BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

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

:DOCKET NO. 971294-EQ
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SECOND DAY

VOLUME IV

PAGE 467 through 563

PROCEEDINGS:	HEARING
BEFORE:	COMMISSIONER SUSAN F. CLARK COMMISSIONER JOE GARCIA
DATE:	Friday, October 31, 1997
TIME:	Commenced at 8:30 a.m. Concluded at 1:15 p.m.
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	NANCY S. METZKE, RPR, CCR Court Reporter Post Office Box 3093 Tallahassee, Florida 32315-3093
APPEARANCES:	
	(As heretofore noted.)

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P R O C E E D I N G S

  (Transcript continues in sequence from Volume III)

  COMMISSIONER CLARK: Let's go back on the record, and we are on the rebuttal testimony of Mr. Schuster. And Commissioner Garcia, I had already made a ruling to allow the supplemental rebuttal testimony, all right?

  COMMISSIONER GARCIA: Okay.

Whereupon,

      LEE G. SCHUSTER

was called as a witness and, having been previously sworn, testified as follows:

      EXAMINATION

BY MR. McGEE:

  Q Mr. Schuster, do you have before you two documents, one entitled "Rebuttal Testimony and Exhibits of Lee G. Schuster," and the other entitled "Supplemental Rebuttal Testimony and Exhibits of Lee G. Schuster?"

  A Yes, I do.

  Q Were those prepared by you as your rebuttal testimony for this proceeding today?

  A Yes.

  Q And starting with your rebuttal testimony, do you have any corrections that you would like to make to that?

  A Yes, I do. I have one correction. Based on

1 Mr. Stallcup's deposition and the exhibits that he provided

2 after his deposition relating to the calculation of

3 standard deviations and variances, I would like to delete a

4 portion of my testimony that took issue with those

5 calculations. That begins on page 12, line 11 of my

6 testimony and extends through page 14, line 19.

7   MR. McGEE: Madam chairman, we will withdraw that

8 portion of his testimony.

9   COMMISSIONER CLARK: All right. We'll strike

10 through it.

11   MR. HOWE: I'm sorry, could I hear where that

12 ended?

13   WITNESS SCHUSTER: It ends on page 14, line 19.

14   MR. HOWE: Thank you.

15 BY MR. MCGEE:

16   Q   With that correction, Mr. Schuster, if you were

17 asked the questions contained in your prepared rebuttal

18 testimony, would your answers be the same today?

19   A   Yes.

20   MR. McGEE: Madam Chairman, we would ask that

21 that testimony be inserted into the record as though read.

22   COMMISSIONER CLARK: The prefiled rebuttal

23 testimony of Mr. Lee Schuster will be inserted in the

24 record as though read with those changes.

25

FLORIDA POWER CORPORATION

DOCKET NO. 961184-EQ

REBUTTAL TESTIMONY OF
LEE G. SCHUSTER

1 Q. Please state your name and business address.

2 A. My name is Lee G. Schuster. My business address is Post Office Box

3   14042, St. Petersburg, Florida, 33733.

4

5 Q. Have you previously submitted testimony in this proceeding?

6 A. Yes. My direct testimony on behalf of Florida Power Corporation

7   ("Florida Power") was filed on August 27, 1997.

8

9 Q. What is the purpose of your rebuttal testimony?

10 A. The purpose of my rebuttal testimony is to respond to the direct

11   testimonies of Mr. Paul Stallcup on behalf of the Commission Staff and

12   Mr. Hugh Larkin on behalf of the Office of Public Counsel. With

13   respect to Mr. Stallcup's testimony, I will address four subject areas:

14   (1) risk and cost/benefit analysis, (2) natural gas price forecast

15   assumptions, (3) power plant construction forecast assumptions, and

16   (4) the risk adjusted discount rate methodology.

1   With respect to Mr. Larkin, I will discuss and respond to each of

2   the five subject areas addressed by his testimony: (1) risk and

3   cost/benefit analysis, (2) the appropriate discount rate, (3)

4   intergenerational fairness, (4) the issue of stranded costs, and (5) his

5   "alternative proposal."

6

7   I. REBUTTAL TO STAFF'S DIRECT TESTIMONY

8

9   Q. Please summarize your overall conclusions regarding Mr. Stallcup's

10   testimony.

11   A. With the exception of several secondary issues, I am in general

12   agreement with Mr. Stallcup's risk analysis, in particular, the use of a

13   reputable third party forecast to test the reasonableness of forecast

14   assumptions and the use alternative forecasts to conduct a risk

15   sensitivity analysis. However, in implementing this methodology, a

16   material arithmetic error was made. When this error is corrected, Mr.

17   Stallcup's risk analysis offers strong support for approval of the OCL

18   contract buyout. His corrected base case yields a net present value

19   (NPV) savings of $100.6 million (compared to $34.6 million from the

20   analysis in my direct testimony), with sensitivity results of $89.3

21   million for his pessimistic case and $106.5 million for his optimistic

22   case. In other words, the corrected results of Mr. Stallcup's own

23   analysis demonstrate that the proposed OCL contract buyout offers

24   very substantial savings to customers with virtually no risk that

25   changes in assumed conditions could eliminate those savings.

1　　　Moreover, when the secondary issues of disagreement that I discuss

2　　　below are properly treated in the analysis, the expected savings from

3　　　the buyout become even greater.

4

5　　　1. Risk and Cost/Benefit Analysis

6

7　Q.　What is your primary concern with respect to Mr. Stallcup's testimony

8　　　and his risk and cost/benefit analysis of the proposed OCL contract

9　　　buyout?

10　A.　Mr. Stallcup's analysis contains a material arithmetic error in the

11　　　treatment of his risk adjusted discount rate which invalidates the results

12　　　of his study cases. In Mr. Stallcup's discussion of the derivation of a

13　　　risk adjusted discount rate at pages 8-9 of his testimony, he correctly

14　　　indicates that it consists of the sum of a risk free discount rate and a

15　　　risk premium. However, in calculating the actual risk adjusted discount

16　　　rates used in his analysis of the OCL buyout (Stallcup Exhibit PWS-4),

17　　　the risk premium is mistakenly subtracted from the risk free rate. My

18　　　rebuttal Exhibit LGS-8 shows both Mr. Stallcup's calculation and a

19　　　corrected calculation in which the risk adjusted discount rate is

20　　　computed as the sum of the risk free rate and a risk premium.

21

22　Q.　If the correct risk adjusted discount rate had been used in Mr.

23　　　Stallcup's analysis, what would the results have been?

24　A.　The results of a corrected analysis are summarized in my rebuttal

25　　　Exhibit LGS-9. These cases are based entirely on Mr. Stallcup's

- 3 -

1 assumptions and methodology as described in his testimony, including

2 the use of a natural gas price forecast prepared by Data Resources, Inc.

3 (DRI). The only difference between the results presented in Mr.

4 Stallcup's Exhibit PWS-5 and my Exhibit LGS-9 is the correction of the

5 error described above and as shown in Exhibit LGS-8. Mr. Stallcup's

6 methodology yields a NPV savings of $100.6 million for the DRI base

7 case (detailed in rebuttal Exhibit LGS-10), NPV savings of $89.3 million

8 for the DRI pessimistic case (detailed in rebuttal Exhibit LGS-11), and

9 NPV savings of $106.5 million for the DRI optimistic case (detailed in

10 rebuttal Exhibit LGS-12). After weighting the sensitivity cases, they

11 produce an expected NPV of savings of $99.2 million, which suggests

12 that there is a negligible probability that the NPV savings could be

13 negative.

14

15 Q. What is your response to Mr. Stallcup's alternative risk analysis based

16   on a hybrid 10.9% discount rate as described on page 16 of his

17   testimony?

18 A. This risk analysis is based on the average of Florida Power's discount

19   rate of 8.81% and the 13% discount rate suggested by Mr. Larkin. Mr.

20   Stallcup offers no justification for using a 10.9% discount rate

21   whatsoever, nor does he endorse its use. Clearly, any number of

22   "mixed bag" discount rates could be created in a similar manner,

23   without ever addressing the underlying question of whether the rate is

24   appropriate. For example, Mr. Larkin's range of 13-18% could be

25   averaged to arrive at 15.5%, or one could average the 15.5% midpoint

- 4 -

1 of Mr. Larkin's range with Florida Power's 8.81% discount rate to

2 arrive at 12.15%, etc. Rather than respond to a calculation by Mr.

3 Stallcup using Mr. Larkin's data, I will address Mr. Larkin's testimony

4 regarding discount rates directly in the next section of my testimony.

5

6 Q. Have you performed a cost/benefit analysis using Mr. Stallcup's risk

7 adjusted discount rate in combination with Florida Power's forecast

8 assumptions?

9 A. Yes. Mr. Stallcup states that he believes that his analysis is more

10 comprehensive than that presented in the testimony of Florida Power

11 or Public Counsel witness Larkin. While I believe that it is fair to test

12 the benefits of the proposed OCL contract buyout using an alternative

13 fuel price forecast such as DRI's, I do not believe that it is appropriate

14 to dispense entirely with Florida Power's fuel forecast as Mr. Stallcup

15 has done. Mr. Stallcup argues that it is appropriate to use the DRI

16 forecast instead of Florida Power's forecast. As discussed below, I

17 take issue with this position and have concerns regarding the data he

18 uses to support his arguments. I also take issue below with the

19 particular DRI index selected by Mr. Stallcup to escalate the cost of the

20 combined cycle unit used in the analysis to replace the last 10 years of

21 the OCL contract. As a result, I have prepared a cost/benefit analysis

22 which restates Mr. Stallcup's results using Florida Power's forecast

23 assumptions.

1   Q. What is the result of Mr. Stallcup's adjusted risk premium analysis

2   using Florida Power's forecast assumptions in place of the DRI forecast

3   data?

4   A. The result of this cost benefit analysis is summarized in my rebuttal

5   Exhibit LGS-13. This case is based on Mr. Stallcup's risk premium

6   methodology as described in his testimony. In addition to correcting

7   the discount rate error described above, only two changes have been

8   made to the assumptions used in Mr. Stallcup's base case presented in

9   his Exhibit PWS-5: (1) the use of Florida Power's fuel forecast in place

10   of the DRI fuel forecast, and (2) the use of DRI's *Fixed Investment,*

11   *Durable Equipment* price index rather than the DRI *Public Utility*

12   *Structures* price index. Both of these changes are discussed below.

13   The results of this analysis indicate a NPV customer benefit of $119.4

14   million.

15

16   2. **Natural Gas Price Forecast Assumptions**

17

18   Q. On page 4 of his testimony, Mr. Stallcup states that Florida Power's

19   natural gas price forecast may substantially understate the future

20   market price of natural gas. Do you agree with this conclusion?

21   A. No, I do not, and in certain respects, neither does the data offered by

22   Mr. Stallcup in support his conclusion. He bases his conclusion on two

23   comparisons. First, he compares the Florida Power price forecast to

24   the gas price forecasts submitted by other Florida utilities in their 1997

- 6 -

1   Ten Year Site Plans. Second, he compares the Florida Power forecast

2   to the DRI base case natural gas price forecast.

3

4   Q. How does Florida Power's natural gas price forecast to the forecasts

5   submitted by other Florida utilities in their 1997 Ten Year Site Plans?

6   A. The Ten Year Site Plan gas price forecasts that Mr. Stallcup refers to

7   and shows in his Exhibit PWS-1 only cover the period 1997-2006. In

8   2006, the final year of these forecasts, the majority of the forecasts,

9   including Florida Power's, indicate a natural gas price between

10   $3.00/MMBtu and $4.00/MMBtu. In forecasting natural gas prices ten

11   years in the future, this $1 range is not unreasonable, especially when

12   one recognizes that this same group of forecasts start out with a price

13   range of about $2 (from slightly over $2.00/MMBtu to approximately

14   $4.00/MMBtu) in 1997, the first year of the forecast.

