retirement?

A No. Well, no. You have to look at that in relationship to this transaction. You can't look at that and say let's switch and look at retirement.

If you were to ask a customer who is saving for retirement to take this kind of risk, it would probably be a significantly higher rates of return than 13%.

Q Let's talk about risk for a minute. Isn't it correct that you don't know what the risk is?

A I don't think I know, nor do you, nor does anybody else.

Q So if you don't know what the risk is, then to say they wouldn't accept it for this kind of risk doesn't tell us anything because you don't know what that risk is?

A I know what I would do and what I think customers with a comparable transaction would accept. And it's my opinion that they would not accept a return of less than 13%, which would go negative.

All the company has done is made the opposite assumption and said, "Here is what we think it would be, the discount rate, and this is where we think it would come out." So the Commission has to conclude their own -- in their own manner what they think the appropriate discount rate is.

Q I agree.

MR. CHILDS: That's all I have.

COMMISSIONER CLARK: Staff. Mr. Keating, how much do you think you have?

MR. KEATING: I think we can all make the evening news. Only a few questions.

COMMISSIONER CLARK: Wait a minute. Are you talking about the 11:00? (Laughter)

MR. KEATING: No, maybe the 6:30.

COMMISSIONER CLARK: All right.

MR. KEATING: I just have a few questions.

CROSS EXAMINATION

BY MR. KEATING:

Q Mr. Larkin, on Page 7 of your testimony you state that you believe that it's unlikely that many, if any, customers will collect for the payments that they have to make currently in order to receive some future benefit which is subject to the risk of fuel and capacity projections and changes in regulation. Have you reviewed any demographic information on Florida Power Corporation's customer base?

A No, but I assume that they are quite old. Or the average age is probably about 50.

Q And what do you base that assumption on?

A Just my own feeling about what the age demographics are in Florida.

Q So you haven't reviewed the percentage of Florida Power Corporation's customers falling within a particular age group?

A No.

COMMISSIONER GARCIA: I would assume your using Jack Shreve to figure out that average, right?

WITNESS LARKIN: He's one of the younger ones.

MR. SHREVE: I was going to suggest that we might put a notice out and let the customers respond as to whether they think they will or not.

Q (By Mr. Keating) Now, Mr. Larkin on Page 5 of your testimony you express your concern about Florida Power Corporation's use of their after-tax marginal cost of capital as the discount rate in their analysis of customer benefits from the buyout; is that correct?

A Yes.

Q On Lines 2 and 3 of Page 7 of your testimony you state that Florida Power Corporation's marginal cost of capital does not affect any of the components of the costs passed on to the ratepayers; is that correct?

A Yes.

Q Doesn't Florida Power Corporation's replacement case assume that Florida Power Corporation puts in a combined cycle unit?

A Yes.

Q Wouldn't the Company's marginal cost of capital affect the cost of putting in a new generating unit?

A Yes.

Q On Page 5 of your testimony, at Lines 17 to 18, you stated that a discount rate more akin to an interest rate on an unsecured loan or a credit card, which you estimate ranges from 13% to 18%, is a more appropriate way to measure ratepayer savings; is that correct?

A Yes.

Q Aren't credit cards and other unsecured loans often available to consumers at much lower rates?

A No. There might be some rates that are teaser rates, or rates that might be that level for 60 days or a year, and then they ramp up to 15, 16. But what I did was go to a bank and get the bank's rates, and I looked at the lowest rate for the unsecured loan.

Q Would you agree, subject to check, that a 13 to 18% discount rate implies a payback period of approximately 5.5 to 8 years?

A Payback? Payback, I guess I'm not following your question.

COMMISSIONER CLARK: Would they give the same 13% rate for something where the payback period was beyond, say, ten years? Would the rate be higher or lower, do you think?

A Oh. Well, based on this kind of unsecured loan it would be higher.

Q Do you believe that replacing Florida Power Corporation's fuel and inflation assumptions with those from a independent source is an appropriate sanity check of Florida Power Corp's fuel and inflation assumptions?