15

16   Q. What is the source for the gas price forecasts attributed by Mr. Stallcup

17   to the utilities' 1997 Ten Year Site Plans for the interval 2007-2023?

18   A. Mr. Stallcup has presented forecast data through 2023 in his Exhibit

19   PWS-1 and cited as his source the 1997 Ten Year Site Plans for each

20   of the respective utilities, even though the plans contain data only

21   through 2006. My direct testimony addressed the issue of Staff

22   creating long term forecasts based on shorter term forecasts prepared

23   by a utility and attributing the entire forecast to the utility. If this

24   practice has been continued in Mr. Stallcup's testimony, there can be

25   no insight gained from comparing these utility gas price forecasts

- 7 -

1 beyond the year 2006, since that portion of the forecast was not

2 prepared, reviewed or issued by the respective utilities.

3

4 Q. What bearing do historical price patterns for natural gas have on Mr.

5 Stallcup's conclusions and the validity of the Florida Power natural gas

6 price forecast?

7 A. Historical natural gas prices for the period 1973-97 are summarized in

8 my rebuttal Exhibits LGS-14 and LGS-15, which are based on data from

9 the Energy Information Administration's *Monthly Energy Review* for

10 August 1997. The movements in natural gas prices over the last 25

11 years may be divided into two periods that are relevant to forecasting

12 prices today. First, from the early 1970's until 1985 there was a ten-

13 fold increase in the price of natural gas, from approximately

14 $0.30/MMBtu to well over $3.00/MMBtu. During this period users

15 experienced repeated price shocks and forecasters regularly revised

16 their price forecasts upward. During 1985-87 the price fell to

17 approximately $2.25/MMBtu and has remained essentially at this level

18 since that time. During recent years, the persistence of stable,

19 relatively low natural gas prices has been an actively debated and much

20 publicized topic. Most recently, during 1996-97 there has been

21 increased volatility in prices, with brief price spikes as high as

22 $4.00/MMBtu, while returning to the neighborhood of $2.25/MMBtu.

23 Given this historical context, it is not at all surprising that different

24 forecasters have different views regarding the future of natural gas

25 prices. I will agree with Mr. Stallcup that DRI and Florida Power have

- 8 -

1 different natural gas price forecasts, but it is no more valid to reject

2 Florida Power's forecast because it "may substantially understate the

3 future market price of natural gas" than to reject DRI's forecast

4 because it may substantially overstate the price. As history has

5 shown, only actual prices in the future will reveal which forecast is

6 more accurate. For example, if a forecaster in 1986 had predicted that

7 natural gas prices would fall to approximately $2.25/MMBtu and remain

8 near that level for a decade, there is little doubt that such a forecast

9 would receive the same type of skepticism that Mr. Stallcup has

10 directed at Florida Power's price forecast. Yet, that forecast would

11 have proven to be absolutely correct and other forecasts of much

12 higher natural gas prices based on historical trends would have proven

13 to be highly misleading.

14

15 3. **Power Plant Construction Forecast Assumptions**

16

17 Q. Mr. Stallcup maintains that DRI's *Fixed Investment, Durable Equipment*

18 price index used by Florida Power to project combined cycle power

19 plant construction costs during the buyout period is not correct, and

20 that the DRI *Public Utilities Structures* price index should be used

21 instead. What is your response to his contention?

22 A. Simply put, a combined cycle power plant is much more like a large

23 machine than it is like a structure or building. I have provided data for

24 the cost breakdown of a typical combined cycle power plant in rebuttal

25 Exhibit LGS-16 which demonstrates that approximately 90% of the

cost is related to equipment and only 10% is related to structures. In reality, the components of a combined cycle power plant relate to both the cost indices for equipment and for structures. A more refined escalation method would weight these two indices in proportion to the contribution of each index to the cost of the various components of a combined cycle power plant. However, in the case of a combined cycle unit, where the cost is determined predominately by one index, it would be a reasonable approximation to use the dominate index to project construction costs.

Q. How do the definitions of the DRI cost indices for equipment and for structures relate to the components of a combined cycle power plant?

A. One of the three largest components in the equipment cost index is electrical machinery expenditures, which includes many of the main components of combined cycle power plants, such as fabricated metals, engines, turbines and electrical equipment. In a combined cycle power plant, the turbines are the single largest cost component, and most of the balance of the equipment and materials used to construct the plant are included in the equipment index. By contrast, the index for public utility structures includes such items as railroad tracks, stations, telephone, electric and gas transmission and distribution systems, and oil and gas well drilling and exploration expenditures. As a result, the public utility structures index includes many items that bear no relation to power plant construction.

1   Q. How can the relative importance of these two cost indices to the

2   escalation of power plant construction costs be determined?

3   A. The proper way to determine an appropriate weighting is to use a cost

4   breakdown for a power plant and identify those costs which relate to

5   each index. This data has been provided in my rebuttal Exhibit LGS-

6   16, which summarizes the construction cost for a typical 250

7   megawatt combined cycle power plant. This cost breakdown

8   demonstrates that only approximately 10% of the total cost is related

9   to the structures index. The largest cost component is mechanical

10   equipment which includes the turbines, the primary component of a

11   power plant of this type. The remaining cost categories include the

12   balance of equipment and materials required to construct this type of

13   power plant.

14

15   Q. What can be concluded from this analysis regarding the proper cost

16   index to use to forecast the construction cost for combined cycle

17   power plants?

18   A. The construction costs for a combined cycle power plant are

19   predominately related to the equipment index. Due to the relatively

20   minor contribution of the structures index it seems reasonable to

21   estimate future construction costs using only the equipment index as

22   I have done in my NPV analysis. I believe that Mr. Stallcup is incorrect

23   to select the structures index in preference to the equipment index.

1 Q. What is the effect of using the Public Utility Structures Index in Mr.

2   Stallcup's analysis instead of the Fixed Investment, Durable Equipment

3   price Index used by Florida Power?

4 A. As Mr. Stallcup points out on page 7 of his testimony, the effect of

5   using the Public Utility Structures Index in place of the Fixed

6   Investment, Durable Equipment Index is to reduce the NPV of the

7   proposed OCL contract buyout by approximately $4.7 million (from

8     $32.7 million to $28.0 million in Mr. Stallcup's example). As discussed

9   above, I believe this is an unjustified and inappropriate reduction.

10

11   4. The Risk Adjusted Discount Rate Methodology

12

13 Q. Do you have any other concerns regarding Mr. Stallcup's risk adjusted

14   discount rate methodology?

15 A. Yes, I do. Mr. Stallcup claims to be measuring volatility or risk by

16   means of computing standard deviations, as described on page 12 of

17   his testimony. However, the variances upon which he calculates the

18   standard deviations are simply the differences between his DRI base

19   case and his DRI expected value case. As a result, all Mr. Stallcup is

20   actually measuring is the symmetry, or lack thereof, of the DRI

21   optimistic and pessimistic cases with respect to the DRI base case. By

22   symmetry I mean the degree to which the optimistic and pessimistic

23   cases deviate from the base case. If they deviate equally, for example

24   the optimistic case being 20% higher than the base and the pessimistic

25   being 20% lower than the base, the cases are symmetric. However,

1   if the optimistic case were 25% higher than the base and the

2   pessimistic 15% lower than the base the cases would be asymmetric.

3   The key point is that if the cases are symmetric, the expected value will

4   be equal to the base case and the variance computed by Mr. Stallcup

5   will be zero. Conversely, the expected value will deviate from the base

6   case and result in a non-zero variance if the cases are not symmetric.

7

8   Q. What is really meant by the risk of the forecast and how can it be

9   measured?

10   A. In essence, risk may be defined as the probability that the actual value

11   for the variable being forecasted is different from the predicted base

12   case value. The degree to which the optimistic and pessimistic

13   forecasts diverge from the base case offers a way to measure this risk.

14   For example, if the three forecasts diverge only slightly and remain very

15   close together, it can be concluded that there is a high probability that

16   the variable being forecasted will have an actual value close to the base

17   case and therefore less risk. Conversely, if the three forecasts diverge

18   widely, there is much more uncertainty regarding the actual value of

19   the variable being forecasted and therefore more risk.

20

21   Q. Can you provide an example as to why Mr. Stallcup's methodology fails

22   to measure this forecast risk in an acceptable manner?

23   A. Yes. This can be illustrated by comparing the risk of the following two

24   forecasts. The first forecast is symmetric, with the optimistic case

25   being 40% higher than the base case and the pessimistic case being

- 13 -

1   40% lower than the base case. The second forecast is not symmetric,

2   with the optimistic case being 3% higher than the base and the

3   pessimistic case being 1% lower than the base case. Common sense

4   suggests that the first forecast has far more risk than the second

5   forecast. However, Mr. Stallcup's methodology would reach the

6   opposite conclusion by determining that the first forecast has zero risk

7   because it is symmetric and the second forecast has a level of risk that

8   is a function of the degree to which it is not symmetric.

9

10   Q. What is your overall opinion of Mr. Stallcup's risk adjusted discount

11   rate methodology?

12   A. The risk adjusted discount rate methodology works reasonably well

13   when the risk premium is determined on an a priori basis. This is the

14   case for the capacity payments in the contract and replacement cases

15   as well as for the contract buyout cost. However, the risk premiums

16   computed for the projected energy costs in the contract and

17   replacement case are suspect for the reasons discussed above. There

18   seems to be little, if any, justification for equating the degree of

19   asymmetry among the base, high and low forecast cases with risk.

20

21   II. REBUTTAL TO PUBLIC COUNSEL'S DIRECT TESTIMONY

22

23   Q. Please summarize your overall conclusions with regard to Mr. Larkin's

24   testimony.

- 14 -

A. Mr. Larkin's discussion deals only with those selected elements of the OCL buyout transaction that support his arguments. As I discuss below, each of Mr. Larkin's arguments are either based on erroneous assumptions, or his arguments are incomplete or misleading. In summary, Mr. Larkin's conclusions and his purported alternative proposal for the OCL contract buyout should be rejected.

1. Cost/Benefit Analysis

Q. On page 2 of his testimony, Mr. Larkin states that the only amount in Florida Power's net present value calculation that can be determined to be fixed, known and measurable is the amount that ratepayers will be charged for the buyout. Do you agree with his statement?

A. No. The majority of the savings from the OCL contract buyout will result from avoiding the known capacity payments required by the existing contract during the period 2014-2023. If the existing contract remains in place, customers will be required to pay $458,990,000 in capacity payments during this period with virtually the same certainty that Mr. Larkin ascribes to the cost of the OCL contract buyout. Mr. Stallcup, at page 8 of his testimony, agrees that the capacity costs under the contract are known with certainty and treats them as such in his risk analysis. Thus, Mr. Larkin begins his risk analysis with a fundamentally flawed premise.

1   Q.   What is your response to Mr. Larkin's claim at page 3 of his testimony

2   that the risk that the ratepayer takes is extremely high because the

3   savings from the transaction are based in part on future projections.

4   A.   Mr. Larkin attacks the projections and underlying assumptions used in

5   Florida Power's projection of customer savings exclusively on the basis

6   that they are, of necessity, projections and assumptions that cannot be

7   determined to be fixed, known and measurable. Based solely on this

8   observation, he concludes that Florida Power's NPV calculation is

9   "extremely speculative" and that "the risk ratepayer takes is extremely

10   high". In doing so, he ignores the fact that this is necessarily the

11   nature of most, if not all, proposals which offer future savings to

12   customers. Often, none of the components of projected savings and

13   costs are fixed, but must be estimated based on reasonable

14   assumptions. Mr. Larkin's testimony classifies projected costs and

15   benefits into two risk categories. Projected costs and benefits which

16   are fixed, known and measurable have zero risk; all other projections

17   are, according to Mr. Larkin, subject to extreme risk. Mr. Larkin's

18   conclusions based on this simplistic risk analysis lack any credible

19   analytical basis whatsoever and should be dismissed.

20

21   2. Discount Rate

22

23   Q.   What is wrong with Mr. Larkin's statement that the use of an 8.67%

24   discount rate to calculate the net present value benefit to ratepayers is

25   inappropriate and not reasonable?

- 16 -

A. Mr. Larkin completely misses the point when he states that the use of
Florida Power's cost of capital as a discount rate is inappropriate simply
because it is Florida Power's cost of capital. As is normally the case
in this kind of present value analysis, the utility's cost of capital is used
as a proxy for the customers' discount rate. This discount rate concept
has been used by Florida Power in numerous dockets and filings over
many years and has been accepted by the Commission, Staff and other
parties to these dockets. As discussed below, the theoretical
arguments regarding the appropriate value for a customer discount rate
span the range from 2-3% up to 18%. Given this wide range, a proxy
value of 8-9% is not at all unreasonable.

Q. What is wrong with Mr. Larkin's statement on page 6 that it would be
unlikely that any sophisticated investor would accept an 8.67% rate of
return on his investment?

A. Mr. Larkin appears to have erroneously assumed that because Florida
Power used an 8.67% discount rate to compute the NPV of customer
savings, that the OCL contract buyout provides an effective return of
8.67%. This is an incorrect conclusion, and consequently Mr. Larkin's
arguments regarding the acceptability of an 8.67% return on
investment are irrelevant. Florida Power calculated a NPV benefit of
$32.5 million using an 8.67% discount rate and subsequently a NPV
benefit of $34.6 million using an 8.81% discount rate (based on
updated assumptions included in late-filed Exhibit No. 8 to my
deposition by Staff). This calculation clearly demonstrates that the

1   effective return to customers is higher than 8.81% because the

2   resulting NPV is positive.

3   The effective rate of return for the proposal is determined by

4   solving for the discount rate which makes the NPV equal to zero. This

5   computation (requested by Staff as late-filed Exhibit No. 1 to my

6   deposition) results in a discount rate of 12.19%. The 12.19% rate is

7   the effective (after-tax) return of the cash flow stream when this

8   proposal is viewed as an investment. In other words, if the buyout

9   payments of $9.8 million per year during the period 1987-2001 were

10   deposited in an investment account at a 12.19% rate of return, the

11   balance of this investment would grow such that, beginning in 2014

12   amounts equal to the projected annual customer savings could begin to

13   be withdrawn from this investment account. Withdrawals could be

14   made each year in amounts equal to projected annual customer

15   savings, and when the final amount is withdrawn in 2023 the

16   investment balance would be reduced to zero.

17

18   Q. Is Mr. Larkin's proposed discount rate of 13-18% appropriate for this

19   type of analysis?

20   A. No. A discount rate based on the interest rate for an unsecured loan

21   or credit card is only one of several concepts included in the theory of

22   customer discount rates. Mr. Larkin makes no mention of the equally

23   valid argument that customers may have no credit card debts

24   whatsoever, but instead make regular deposits to a passbook savings

25   account earning 3-4% (before taxes). Alternatively, other customers

- 18 -

1   may make investments in bonds at an 8% yield. To illustrate the

2   complications of the customer discount rate argument, there are also

3   customers who have a credit card debt balance and are nevertheless

4   also putting money aside in a savings account. Mr. Larkin conveniently

5   ignores these other arguments which would suggest lower customer

6   discount rates and reveal the complexity of the issue he raises. It is for

7   precisely these reasons that a reasonable, well understood proxy for the

8   customer discount rate has been established by convention and

9   consistently used to compute the net present value of customer savings

10 in analyses such as the OCL contract buyout analysis.

11

12 Q. What else has Mr. Larkin overlooked in his discount rate discussion?

13 A. In his discussion of acceptable investment returns, Mr. Larkin makes no

14 distinction between a pre-tax return on investment and an after-tax

15 return on investment. For a typical customer, the 12.19% return

16 represented by the OCL contract buyout corresponds to an after-tax

17 rate of return. In order for an investment opportunity to provide a

18 comparable return it would need to offer a higher pre-tax return. For

19 example, a marginal federal income tax rate of 15% to 28% would

20 imply that the investment must provide a pre-tax return of 14.34% to

21 16.93% in order to be comparable to the OCL buyout. As a result, I

22 would challenge Mr. Larkin's assertion that no sophisticated investor

23 would be likely to accept the return inherent in the proposed OCL

24 contract buyout when viewed as an investment.

1 Q. Do you agree with Mr. Larkin that the appropriate discount rate must

2   reflect the nature of a high risk investment?

3 A. No. Mr. Larkin's characterization that substantial risk is related to

4   Florida Power's proposal is unsupported speculation. He has provided

5   no basis for this conclusion which justifies his arguments for a higher

6   discount rate.

7

8 3. Intergenerational Fairness

9

10 Q. Do you agree with Mr. Larkin's assertion that there are intergenerational

11   inequities associated with the OCL contract buyout?

12 A. No, I do not. As I pointed out in my direct testimony, the buyout does

13   not create intergenerational inequity, but rather helps to counterbalance

14   an existing intergenerational inequity inherent in the structure of the

15   original OCL contract. Compared to the costs of the unit avoided by

16   the OCL contract, current customers are still better off under the

17   contract even with the buyout cost through 2002. To the extent that

18   intergenerational fairness is an issue in this proceeding, it weighs

19   strongly in favor of -- not against -- approval of the OCL buyout.

20

21 Q. Do you agree with Mr. Larkin's argument on page 8 that the low

22   capacity payments made by customers during the early years of the

23   OCL contract is not an intergenerational inequity, but simply

24   compensation for a higher risk of non-performance by OCL?

A. Absolutely not. Mr. Larkin is correct only to the extent that one of the reasons for adopting the value of deferral methodology, which "back-end loaded" the capacity payment stream, was to ensure QF performance for the duration of the contract. The point, however, is that to achieve this important performance-ensuring objective, of necessity, an intergenerational inequity was created compared to traditional revenue requirements ratemaking. To suggest, as Mr. Larkin does, that this shifting of substantial costs from current to future customers was done to compensate current customers for a higher risk of non-performance is absurd. By heavily back-end loading the QF's capacity payments, the likelihood that the QF will perform throughout the term of the contract is greatly enhanced. Thus, the risk of non-performance is reduced in each and every year of the contract, even though the cost of this risk reduction is borne by future customers to the benefit of current customers.

Moreover, viewed in terms of circumstances as we know them today, non-performance by OCL can no longer be considered a "risk." Indeed, the entire premise of the OCL contract buyout is that, due to changed economic circumstances, there is value in paying OCL not to perform during the last ten years of the contract. Given this demonstrated value of non-performance under the contract, it makes no sense to perpetuate the notion that current customers should be compensated, or future customers should pay, for a risk that has now become a benefit.

4. Stranded Costs

Q. Is there any merit in Mr. Larkin's discussion of the effect of this transaction on the issue of stranded cost?

A. No. My direct testimony made it clear that the issue of potential strandable costs need not be addressed as part of the Commission's decision regarding the OCL contract buyout. Mr. Larkin makes the error of assuming that, to the extent that the OCL buyout reduces potential strandable costs, it somehow precludes a process of netting stranded costs and benefits in the future. Nothing could be further from the truth. In the context of stranded costs, the OCL buyout constitutes a mitigation of potential future strandable costs. Such mitigation efforts will serve only to reduce the level of stranded costs which may exist in the future and in no way conflicts with the offsetting of stranded costs and benefits discussed by Mr. Larkin. Mr. Larkin seems to believe that a cost reduction effort on the part of Florida Power is somehow one-sided and inequitable unless it is accompanied by some final accounting of stranded costs and benefits. Mr. Larkin has digressed into a speculative discussion related to the future restructuring of the electric industry which has no bearing on the proposed OCL contract buyout.

5. Larkin's "Alternative Proposal"

Q. What is wrong with Mr. Larkin's proposal that Florida Power make the buyout payments and receive the benefits of the buyout transaction rather than Florida Power's customers?

A. In essence, Mr. Larkin is proposing that Florida Power convert an opportunity to provide at least $472 million in savings to its customers into an transaction which would benefit only Florida Power's shareholders. If Florida Power had made this proposal itself it would undoubtedly have been sharply criticized, and properly so. The fact that Mr. Larkin has advanced such a dubious proposal does not change its essential nature.

Q. Is Mr. Larkin correct in assuming that Florida Power could undertake the OCL buyout transaction in place of the customers, with the transaction remaining unchanged?

A. No. Mr. Larkin makes the simplistic and erroneous assumption that the transaction would be unchanged if the Company were to "step into the shoes of the customer" and engage in the buyout transaction rather than Florida Power's customers. This is simply not the case. The Company's proposal will deliver savings directly to customers in the form of lower electric rates. If Florida Power were to receive these same benefits in the form of revenues from customers, this revenue would represent taxable income to the Company. In order for Florida Power to earn its authorized rate of return as proposed by Mr. Larkin,

1   it would be necessary to collect revenues corresponding to Florida

2   Power's pre-tax rate of return. Mr. Larkin gives no indication that he

3   recognizes the implications of his own proposal, and he has not

4   presented any form of analysis to substantiate his claims.

5

6   Q. Under his alternate proposal, Mr. Larkin claims that the Company will

7   receive a rate of return equal to its current authorized rate of return and

8   at the same time be able to reduce its future capacity and energy costs

9   and achieve its stated goal of offering competitive prices to its

10   customers. How is this possible?

11 A. It is not. In touting his proposal, Mr. Larkin double counts the resulting

12   benefits. Obviously, if the Company receives the future benefits of the

13   buyout in the form of higher revenues from customers in compensation

14   for making the near-term buyout payments, there would, in all

15   probability, be no rate reduction for customers.

16

17 Q. What is your reaction to Mr. Larkin's statement that Florida Power will

18   suffer no harm if the Commission were to deny its petition?

19 A. Mr. Larkin's statement is irrelevant to the subject at hand. It is Florida

20   Power's customers, not the Florida Power, who will be directly harmed

21   if the Company's petition is rejected and customer's are denied the

22   benefits which would result from the OCL contract buyout. Mr. Larkin

23   is simply rehashing the argument previously made by Public Counsel in

24   its motion to dismiss Florida Power's request for a hearing on its

25   petition, claiming Florida Power lacked standing to advocate actions it

1   believed to be in the best interests of its customers. The Commission

2   rejected that argument before and it has gotten no better with age.

3

4   Q. Does this conclude your rebuttal testimony?

5   A. Yes.

1   MR. McGEE: And attached to that testimony are

2 Exhibits LGS-8 through LGS-16. We would ask those be

3 marked for identification.

4   COMMISSIONER CLARK: They will be marked as

5 Exhibit 19.

6 BY MR. McGEE:

7   Q   Mr. Schuster, do you have any corrections to make

8 to your supplemental rebuttal testimony?

9   A   Yes, I do. I would like to make three

10 corrections of a typographical nature. On page, line 1,

11 the very last word should be spelled --

12   COMMISSIONER GARCIA: This is not your

13 supplemental rebuttal, this is just your rebuttal?

14   MR. McGEE: No, this is the supplemental.

15   COMMISSIONER GARCIA: Okay. I'm sorry.

16   WITNESS SCHUSTER: Yeah, I'm making three

17 corrections to my supplemental rebuttal.

18   COMMISSIONER GARCIA: Okay. Thank you. And they

19 are on?

20   WITNESS SCHUSTER: Page 2, line 1, the very last

21 word after the hyphen should be spelled p-e-r rather than

22 p-r-e.

23   COMMISSIONER CLARK: Say that again. Page 2?

24   WITNESS SCHUSTER: Page 2, line 1, the very last

25 word which says "re-preformed," should be "reperformed."