A Well, I never looked at the individual assumptions. I just accepted them the way they are. I think they are all fairly risky.

Q But do you believe that if their assumptions were replaced with assumptions from a independent that that would be an adequate sanity check?

A Yes, that would be a better analysis.

Q How long do you estimate that customers who make payments in the first five years must remain on the system to receive benefits? (Pause)

A Seventeen years before the first benefit is received. In the 18th year.

Q Would you agree that today's ratepayers may be enjoying the benefits of costs borne by yesterday's ratepayers for other projects, for example, in the case of a generating plant which is largely depreciated?

A No. I mean, they may be paying the same rates that those other ratepayers pay.

Q On Page 8 of your testimony you state that the higher payments at the end of the contract are justified to guarantee performance of the cogen and that customers at the beginning of the OCL contract are compensated for the risk of nonperformance with lower costs; is that correct?

A Yes.

Q Under value of deferral methodology, isn't the net present value of the payment stream less than or equal to the net present value if the company built the avoided unit under traditional ratemaking practices?

A State the question again.

COMMISSIONER CLARK: Mr. Keating, would you speak up a little bit? I'm having trouble hearing you.

MR. KEATING: Sure.

Q (By Mr. Keating) Under value of deferral methodology, isn't the net present value of the payment stream less than or equal to the net present value if the company built the avoided unit under traditional ratemaking practices?

A I don't know. I didn't look at it from that standpoint. That could be correct. I just don't know.

Q Would you summarize the alternative proposal to the buyout that you addressed in your testimony on Pages 11 to 13?

A There's only one alternative proposal and that is that the company fund the buyout and receive back its net present value plus a rate of return equal to its overall rate of return with a balance going to the ratepayer. And that could be structured to occur whenever it occurs.

Q Under your alternative proposal, you state that in return for making the buyout payments Florida Power Corporation should receive a return, plus the buyout payments in the years 2014 through 2023. Is that correct?

A Well, to the extent necessary to compensate them for their up-front payments and their cost of capital. I did not state or I don't believe I stated that they ought to receive all of the benefits if there are any.

Q Are you finish with your answer, Mr. Larkin?

A Yes.

Q Okay. How would the Company receive the savings?

A Well, that's the question. They would continue -- if there is an automatic adjustment clause, they would continue to charge the ratepayer.

Q Under your alternative proposal, how would the Company receive the savings?

A They would continue -- if there's an automatic adjustment clause, they would continue to charge the ratepayer at the higher capacity cost until the time that they've recovered all of their up-front payments plus the net present value rate of return, so that they end up having paid nothing or gained nothing.

Q Would you now please refer to Composite Exhibit 8? Do you have a copy of that exhibit?

A Oh, that's your Composite Exhibit 8. No, I don't, and I'm going to get a copy.

Q Yes. Staff is bringing a copy to you.

A Well, I've got it up here. Tell me what the numbers at the bottom are.

Q It was previously identified as LGS-24.

A I've got it. Composite Exhibit 4, LGS-24, okay. What page?

Q I believe that there's a -- I'm sorry. Did I give you Composite Exhibit 4? Did I refer you to Exhibit 4?

A LGS-24 is what I have. And I've got that marked as Composite Exhibit 4. Now, I may have it mismarked.

Q I apologize. It's Composite Exhibit 8 that was previously identified as LGS-30.

COMMISSIONER CLARK: Is it getting late, Mr. Keating?

MR. KEATING: Excuse me?

COMMISSIONER CLARK: I said is it getting late?

WITNESS LARKIN: I've got it.

Q (By Mr. Keating) I believe that's only one page?

A Yes.

Q Do you recall the discussion that I had earlier with Mr. Schuster concerning this page?

A I believe so. About the debt tax deduction component? Is that the question?

Q Yes.

A Okay.

Q Does it appear to you that the derivation of this discount rate assumes the mixture of long-term debt and equity?