1   The second correction is on page 5, line 9, the

2   reference to the Stallcup deposition, page 93, should be a

3   reference to page 92.

4   And the third correction is on page 13, line 4,

5   the fourth words which says "preset" should be "present."

6   And those are all the corrections I have.

7   BY MR. McGEE:

8   Q   With those corrections, if you were asked the

9   questions contained in your supplemental rebuttal

10 testimony, would your answers be the same today?

11   A   Yes.

12   MR. McGEE: Madam Chairman, we ask that that

13 testimony be inserted into the testimony as though read.

14   COMMISSIONER CLARK: It will be inserted in the

15 record as though read.

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FLORIDA POWER CORPORATION

DOCKET NO. 961184-EQ

SUPPLEMENTAL
REBUTTAL TESTIMONY OF
LEE G. SCHUSTER

1 Q. Please state your name and business address.

2 A. My name is Lee G. Schuster. My business address is Post Office Box

3   14042, St. Petersburg, Florida, 33733.

4

5 Q. Have you previously submitted testimony in this proceeding?

6 A. Yes. My direct testimony on behalf of Florida Power Corporation

7   ("Florida Power") was filed on August 27, 1997. My rebuttal

8   testimony was filed on October 8, 1997.

9

10 Q. What is the purpose of your supplemental rebuttal testimony?

11 A. The purpose of my testimony is to supplement the portion of my

12   rebuttal testimony addressing what I perceived at the time to be an

13   arithmetic error in the direct testimony of Mr. Paul Stallcup regarding

14   the application of his risk adjusted discount rate (RADR) methodology.

15   In my rebuttal testimony, I noted that, although Mr. Stallcup described

16   his RADR methodology as involving the calculation of a risk premium

17   which was then added to a risk free rate, he had inadvertently

18   subtracted the risk premium when preforming his net present value

19   (NPV) analysis. While not expressly endorsing the use of Mr. Stallcup's

1 RADR methodology, I corrected the perceived error and re-performed

2 his analysis to show the results of his methodology when properly

3 applied. (See my rebuttal Exhibits LGS-8 and LGS-9.) However, during

4 the course of his October 10, 1987 deposition, Mr. Stallcup explained

5 that he, in fact, intended to subtract the risk premium from the risk free

6 rate in calculating his risk adjusted discount rates and cited an

7 academic reference on adjusting discount rates for "risky cash

8 outflows" as support for doing so.

9   Based on this new information, my supplemental rebuttal

10 testimony explains why (1) the controversial "risky cash outflows"

11 concept described in the cited reference is inappropriate for NPV

12 analyses used by this Commission in evaluating measures such as the

13 OCL contract buyout, and (2) even if this concept were to be used, it

14 has been grossly misapplied by Mr. Stallcup. With respect to the

15 misapplication of this concept, and consistent with my rebuttal

16 testimony, I have also re-performed Mr. Stallcup's analysis using a

17 more reasonable application of the concept.

18

19 Q. Wasn't Mr. Stallcup's calculation of risk adjusted discount rates

20   adequately explained in his testimony?

21 A. No, it was not. The portion of his analysis which is at issue is the

22   calculation of risk adjusted discount rates. Mr. Stallcup bases his

23   calculation on a present value concept described in his deposition as

24   "risky cash outflows." However, Mr. Stallcup's testimony describes

25   only a conventional risk adjusted discount rate methodology, and fails

- 2 -

1   to mention, much less provide support for his use of a purported risky

2   cash outflow methodology.   At face value, the calculations in his

3   analysis contradict the description of the methodology contained in his

4   testimony.   This is why I characterized Mr. Stallcup's calculation as

5   containing a material arithmetic error in my rebuttal testimony.

6

7   Q.   What does Mr. Stallcup's academic reference have to say about risky

8   cash outflows?

9   A.   Mr. Stallcup cites the text *Financial Management Theory and Practice*,

10   fourth edition, by Eugene F. Brigham (in collaboration with Louis C

11   Gapenski) as the justification for subtracting his risk premium from the

12   risk free rate.   In this reference, Professor Brigham identifies a

13   conceptual problem with the normal method of developing risk adjusted

14   discount rates when dealing with risky cash outflows, as opposed to

15   cash inflows.   In order to address this problem, Professor Brigham

16   suggests that the risk adjustment for a risky cash outflow is the exact

17   opposite of that for an inflow, or the "normal" risk adjustment.   The

18   basis for this conclusion is a discussion that illustrates that the

19   application of a normal above-average risk adjusted discount rate to

20   risky cash outflows results in an apparently contradictory result.   The

21   suggested solution is to make an adjustment in the opposite direction

22   to arrive at a lower than average risk adjusted discount rate for a risky

23   cash outflow.

Q. Based on the information provided in Mr. Stallcup's deposition, what is your assessment of the risk adjusted discount rates used in his NPV analysis?

A. Mr. Stallcup's methodology of adjusting discount rates <u>downward</u> for above average risks is counter-intuitive, untested in practical application, and controversial among academic experts. Moreover, his particular application of this methodology, by making a downward adjustment to a <u>risk free</u> rate, is a logical contradiction that has no support even among the academic advocates of the methodology. Specifically, I have identified seven substantial reasons to question Mr. Stallcup's "risky cash outflows" methodology and his application of that methodology: (1) the methodology has never been applied before and is untested; (2) Professor Brigham discusses the adjustment of discount rates for risky cash outflows conceptually, but clearly admits that he does not know how to apply his concept practically; (3) Professor Brigham's discussion provides no support for Mr. Stallcup's application of the methodology to risk free rates; (4) the experts disagree as to the validity of Professor Brigham's concept of reducing the discount rate for risky cash outflows; (5) none of the experts recognize the existence of a negative risk premium (i.e., a risk less than zero) inherent in Mr. Stallcup's application; (6) a more moderate and reasonable application of Professor Brigham's risk adjustment concept for risky cash outflows exists; and (7) there is no compelling reason to depart from the standard method of NPV analysis used by this

1   Commission to evaluate ratepayer benefits from utility measures such

2   as the proposed OCL contract buyout.

3

4   Q.   Has Mr. Stallcup provided any evidence that his methodology has been

5   applied before or subjected to any type of review or evaluation?

6   A.   No. On the contrary, Mr. Stallcup stated in his deposition that he has

7   never used this methodology before in an analysis, nor is he aware of

8   any instance when the Commission Staff has proposed or used risk

9   adjusted discount rates in any docket (Stallcup Dep. p. 92, line 12).

10   Since the methodology has never been used, it certainly has never been

11   applied in a manner that produces a negative risk. For this reason

12   alone, his results should be considered on a conditional basis subject

13   to a thorough review of his methods. This is made more difficult by

14   the fact that Mr. Stallcup's testimony fails to mention his use of the

15   unconventional "risky cash outflow" methodology or provide a single

16   word of explanation or support for his radical application of that

17   methodology. It was only in deposition, after this portion of his

18   analysis was challenged as being in error, that Mr. Stallcup explained

19   his departure from the conventional use of risk adjusted discount rates.

20

21   Q.   Does the academic reference cited by Mr. Stallcup provide a means for

22   computing risk adjusted discount rates for risky cash outflows?

23   A.   No, it does not. Significantly, Professor Brigham does not provide a

24   method, and states in strong terms that he knows of no method for

25   performing this computation. Referring to an example of his risky cash

- 5 -

outflows approach where a discount rate for a higher risk project was adjusted down to 7 percent relative to an average risk of 10 percent, Professor Brigham states:

"An obvious question, but one we have no answer for, is 'Where did you get the 7 percent?' The 10 percent was found as the company's cost of capital; the cost of capital rises as the firm takes on riskier projects; but things do not work out as they should if large, but risky, cash outflows are expected during or at the end of the project's life. We wish we had a good answer to this dilemma, but we don't" *(Financial Management Theory and Practice*, p. 405.)

In an article cited by Professor Brigham titled "Some Observations on Risk-Adjusted Discount Rates," *(Journal of Finance*, September 1977) the author, Wilbur G. Lewellen, makes a similar comment regarding the difficulty of calculating risk adjusted discount rates for risky cash outflows:

"What is more severe, of course, is the implementation problem. The execution of any risk-adjusted net present value analysis requires some ability to determine the market-required yield benchmarks to employ. This is the cost-of-capital measurement issue, and it is one thing to be able to cope with that challenge even for broad project categories, let alone to advance to the higher level of measurement skill demanded by an attempt to discriminate among cash flow risk characteristics within projects."

1   Q. Does Mr. Stallcup's academic reference provide support for his

2   application of the risky cash outflows methodology by adjusting the risk

3   free discount rate downward?

4   A. No, it does not. On the contrary, for risky cash outflows Professor

5   Brigham suggests that the <u>average risk</u> (in his example, the utility's

6   overall cost of capital) be adjusted downward from a higher than

7   average risk to a lower than average risk. While he conceded that he

8   knew of no method to calculate the amount of the downward

9   adjustment, he offered no suggestion whatsoever that the adjustment,

10   in whatever amount, could be properly made to the risk free rate. By

11   contrast, Mr. Stallcup first claims to be able to quantify the amount of

12   the downward adjustment, even though his source, Professor Brigham,

13   admits he can't, and then proceeds to produce a <u>negative</u> risk by

14   applying the downward adjustment to a risk free rate, even though his

15   source adjusts an average risk. The following question and answer

16   from Mr. Stallcup's deposition illustrates his inability to tie his

17   calculation to the source he cites for his only support:

18   "Q. Let's pursue this one for a moment. Where does it say in this

19   quote that the way to calculate the risk adjusted discount rate

20   is to subtract the relative risk premium from the riskless

21   interest rate or riskless cost?

22   A. I believe the other parts of that analysis are scattered

23   throughout the entire textbook. Within the next book, I'm

24   sure it's in there somewhere, that the treasury bond rate is a

25   fair representation of a risk free rate, and I don't have that

1   cite with me, but I'm sure I can provide that. And I can also

2   provide, if you like, a reference to -- shall I continue?

3   (Stallcup Dep. p. 124, line 16-17)

4

5   Q. Is there evidence to suggest that there is disagreement among experts

6   regarding the proper treatment of risky cash outflows?

7   A. Yes, there is. Professor Brigham's text, as cited by Mr. Stallcup, refers

8   the reader to other literature on the topics of risky cash outflows and

9   risk adjusted discount rates. These additional references make clear

10   that this is subject area is unsettled. For example, in an article titled

11   "Some Observations on Risk-Adjusted Discount Rates" (Journal of

12   Finance, September 1977) Wilbar G. Lewellen disagrees with Professor

13   Brigham: "The matter of cash outflow risk, however, is an instance

14   wherein intuition is a poor guide. It turns out that a higher discount

15   rate, for higher risk, applied to outflows is exactly what is called for in

16   a market valuation framework. The standard approach is correct." Mr.

17   Lewellen continues in his concluding remarks: "Be that as it may, the

18   point is that, if risk-adjusted rates are to be employed, a higher-rate

19   treatment of cash-outflow risk is not only conceptually consistent but,

20   indeed, mandatory from a market perspective."

21   Two years later, Stephen E. Celec and Richard H Pettway

22   commented on Mr. Lewellen's 1977 article in "Some Observations on

23   Risk-Adjusted Discount Rates: A Comment", (Journal of Finance,

24   September 1979). In summary, the authors maintained that Mr.

25   Lewellen's argument represented only a special case of risky cash

...

outflows and therefore did not constitute a generalized treatment of the issue. Mr. Lewellen replied to this comment in his "Reply to Pettway and Coles" (*Journal of Finance*, September 1979), in which he agreed that, in some situations, risky cash outflows demand a higher discount rate, while other situations require a lower discount rate for proper treatment. However, Mr. Lewellen maintained that in most analyses, the proper treatment of risky cash outflows would demand that a higher rather than a lower discount rate be employed.

Q. Is there reason to question the negative risk premiums which result from Mr. Stallcup's unique application of the risky cash outflow methodology?

A. Yes, there is. By subtracting the risk premium from the risk free rate, Mr. Stallcup's method results in a negative value for risk. This interpretation is required in order to reconcile Mr. Stallcup's method with the definition of a risk adjusted discount rate as being the sum of a risk free interest rate and a risk premium. Such negative risk premiums have been discussed in the financial literature. For example, in his text *Utilities' Cost of Capital*, Roger A. Morin discusses negative risk premiums and concludes as follows:

"The notion of a negative risk premium refers to the situation where the expected market return of common equity is less than that of the bonds of the same issuer. Expressed in another way, the debt securities having prior claims are more costly to the issuer than the securities having residual claims. Such a view is not

consistent with the basic precepts of finance, economics and business law. ... The existence of a negative risk premium is highly unlikely, as it is at serious odds with the basic tenets of finance and law."

This viewpoint is reflected in the definition of risk adjusted discount rates and risk premiums which, at a minimum, makes no provision whatsoever for the possibility of negative risk premiums and, fairly interpreted, rule out the possibility of negative risk premiums altogether. For example, my Exhibit LGS-23 contains a discussion of risk adjusted discount rates and the definition of risk premium from the text *Essentials of Managerial Finance* by J. Fred Weston and Eugene F. Brigham. In this text, Professor Brigham makes no mention or provision for the possibility of negative risk premiums and by illustration shows the lower bound to be zero.

Q. Is there another way to apply Professor Brigham's discussion of risk adjusted discount rates for risky cash outflows to the OCL contract buyout other than the manner used by Mr. Stallcup?

A. Yes. It is very easy to suggest an application of the risky cash outflows methodology which is perfectly consistent with Professor Brigham's discussion that does not result in problematic negative risk premiums produced by Mr. Stallcup's application. Very simply, a more reasonable application would be to make the desired adjustment in the opposite direction from the normal risk adjustment relative to the average risk adjusted discount rate, rather than in the opposite direction

1 relative to the risk free interest rate as done by Mr. Stallcup. In fact,

2 this is exactly how Professor Brigham describes the adjustment:

3 "Therefore, a stream of cash outflows that has a higher-than-average

4 risk must be evaluated with a lower-than-average cost of capital."

5 Furthermore, this is exactly what was done in Professor Brigham's

6 example regarding the evaluation of cash outflows associated with

7 higher risk nuclear plant investment. This example, which arrives at an

8 risk adjusted discount rate of 7 percent, is perfectly consistent with a

9 risk adjustment relative to the average risk level, but is inconsistent

10 with a calculation in which the risk premium is subtracted from the risk

11 free rate.

12

13 Q. Have you performed an analysis applying the risky cash outflow

14 methodology in the manner you described above to determine how the

15 results would differ from Mr. Stallcup's analysis?

16 A. Yes. The results of this analysis are summarized in my Exhibits LGS-17

17 through LGS-21, which update corresponding exhibits LGS-8 through

18 LGS-12 to my rebuttal testimony. The calculation of the risk adjusted

19 discount rates in the manner described above appears on Exhibit LGS-

20 17, with the adjustment being symmetric with respect to the average

21 risk premium of 10.02 percent. These cases are based on the

22 economic assumptions described in Mr. Stallcup's testimony. The only

23 difference between the results presented in Mr. Stallcup's Exhibit PWS-

24 5 and my Exhibit LGS-18 is the use of the "risky cash outflows"

25 discount rates calculated in the manner described above and shown

- 11 -

1   Exhibit LGS-17 in place of "negative risk" rates calculated by Mr.

2   Stallcup. This shows that Mr. Stallcup's analysis, when performed

3   using a reasonable application of his "risky cash outflows"

4   methodology, supports the proposed OCL contract buyout. The

5   analysis yields a NPV savings of $75.4 million for the DRI base case

6   (detailed in Exhibit LGS-19), NPV savings of $53.4 million for the DRI

7   pessimistic case (detailed in Exhibit LGS-20), and NPV savings of $86.9

8   million for the DRI optimistic case (detailed in Exhibit LGS-21). As with

9   the corresponding analysis in my rebuttal exhibits, these results suggest

10   that there is a negligible probability that the NPV savings would be

11   negative.

12   In addition, my Exhibit LGS-22 updates my rebuttal Exhibit LGS-13

13   and shows an NPV analysis of the OCL buyout using the discount rates

14   produced by a more reasonable application of Mr. Stallcup's "risky cash

15   outflows" methodology, as shown on my Exhibit LGS-17, and Florida

16   Power's forecast assumptions for natural gas prices and combined

17   cycle power plant escalation rates, as described on page 6 of my

18   rebuttal testimony. The results of this analysis show a NPV customer

19   benefit of $ 102.5 million.

20

21   Q. Was it necessary or appropriate for Mr. Stallcup to base his analysis of

22   the OCL contract buyout on a radical application of a questionable and

23   untested methodology for risk-adjusting discount rates?

24   A. No, it was neither necessary or appropriate. As Mr. Stallcup stated at

25   page 3 of his testimony, he began his analysis by adopting the overall

- 12 -

1   methodology which I used in my direct testimony. He could have easily

2   completed his sensitivity analysis using Data Resources, Inc. forecast

3   data in combination with the proven and accepted method of

4   computing the net present value of cost/benefit cash flow traditionally

5   used by the Commission for such purposes. Instead, his chose to base

6   his results on a dubious application of a methodology loosely related to

7   an academic debate dating from 1977. When considering the use of

8   Mr. Stallcup's methodology in this proceeding, I would urge the

9   Commission to give careful consideration to the serious implications of

10 using this methodology in other instances where NPV analyses are

11 employed to evaluate ratepayer benefits.

12

13 Q. Does this conclude your supplemental rebuttal testimony?

14 A. Yes.

1   MR. McGEE: Attached to that are Exhibits LGS-17

2 through 23, and we ask that be marked for identification.

3   COMMISSIONER CLARK: Give me the numbers again.

4   MR. McGEE: LGS-17 through LGS-23.

5   COMMISSIONER CLARK: 23. That will be marked as

6 Exhibit 20.

7   Let me ask a question. I noticed, going back to

8 your prefiled rebuttal testimony, look at page 7, in the

9 question that starts on line 4, is there a word missing?

10   WITNESS SCHUSTER: Yes, I believe there is. I

11 believe the word "compare" should be inserted after the

12 word "forecast," the first "forecast."

13   COMMISSIONER CLARK: Okay. All right.

14   MR. McGEE: Thank you.

15   WITNESS SCHUSTER: Thank you.

16   COMMISSIONER CLARK: Does Mr. Schuster have a

17 summary?

18   MR. McGEE: Yes. What was the exhibit, the

19 composite exhibit number given to his supplemental

20 exhibits?

21   COMMISSIONER CLARK: 20.

22   MR. McGEE: 20, okay.

23 BY MR. McGEE:

24   Q   Mr. Schuster, would you give us a summary of your

25 combined rebuttal and supplemental rebuttal testimony?

1   A   Yes. My testimony addresses the testimony of

2 Mr. Stallcup and Mr. Larkin. I would like to briefly

3 summarize each of those separately.

4   With respect to Mr. Stallcup's analysis, I

5 believe that his calculation of a risk-adjusted discount

6 rate by subtracting the risk premium from the risk-free

7 rate is incorrect and results in a flawed methodology. He

8 has not provided a single example of another instance where

9 this methodology has been used, nor has he provided any

10 academic reference which indicates specifically a

11 calculation in which a risk premium is subtracted from a

12 risk-free rate.

13   I believe that this calculation produces invalid

14 results. It produces results that are contradictory, and

15 it produces a calculation of discount rates that defy

16 interpretation. He describes his analysis as being a

17 methodology that views the buyout as an investment

18 opportunity being offered to ratepayers. His calculation,

19 however, results in discount rates in the range of 1 1/2%

20 for several of the cash flow columns. Those discount rates

21 cannot be interpreted as investment rates of return given

22 that the risk-free rate is higher.

23   If an investor has an opportunity to invest in a

24 risk-free investment with a return of, let's say, 6%, under

25 no circumstances would they invest in an investment that

1   contains risk at a lower rate of return. So I would submit

2   that that type of a calculation resulting in a discount

3   rate at that level cannot be interpreted in a consistent

4   way, in the way that a normal risk-adjusted discount rate

5   can be interpreted.

6   Under normal circumstances, you add the risk

7   premium to the risk-free rate and you end up with a rate

8   that is higher than the risk-free rate and which

9   compensates the investor for risk. That is not the case

10   with Mr. Stallcup's methodology.

11   I also disagree with Mr. Stallcup's use of a

12   structures index to escalate the cost of the combined cycle

13   plant. My rebuttal testimony discusses that point and

14   defends my use of an equipment index. I show through a

15   materials breakdown for the construction of a typical

16   combined cycle plant that the equipment index is the

17   appropriate index to use for approximately 90% of the total

18   cost of a combined cycle plant. And a structures index

19   could fairly be applied to the balancing 10%, but it would

20   be inappropriate to select the structures index in

21   preference to an equipment index given that relative

22   importance in the construction of a combined cycle plant.

23   I would also like to say a few words about

24   Mr. Larkin's testimony. In summary, I believe that

25   Mr. Larkin's testimony is very little more than speculation

1 on each of the points that he raises.

2   With respect to risk, his discussion I think

3 could fairly be characterized as not even being a criticism

4 of the OCL buyout. It is a generic criticism of any type

5 of a project or a decision that is dependent upon future

6 assumptions. And the fact that he refers in the course of

7 this discussion to the OCL project doesn't make it any more

8 relevant to the OCL project. It could be applied to any

9 project, anything that this Commission considers, and raise

10 the specter of risk using the words that he describes;

11 therefore, I don't think it applies to the OCL project

12 other than to tell everyone involved what they already

13 know, that every forecast has some uncertainty associated

14 with it.

15   With respect to his discount rates, I believe

16 that he has taken an opportunistic approach in quoting 13

17 to 18% rates and has ignored the balance of the arguments

18 and the complexity of the customer discount rate

19 discussion, some of which indicate the customer discount

20 rates can be much lower, and has ignored the real basis why

21 this Commission has accepted an after-tax discount rate on

22 the part of the company as a proxy for the customer

23 discount rate. He doesn't appear to recognize that as

24 being an estimation technique to serve as a proxy for the

25 customer discount rate.

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1   I'm troubled by his discussion of industry

2   restructuring. He appears to think that the company should

3   stop taking actions to reduce rates for customers, in

4   particular this buyout opportunity, and wait for industry

5   restructuring to do that for us. I submit to you that we

6   cannot stop doing things that are right. If we have an

7   opportunity to reduce costs, if a project or a buyout or an

8   action by the company is the right thing to do and it's

9   going to save customers money, it should not be denied or

10 rejected simply because some changes may occur in the

11 industry at some future time.

12   Finally, with respect to his alternative

13 proposal, he has freely admitted it is not based on any

14 analysis. To the extent that I have reviewed his proposal,

15 he has not recognized the differences between the company

16 undertaking this transaction versus the customer. No one

17 has conducted that analysis and, therefore, his claims that

18 it would provide savings or would reimburse the company

19 have no basis and should not be given consideration.

20   COMMISSIONER CLARK: Mr. Schuster, what would be

21 the differences? I mean if you are going to use the

22 company's discount rate as a proxy, what is different in

23 the analysis?

24   WITNESS SCHUSTER: Well, we discussed this

25 briefly yesterday. In essence the differences have to do

1 with the taxes.

2   COMMISSIONER CLARK: Okay.

3   WITNESS SCHUSTER: When the company undertakes an

4 investment, there are tax consequences that are not

5 involved in a customer's rate simply being reduced.