A Yes.

Q Referring to the line titled, "Debt Tax Deduction Component," does it appear to you that this line represents the savings and income taxes due to the deduction of interest expense associated with the long-term debt financing?

A It is.

Q Would you agree that Florida Power Corporation -- I'm sorry, I withdrew that.

If Florida Power Corporation finances the OCL buyout by collecting additional revenues from ratepayers through the adjustment clauses, is there any long-term debt or associated interest expense?

A There is none.

Q So in your opinion, is it appropriate to deduct a debt tax deduction component from the composite cost of capital on this table if Florida Power Corporation will not issue any additional debt and will not have any additional interest expense for the contract buyout?

A No, it is not appropriate, and neither is the discount rate appropriate.

MR. KEATING: Staff has no more questions.

COMMISSIONER CLARK: Commissioner Garcia?

I just have one question and you may have answered it in all of your questions.

Have we ever used the customer discount rate in making this kind --

WITNESS LARKIN: I don't know that you have. I don't know one way or the other, but it's appropriate to do so.

COMMISSIONER CLARK: Okay. Redirect?

MR. HOWE: No redirect.

COMMISSIONER CLARK: Any recross? I'm just kidding.

All right. Mr. Larkin, are you through answering questions? You appear to continue to look --

WITNESS LARKIN: Mr. Childs asked me about --

COMMISSIONER CLARK: I'm just kidding. There's no question pending. There's nothing.

WITNESS LARKIN: There is one in my mind, though.

COMMISSIONER CLARK: You can get with

Mr. Childs.

WITNESS LARKIN: There is one that is not answered in my mind and in my heart.

COMMISSIONER CLARK: All right.

MR. SHREVE: I thought I saw Commissioner Garcia wanting to ask him what he was thinking about.

COMMISSIONER CLARK: No. I just think that's impermissible. (Laughter)

There's no redirect. Are there exhibits that we need to move into the record?

MR. [illegible]: Commissioner Clark, we would move the admission of Exhibit 10.

COMMISSIONER CLARK: All right. Without objection, that's entered into the record.

(Exhibit 10 received in evidence.)

COMMISSIONER CLARK: Mr. Childs your 11?

MR. CHILDS: I'll move 11. It's simply for a reference point. It's not additional to what Mr. Schuster's --

COMMISSIONER CLARK: Without objection, Exhibit 11.

(Exhibit 11 received in evidence.)

MR. CHILDS: And I ask again, if I haven't already, that you take administrative notice of Order 24734.

COMMISSIONER CLARK: I did that, Mr. Childs.

MR. CHILDS: Sorry.

COMMISSIONER CLARK: Is that the one you passed out?

MR. CHILDS: That's the order, and Rule 25-17.082, your rule.

COMMISSIONER CLARK: We'll take official notice of it.

Anything further for this witness?

Thank you, Mr. Larkin. I hope you can head home tonight.

WITNESS LARKIN: No.

COMMISSIONER CLARK: I'm sorry. Oh, great, it's not because we went late, then?

WITNESS LARKIN: Oh, no. I wasn't planning on going -- the plane leaves at 7:00 anyway.

COMMISSIONER CLARK: Okay. Well reconvene tomorrow at 8:30, and we'll take Mr. Stallcup.

All right. I hope we can finish tomorrow morning.

MR. CHILDS: Can we leave our materials here overnight?

COMMISSIONER CLARK: You know, I really don't know the answer to that. I don't think they will be disturbed. I don't know what the cleaning crew does. Have we left things here before?

MR. [illegible]: Yes, I think so.

COMMISSIONER CLARK: All right. You can leave them.

All right. Thank you very much. We'll reconvene at 8:30 tomorrow morning and we will begin with Mr. Stalloup.

(Thereupon, the hearing adjourned at 6:10 p.m. to reconvene at 8:30 a.m., Friday, October 31, 1997 at the same location.)

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(Transcript continues in sequence in Volume 3.)