6   COMMISSIONER CLARK: Okay.

7   WITNESS SCHUSTER: That concludes my summary.

8   MR. McGEE: Tender Mr. Schuster for cross

9 examination.

10   COMMISSIONER CLARK: Mr. Howe.

11   EXAMINATION

12 BY MR. HOWE:

13   Q   Good morning, Mr. Schuster. It seems like

14 afternoon. Mr. Schuster, would you refer, please, to page

15 18 of your prefiled rebuttal testimony?

16   A   Yes.

17   Q   And I'm looking there at lines 23 through 25

18 where you refer to the fact that some customers have no

19 credit card debts but instead make regular deposits to

20 passbook savings.

21   A   Yes.

22   Q   Now a customer who has a passbook savings

23 account, can he get his money back right away?

24   A   Yes.

25   Q   Can he go into the bank and just withdraw it

1 immediately?

2   A   Yes.

3   Q   Would that customer, if he were to invest in this

4 buyout deal proposed by Florida Power Corporation, be able

5 to get his money back on demand?

6   A   No, he would not.

7   Q   A passbook savings account is usually insured by

8 FDIC in the amount of a hundred thousand dollars, is it

9 not?

10   A   Most of them are, yes.

11   Q   Will the customers' investment in this buyout

12 proposal offered by Florida Power Corporation be insured

13 by anybody?

14   A   No, it will not.

15   Q   Will it be guaranteed in any way?

16   A   No.

17   Q   Is Florida Power Corporation providing any

18 assurances at all that any portion of the savings the

19 company is projecting will, in fact, be made available to

20 the customers in the years 2014 through 2023?

21   A   Only to the extent that our analysis indicates

22 that it is very likely and very probable that most or all

23 or possibly even more than the savings projected will

24 accrue to the customers.

25   Q   Would you agree that when an individual accepts

1 low rates of return, such as a 3 to 4% passbook savings

2 rate, there is essentially no risk associated with either

3 receiving the interest earned or a return on their

4 principal?

5   A   Yes.

6   Q   Isn't it correct that in order to motivate

7 individuals to invest in high-risk ventures one has to

8 increase their potential return well above those of

9 risk-free returns?

10   A   Yes.

11   Q   Mr. Schuster, if you'd refer please to the next

12 page of your prefiled rebuttal testimony, page 19.

13   A   Yes.

14   Q   There you calculate a 12.19% return that is

15 represented by the OCL contract buyout; is that correct?

16   A   Yes.

17   Q   And you characterize that return as an after-tax

18 rate of return; is that correct?

19   A   Yes.

20   Q   Could you explain that in further detail, what

21 you mean by an after-tax return?

22   A   Yes, that 12.19% return is an internal rate of

23 return that is calculated based upon the final right-hand

24 column of the buyout analysis. In effect, those are the

25 dollars that would be charged to customers in the near term

1   and that the customers would receive in benefits after 2013
2   in return for the buyout transaction. Those dollars to
3   customers are on an after-tax basis. There is no tax
4   consequence to them of increasing or decreasing their
5   electric bill incrementally.
6   Q   And this is because -- do you mean because, for a
7   residential customer, for example, that utility bills are
8   neither -- are not tax deductible?
9   A   Right.
10   Q   And refunds or reductions in utility bills are
11   not taxable for the same reason?
12   A   Yes.
13   Q   Would you agree then, based on your logic, that a
14   customer who has a cost that is above 12.19% would be
15   better off investing his money in reducing that cost rather
16   than investing in the OCL buyout?
17   A   Yes, viewing it as a hypothetical financial
18   transaction, an investor should always seek to invest or
19   retire a debt in such a way as to maximize his return.
20   Q   And this would apply, would it not, to customers
21   who have unsecured loans in the 13% range or credit card
22   debt in ranges above 13%?
23   A   Yes.
24   Q   Am I correct that under your proposal and your
25   scenario as described beginning on page 19 that in order to

1   receive the returns you referenced there in the range of

2   14.34% to 16.93% that your customers would have to wait

3   until the year 2026 in order to receive this full return?

4   A   Well, it would take until that point in time for

5   the transaction to be completed, but they would effectively

6   be earning that return from the very first year. It

7   applies to the entire interval of the transaction.

8   Q   They just wouldn't get the money until the end;

9   is that correct?

10   A   They wouldn't get the last dollar of the

11 principle and interest, principle and return back until the

12 end of the transaction, that's correct.

13   Q   And would it be correct to say that the customers

14 wouldn't get any return at all if there were no automatic

15 adjustment clause to flow through the savings to them?

16   A   No, I disagree with that statement.

17   Q   And I assume you would disagree for the same

18 reasons you stated yesterday?

19   A   Yes, that's correct.

20   Q   At the bottom of page 19 of your prefiled

21 testimony you said you would challenge Mr. Larkin's

22 assertion that no sophisticated investor would be likely to

23 accept the return inherent in the proposed OCL contract

24 buyout. Has Florida Power Corporation thought about

25 seeking a sophisticated investor? In other words, in

1 return for an investor providing the buyout funds, Florida

2 Power Corporation would provide a reasonable return?

3   A   No, we have not.

4   Q   Would you consider Florida Power Corporation to

5 be a sophisticated investor?

6   A   Yes, I would.

7   Q   Well, then would Florida Power Corporation find

8 it attractive to fund this buyout if Florida Power

9 Corporation were allowed to receive the savings that you

10 are projecting?

11   A   No, we discussed that yesterday.

12   Q   Well, then in what sense is Florida Power

13 Corporation sophisticated?

14   A   I think the distinction is is I was using

15 Mr. Larkin's words where he referred to a sophisticated

16 investor, and I was describing whether or not an investor

17 would consider those returns acceptable. I was not

18 describing a specific investment and the willingness of a

19 specific sophisticated investor to undertake a specific

20 investment.

21   Q   Mr. Schuster, if you'd refer, please, to page 20

22 of your prefiled direct testimony, and there beginning on

23 lines 10 and following you take issue with Mr. Larkin's

24 assertion that there are intergenerational inequities, and

25 you conclude that are not; is that correct?

1   A   Yes.

2   COMMISSIONER CLARK: Mr. Howe, just so the record

3 is correct, I think you referred to his direct testimony,

4 and you are referring to the rebuttal, right?

5   MR. HOWE: I'm sorry. You're correct. I'm

6 referring to Mr. Schuster's first rebuttal testimony.

7 Thank you.

8 BY MR. HOWE:

9   Q   Mr. Schuster, the Commission approved the

10 original contract in this case, did they not?

11   A   Yes.

12   Q   And in request for approval of that contract,

13 would you agree that Florida Power Corporation told the

14 Commission how the capacity cost would be recovered from

15 the ratepayer?

16   A   Yes.

17   Q   Would you agree that the company was forthright

18 when they told the Commission that the capacity costs were

19 lower in the beginning and higher at the end of the

20 contract?

21   A   Yes.

22   Q   Did the company provide an explanation to the

23 Commission of why that was correct and why it was

24 beneficial to the ratepayer?

25   A   I don't know what explanation was provided. My

1 understanding is that that was a topic that was discussed

2 and understood by all of the parties to the approval.

3   Q   Is there anything in the Commission's order

4 approving the contract that would indicate that they

5 approved it based on any assumption or knowledge that the

6 contract would create intergenerational inequities?

7   A   No.

8   Q   Would you agree that when Florida Power

9 Corporation signed the contract with OCL that Florida Power

10 Corporation had a concern about OCL performing under the

11 contract?

12   A   Yes.

13   Q   Is it correct that the capacity payments were

14 back-end loaded in order to ensure performance?

15   A   Yes, that was one of the reasons and the

16 justifications for structuring the capacity payment stream

17 as it is.

18   Q   And under that contract with the back-end

19 loading, OCL had to perform throughout the contract in

20 order to receive all the capacity payments, is that

21 correct?

22   A   Yes.

23   Q   Would it be correct then to say that Florida

24 Power Corporation perceived a risk of nonperformance on the

25 part of OCL?

1   A   Yes.

2   Q   Is it correct that the purchase of capacity and

3 energy for this contract is passed through the capacity and

4 energy adjustment clauses directly to the ratepayers?

5   A   Yes.

6   Q   Well, then isn't it correct that any risk

7 inherent in the payment, in the payments, are flowed

8 through the capacity and fuel adjustment clauses?

9   A   No, I think I would disagree with that statement

10 because the risk would take the character of having OCL not

11 deliver energy and capacity to Florida Power and its

12 customers, and that would have a physical consequence for

13 the operation of our system and the availability of

14 adequate resources for our customers but might not be

15 directly reflected in the capacity and energy clauses.

16   Q   But didn't you agree earlier to a question of

17 mine that the capacity payments were back-end loaded in

18 order to ensure performance by OCL?

19   A   Yes, I indicated that that was one of the reasons

20 for structuring the capacity payments in that manner.

21   Q   And those capacity payments are flowed through to

22 your customers as they are incurred, are they not?

23   A   Yes, they are.

24   Q   So those capacity payments that are structured as

25 they are for risk are being borne by the customers as the

1   costs are incurred by the company; is that correct?

2   A   Yes, with the qualification that risk is only one

3   element of the reason for that structure.

4   Q   Staying on the subject of the structure of the

5   contract and the question of intergenerational fairness

6   that you address on page 20 of your rebuttal testimony,

7   because of the back-end loading of the contract, would it

8   be fair to say that over the 30-year term of the contract

9   customers -- for example, if we break them into thirds --

10   customers in the first ten years would pay lower capacity

11   payments, customers in the middle ten years would pay

12   average capacity payments and customers in the last ten

13   years would pay higher capacity payments?

14   A   Yes.

15   Q   Now if Florida Power Corporation's proposal in

16   this case is approved, how will customers in those first

17   ten years be treated in comparison to those customers the

18   last ten years?

19   A   Well, based on your example, they would still be

20   paying lower costs than the customers in the last ten

21   years.

22   Q   No, I'm saying if your proposal is approved.

23   A   I'm sorry, I misunderstood your question.   Let me

24   back up.

25   Q   My question is based on assuming that the

1   company's proposal is approved.

2   A   I missed your question. If that were the case,

3   then the pattern would be shifted, and there would be a

4   situation where it would be closer to being levelized than

5   the pattern which existed prior to the buyout.

6   Q   In fact, it won't be close to being levelized, in

7   other words, the customers the first ten years, those on

8   line from 1994 through 2013, will pay significantly more

9   for electricity from Florida Power Corporation associated

10 with an equivalent amount of capacity than those in the

11 years 2014 through 2023; isn't that correct?

12   A   Well, I don't have those numbers here in front of

13 me. The customers in the near term are not paying their

14 full fair share of the capacity payments; they are getting

15 a bargain. The customers in the last ten years, according

16 to your example, are paying more than their fair share,

17 substantially more; and what we are talking about doing

18 here is lowering the cost in the last ten years and

19 slightly increasing the cost in the first ten years.

20   Q   Well, actually, what you're going to do is

21 increase the cost in the first ten years by the rates that

22 you've mentioned in your direct testimony and reduce your

23 cost in the last ten years by the savings you expect to

24 achieve by being out of the contract; isn't that correct?

25   A   That's exactly right, and that was the reason for

1   my statement that the effect of that is going to move from

2   a pattern where it slopes up very steeply over the term of

3   the contract to one in which it's more closely levelized.

4   Q   Actually, it's going to slope quite steeply

5   downwards, is it not? In other words, the current

6   customers are going to pay an additional $49,405,000, and

7   those in the last ten years are going to get all the

8   savings?

9   A   I wouldn't agree that it will slope steeply

10   downwards, no.

11   Q   Would you agree that it will slope downwards?

12   A   No, I can't agree with that. I just don't have

13   those numbers here in front of me. I can't remember the

14   pattern offhand.

15   Q   Mr. Schuster, let's just speak then, if the

16   company, if this proposal is approved and the company is

17   allowed to buy out the last ten years of the contract,

18   we'll basically be dealing with a 20-year contract; is that

19   correct?

20   A   Yes.

21   Q   How will the customers over the first ten years

22   of the contract be treated in terms of rate payments in

23   relation to customers over the last ten years of the

24   contract?

25   A   Well, the two groups of customers will both pay

1 the capacity payments in the respective portions of the

2 time interval that applies to them, and the customers in

3 the first group will in addition pay the buyout costs

4 during the first five-year term after the termination.

5   Q   And that would be the $49,405,000 figure?

6   A   Yes.

7   Q   Mr. Schuster, if you'd refer, please, to your

8 page 24. I'm looking at the question and answer appearing

9 beginning on line 17. The question is, "What is your

10 reaction to Mr. Larkin's statement that Florida Power will

11 suffer no harm if the Commission were to deny its

12 petition?" Would it be correct to state that in response

13 to that question you do not identify any harm being

14 suffered by Florida Power Corporation itself?

15   A   Yes.

16   Q   When this contract was originally approved, how

17 was Florida Power Corporation affected either beneficially

18 or detrimentally?

19   A   It was affected I believe both beneficially and

20 detrimentally. It was beneficially affected because it

21 obtained a resource, a generation resource for capacity and

22 energy at what was believed at that time to be a reasonable

23 cost. It was affected detrimentally to the extent, as one

24 example, that it was signing a take or pay contract for a

25 stream of capacity payments that would affect its financial

1 posture with rating agencies.

2   Q   Did it, in fact, affect the company's financial
3 posture with the rating agencies?

4   A   Yes, it did.

5   Q   And when was this effect felt? Was it at the
6 time of entering into the contract or when changes were
7 perceived in the energy markets?

8   A   It was at a time after the contracts were
9 signed. I don't know what time frame you are referring to
10 when you say changes perceived in the energy markets.

11   Q   Well, then I guess I'd return to my question as I
12 think I posed it. At the time Florida Power Corporation
13 had this contract approved by the Commission, how was
14 Florida Power Corporation affected either beneficially or
15 detrimentally?

16   A   I thought I had answered that question. The
17 beneficial effect is the benefit of obtaining a capacity
18 and energy resource. The detrimental effect was the fixed
19 obligation that Florida Power was assuming under the
20 contract.

21   Q   If the Commission were to reject Florida Power
22 Corporation's proposal in this docket, wouldn't Florida
23 Power Corporation be affected in the same beneficial and
24 detrimental fashion in the future for the life of the
25 contract?

1 A I don't understand your questioning. Could you

2 elaborate?

3 Q What would change in terms of the beneficial or

4 detrimental effects on Florida Power Corporation if this

5 Commission were to deny the proposal the company is

6 offering in this docket?

7 A Well, as I mentioned earlier, the first order

8 effect, if this transaction is denied, the effect would be

9 transparent to Florida Power under the assumption that the

10 capacity and energy payments will be passed through dollar

11 for dollar to customers over the remaining term of the

12 contract. As you pose the question, you can think of

13 second order effects. For example, Florida Power would

14 have higher rates if this proposal is denied because it

15 won't have the opportunity to buy out the contract in the

16 last ten years and obtain resources at a lower price and

17 provide a lower price to our customers. The company is

18 definitely impacted by the price of its product, so I would

19 say as a second order effect that inability to use this

20 transaction to lower our prices would be an adverse effect.

21 Q Over the next five years as this transaction is

22 approved, will Florida Power Corporation's rates to its

23 customers increase?

24 A Well, there would be an increment attributable to

25 the recovery of the buyout cost, yes.

1   Q   Is the answer to the question yes?

2   A   Yes.

3   Q   Mr. Schuster, would you refer, please, to your
4   prefiled supplemental rebuttal testimony?

5   A   Yes.

6   Q   And I'm looking at your Exhibit LGS-19.

7   A   Yes.

8   Q   And this you portray as an example of reasonable
9   application of risky cash outflow methodology; is that
10   correct?

11   A   Yes.

12   Q   Now in response to a question earlier from
13   Commissioner Clark, I believe when you were giving your
14   summary in this current visit to the stand, you stated that
15   the company funding the buyout, the significant difference
16   between that and the customers doing it would be taxes; is
17   that correct?

18   A   Yes.

19   Q   Now Mr. Schuster, am I correct that based on your
20   answers to some questions yesterday that the company will
21   incur and pay the buyout costs shown in column 6 of Exhibit
22   LGS-19; is that correct?

23   A   Yes.

24   Q   And am I correct in recalling that you said that
25   you did not expect that those expenses would be tax

1 deductible in the years in which incurred?

2   A   Under Mr. Larkin's alternative proposal, yes,

3 that was my statement.

4   Q   Well, I'm just saying, under this proposal, or

5 this example that you are giving in LGS-19, regardless of

6 the specific proposal we are talking about, if the buyout

7 goes through, Florida Power Corporation is going to have to

8 pay Orlando Cogen $9,881,000 a year for five years, is it

9 not?

10   A   Yes.

11   Q   It is either going to write a check in that

12 amount to OCL, or it's going to credit it in some fashion;

13 is that correct?

14   A   Yes.

15   Q   Now am I correct that that, for example,

16 $9,881,000 payment from Florida Power Corporation to OCL in

17 1997 will not be tax deductible to Florida Power

18 Corporation in 1997?

19   A   No, I don't think you're correct in that

20 statement.

21   Q   Isn't that what you told me yesterday, sir, that

22 we could not calculate the company's after-tax costs on a

23 year by year basis if the company were to fund the buyout

24 because that would assume that these amounts would be tax

25 deductible and it was your understanding that they would

1   not be tax deductible in the year in which incurred?

2   A   Yes, as we were discussing Mr. Larkin's proposal.

3   Q   And now we are discussing your exhibit, LGS-19.

4   Is it correct, sir, that if Florida Power Corporation makes

5   a payment to OCL in 1997 in the amount of $9,881,000 that

6   Florida Power Corporation will not be able to treat that as

7   a tax deductible expense in 1997?

8   A   No, I would disagree with that statement.

9   Q   Will they be able to treat that as a tax

10 deductible expense?

11   A   I believe they would be, yes.

12   Q   It will be currently deductible?

13   A   Well, we are -- to clarify, we are talking now

14 about the proposal that is represented in the exhibit you

15 are referring to, and that is a current recovery. It's a

16 pass-through of costs. When we pass through capacity

17 payments, when we charge our customers for the OCL capacity

18 payments and remit those capacity payments to OCL, it's a

19 pass-through; there is no tax effect.

20   Q   I understand that, sir. My question is, does

21 Florida Power Corporation expect that its payment to OCL in

22 1997 in the amount of $9,881,000 will, in fact, be

23 considered a tax deductible expense of Florida Power

24 Corporation in 1997?

25   A   That is the expectation. I would qualify that by

1 saying this infringes upon the unsettled area of tax law
2 that I referred to yesterday. So there's -- unfortunately,
3 with respect to corporate taxes, there are no absolutes.
4   Q   And would you agree that if it is not tax
5 deductible in the year in which incurred that then the
6 payment from the customer in the amount of $9,881,000 will
7 itself be treated by the IRS as taxable income?
8   A   Well, that would happen in any case. The answer
9 to your question is yes, from a tax standpoint the receipts
10 from the company are taxable income. Disbursements from
11 the company are treated as an expense, possibly deductible,
12 possibly not; possibly current, possibly not. The thing
13 that creates the transparency is when receipts and
14 disbursements match as with the capacity pass-through that
15 I mentioned a few minutes ago.
16   Q   And would you agree that if the expense is not
17 tax deductible but the revenues received from the customers
18 are that on a net-of-tax basis Florida Power Corporation
19 will incur an expense of $9,881,000 but on a net-of-tax
20 basis will only receive from the customers approximately
21 six million dollars?
22   A   If we didn't get a current tax deduction, yes,
23 you're absolutely correct that Florida Power would come up
24 short. I would like to add to that, that once again,
25 recognizing this is an unsettled area of tax law, Florida

1 Power has not requested a contingency provision to protect
2 Florida Power from that consequence, we are accepting that
3 risk. We feel that we are going to get the deduction based
4 on this structure. If we don't get the deduction, we will
5 accept that consequence.

6   Q   If you do not get that deduction, Florida Power
7 Corporation will be funding the buyout at least in part,
8 will it not?

9   A   It will have a deferred tax item on its balance
10 sheet. I would not characterize that as funding a
11 transaction.

12   Q   Well, Florida Power Corporation will make up the
13 difference between the $9,881,000 and the net-of-tax
14 receipts from its customers if the deduction is not allowed
15 currently, won't it?

16   A   Yes, it will, but I would like to reiterate that
17 there are numerous examples of receipts that Florida Power
18 receives from customers, makes payments in the ordinary
19 course of business where there are tax consequences. Those
20 are not viewed as an investment by Florida Power. They are
21 not viewed as funding a portion of whatever is occurring.
22 They are viewed as tax consequences which generate either a
23 prepaid or a deferred tax on the balance sheet that are
24 treated appropriately for accounting purposes. They are
25 not investments.

1   Q   Well, let's just speak in terms of a source of

2   funds. If Florida Power Corporation receives

3   approximately -- receives $9,881,000 from its customers and

4   that is taxable and assume, please, based on the company's

5   current tax rate, that the net receipts from the customer

6   will be six million dollars, would you agree that Florida

7   Power Corporation in making that payment to OCL will only

8   be reimbursed by its customers on a net-of-tax basis by six

9   million dollars and Florida Power Corporation itself will

10   have paid the additional $3,881,000?

11   A   I would agree that that's one way to characterize

12   the transaction. If you just look at the dollars that are

13   moving, you could put those labels on them. In my opinion,

14   that's not the correct way to view it from a financial

15   standpoint.

16   Q   Would you agree that if the buyout payments

17   Florida Power Corporation will be making to OCL are not

18   currently deductible for tax purposes that if Florida Power

19   Corporation wanted to have its customers pay a sufficient

20   amount such that after tax the customers would provide

21   $9,881,000 that the customers would have to pay $16,000,000

22   approximately in the years 19 -- each year in the years

23   1997 through the year 2001 so that Florida Power

24   Corporation would have received net of taxes $9,881,000?

25   A   Yes, I would agree with your example and your

1   calculation, but I would like to reiterate that we have

2   considered that as a possibility and we have not requested

3   that from the Commission, to obtain that protection against

4   that tax consequence. We have no intention of grossing up

5   the receipts from the customers for taxes.

6   Q   Mr. Schuster, still with reference to Exhibit

7   LGS-19, you've calculated a net present value of

8   $75,369,000; is that correct?

9   A   Yes.

10   Q   Based on the numbers shown here, if Florida Power

11   Corporation were to fund the buyout and pay its customers

12   in 1997 $75,369,000 and Florida Power Corporation were

13   allowed to retain all the savings in the years 2014 through

14   2023, wouldn't Florida Power Corporation break even?

15   A   Well, a short answer is yes. I mean you could

16   use these numbers and say we would break even. I would

17   like to point out that these are rebuttal exhibits. I am

18   not endorsing this calculation. I am merely presenting it

19   as an alternative to Mr. Stallcup's calculation.

20   MR. HOWE: No further questions. Thank you very

21   much.

22   COMMISSIONER CLARK: Staff.

23   EXAMINATION

24   BY MR. KEATING:

25   Q   Mr. Schuster, you mentioned in your summary that

1 it doesn't make sense to use rates of return less than the

2 risk-free rate which you believe are implied by the

3 discount rates that would result from subtracting the risk

4 premiums from the risk-free rate; is that correct?

5   A   Yes.

6   Q   Do you believe that Mr. Stallcup's methodology of

7 adjusting discount rates downward is counterintuitive,

8 untested in practical application and controversial?

9   A   Yes, I do.

10   Q   Okay. If you could please refer to Exhibit 7 to

11 your direct testimony.

12   A   Yes.

13   Q   Would you agree that columns 1 through 7

14 represent cash expenditures for ratepayers and these

15 expenditures are cash outflows from the ratepayers' point

16 of view?

17   A   Yes.

18   Q   And would you agree that column 8, which is the

19 difference between columns 3 and 7, represents cash

20 benefits from the buyout and can be considered cash inflows

21 to ratepayers?

22   A   No, I wouldn't agree entirely with that. That is

23 the way Mr. Stallcup characterized column 8 in his

24 deposition. Column 8 is the summation of the other seven

25 columns, and it contains both positive and negative

1   numbers. Specifically, the numbers in the first five years
2   are identical to the numbers in column 7 which Mr. Stallcup
3   describes as cash outflows, so I would have to describe
4   column 8 as a mixture of inflows and outflows as opposed to
5   just a pure inflow.

6   Q   Let's assume a hypothetical scenario. In this
7   scenario Florida Power Corporation has firm fuel contracts
8   and a firm construction contract through the year 2023 so
9   that there is no uncertainty associated with any of the
10   cash expenditures contained in your Exhibit 7. Under this
11   hypothetical scenario, would you agree that we could
12   calculate the net-present-value savings of the proposed
13   buyout using the risk-free rate with absolute certainty?

14   A   Yes, you could certainly do that. You know, if
15   one chooses to do this analysis, they have the freedom to
16   choose whatever discount rate they want to use. The
17   conventional analysis is to apply the after-tax discount
18   rate of the utility to the final column representing the
19   summation of the costs and the benefits to derive a
20   net-present-value number. The use of a risk-free rate in
21   that application would be starting to tilt towards
22   Mr. Stallcup's methodology of using a risk-adjusted
23   discount rate.

24   Q   So you'd agree that everything else constant --
25   If you would give me just a minute. I'll move on.

1   Changing the scenario slightly, if we introduce

2   some risk in column 4 of your Exhibit 7, the capacity

3   component of the replacement case so that these estimated

4   costs vary by, say, plus or minus 5% while we still assume

5   that the contract case is known with certainty, given

6   whatever discount rate is used, would you expect that the

7   proposed buyout looks less attractive in this scenario than

8   in the previous one and that the net present value of the

9   buyout is smaller than before?

10   A   No, I wouldn't agree with that because the --

11   it's understood that each of these columns, with the

12   exception perhaps of column 6 and column 1, can vary upward

13   or downwards, that's in the context of a sensitivity

14   analysis. The recognition that column 4 may be higher or

15   lower I would characterize as an alternative analysis. The

16   numbers that are presented here are unchanged, and they

17   would not change then at present value.

18   Q   Let me see if I can reexplain my scenario, and

19   maybe that would lead to a different answer, I'm not sure.

20   A   Okay.

21   Q   If we start from the premise in my prior question

22   and scenario that the net-present-value savings could be

23   calculated with absolute certainty with there being no risk

24   involved in columns 1 through 7, in any of those columns,

25   if we change that and introduced some risk in column 4

1 only, would you expect that the proposed buyout looks less

2 attractive and that the net present value of the buyout is

3 smaller?

4   A   Yes and no. I would agree that the injection of

5 risk would make it directionally less attractive. The net

6 present value that I understand you're referring to is the

7 base-case net present value as presented here, and the base

8 case would be unchanged. I assume you're referring to an

9 analysis such as Mr. Stallcup did, where he'd do an

10 alternative with an optimistic case which would reflect an

11 increase -- excuse me, a pessimistic case which would

12 reflect an increase in column 4, and that would give you a

13 different net present value as a sensitivity case. And

14 then you'd go the other direction and reduce the capacity

15 payments and calculate a third net present value as an

16 optimistic case, and you end up with three cases that you

17 can then do a risk analysis based on. But the assumption

18 of risk or variation in one of the columns doesn't change

19 then that present value for the base-case analysis.

20   MR. KEATING: Commissioner Clark, could I have

21 just a minute?

22   COMMISSIONER CLARK: Yep.

23   (DISCUSSION OFF THE RECORD)

24 BY MR. KEATING:

25   Q   Mr. Schuster, I'm going to move on to a different

1 line of questioning. In your testimony, you describe

2 subtracting risk premiums from the risk-free rate as being

3 untested in practical application; is that correct?

4   A   Yes.

5   Q   Do you know what variable rate bonds are?

6   A   Generally speaking, yes.

7   Q   Would you agree that variable rate bonds are

8 bonds that pay an interest rate that can vary depending on

9 the overall level of interest rates?

10   A   Yes.

11   Q   Would you agree that for company's that issue

12 variable rate bonds the interest paid to bond holders is a

13 cash outflow from the company?

14   A   Yes.

15   Q   And if the cash outflow is variable or not known

16 with certainty, is there a degree of risk associated with

17 the cash outflow?

18   A   Yes.

19   Q   And if there is a degree of risk, should there be

20 a risk premium associated with these bonds?

21   A   Yes.

22   Q   Would you believe that, or would you agree that

23 in order to be compensated for accepting this risk a

24 company issuing variable rate bonds would add these risk

25 premiums to the risk-free rate and not subtract them;

1 would that be your position?

2   A   I apologize. You are starting to lose me here

3 because, normally, if a company issues variable rate bonds,

4 they set the parameters on the variation of the interest

5 rate in such a way that it's acceptable to the company.   I

6 don't know that they dissect it and think of it in terms

7 of a risk-free rate and a risk premium and do adding and

8 subtracting, I'm not aware that they apply that type of

9 methodology to the thought process.

10   MR. KEATING: Staff is going to hand out an

11 exhibit that is identified as LGS-32. It consists of

12 Florida Power Corporation's historical earnings

13 surveillance report data and historical treasury bond

14 rates.

15   COMMISSIONER CLARK: LGS-32 will be marked as

16 Exhibit 21.

17 BY MR. KEATING:

18   Q   Do you recognize these documents?

19   A   Yes, with the exception of the final page.

20   Q   Would you accept subject to check that the first

21 seven pages are excerpts from Florida Power Corporation's

22 earnings surveillance reports submitted by your company to

23 the Commission every year?

24   A   Yes.

25   Q   Would you agree that these reports contain

1 detailed information regarding your company's capital

2 structure for each year for the period 1990 to 1996?

3   A   Yes, with the qualification that these are stated

4 on a commission basis.

5   Q   I'm sorry, what does that mean when you say that

6 they are stated on a commission basis?

7   A   As we discussed yesterday, there are two primary

8 ways of presenting capitalization and cost of capital

9 numbers. The financial basis is as we presented in our

10 engineering and economy mannual, which is based directly

11 upon the balance sheet of the company. This presentation

12 is a regulatory presentation which includes items that are

13 not considered in a financial presentation.

14   Q   Would you accept subject to check that the last

15 page of this exhibit summarizes the long-term fixed rate

16 and variable rate bond components of your company's capital

17 structure?

18   A   Yes.

19   Q   And would you also accept subject to check that

20 the variable rate bonds on the last page are medium term

21 debt instruments issued by your company with a term greater

22 than one year but generally shorter than 30 years which pay

23 bondholders a variable rate of interest?

24   A   Yes.

25   Q   From Florida Power Corporation's point of view,

1   the interest paid to these bondholders would be a cash

2   outflow to the company, wouldn't it?

3   A   Yes.

4   Q   And to the extent that these cash outflows are

5   variable, would you agree that they represent a form of

6   financial uncertainty or risk to the company?

7   A   Well, yes, to the extent that they are variable,

8   but the bulk of Florida Power's bond obligations are fixed

9   payment obligations.

10   Q   If you could please look at the row at the bottom

11   of the last page or the set of rows that's labeled

12   "Five-Year Treasury Bond Rates." Would you agree that

13   these rates are a reasonable measure of the risk-free rate

14   for medium term bonds?

15   A   They are a reasonable measure. There are

16   alternatives. Some people like to use a longer rate than

17   five years as a risk-free rate, but it's one measure that

18   can be used.

19   Q   Now if you could please take a look at the two

20   years, 1992 and 1993 in particular. In 1992 Florida Power

21   Corporation had no outstanding variable rate bonds; is that

22   correct?

23   A   That's correct.

24   Q   Then in 1993, according to Florida Power

25   Corporation's earnings surveillance reports --   I'm sorry,

1 if you could turn to, I believe it's the fourth page of

2 this exhibit containing the company's, Florida Power

3 Corporation's earnings surveillance report for 1993.

4   COMMISSIONER GARCIA: The fourth page?

5   MR. KEATING: I believe it's the fourth page.

6 It's the top left corner. It's schedule 4, page 5 of 9,

7 but I believe all of those say that. Never mind. It's a

8 table titled "Florida Power Corporation Average Capital

9 Structure, FPSC adjusted basis, December 1993."

10   A   Yes.

11   Q   Okay. According to this report, is it correct

12 that Florida Power Corporation issued 152.9 million dollars

13 of variable rate bonds paying 3.35% interest?

14   A   Yes, that appears to be the case.

15   Q   And if you turn back to the last page of this

16 exhibit. I think as you stated earlier, you would agree

17 that the rate in 1993 -- well, that the rate for the

18 five-year treasury bond is a good approximation of a

19 risk-free rate, and for 1993 that rate is 5.07%. Is it

20 correct that Florida Power Corporation was paying only

21 3.35%, which is a difference of 1.72%?

22   A   Yes, that's the arithmetic of the two numbers.

23   Q   Okay. Does it appear to you that Florida Power

24 Corporation was paying an interest rate which was less than

25 the risk-free rate in 1993 and that this rate was

1   associated with a bond that we identified earlier as having

2   all the characteristics of a risky cash outflow?

3   A   Well, yes, that is the implication of those two

4   numbers, and I think either with this question or the next

5   one I would like to provide an explanation, so go ahead.

6   Q   I'm sorry, could you please repeat what you just

7   said?

8   A   I think we are getting towards the end of your

9   line of questioning, and I would like to provide at some

10 point an explanation or a qualification to where you're

11 headed here.

12   Q   Okay. Then if you could make that qualification

13 now, I believe I'm at the end of my line of questioning.

14   A   Okay. I think your implication is that you are

15 demonstrating an instance where there is a negative risk

16 premium where a risky cash outflow bond is being issued as

17 a rate that is less than the risk-free rate. And I

18 apologize for not being able to fully explain that right at

19 the moment, but I can provide a number of examples why that

20 is not a correct -- you can't draw that conclusion from

21 these numbers.

22   I am not aware of the terms of these variable

23 rate bonds, but they typically are complex financial

24 instruments, and let me just give you a couple of examples

25 of what could be going on here. One is that the variable

1 rate could step up over time, and I think the important

2 concept to keep in mind here is what is the yield to

3 maturity of those particular bonds. I suspect that the

4 yield to maturity is not 3.35%.

5   If you were to issue a financial instrument where

6 for the first five years the rate was 3.35 and then it

7 would step up to 4% in the next five years, 6% in the next

8 five years and 7% in the final five years, the yield to

9 maturity on that bond would be much higher than the initial

10 3.35%. Investors who invest in that are accepting that

11 full-term return on that investment, and it's evaluated as

12 such. So I'm not saying that's what's happening here, but

13 the terms of that bond I am fairly certain would provide a

14 better explanation of why that initial rate is as low as it

15 is.

16   Another possible explanation is there are very

17 often debt instruments that are convertible into equity

18 that represent a considerable value to the investors.

19 Typically those bonds may go out at a very low interest

20 rate that is below a risk-free rate. That doesn't mean

21 they have a negative risk premium. They are a financial

22 instrument. So I would not under any circumstances take

23 the numbers you've presented here and consider them to be

24 evidence of the existence of a negative risk premium.

25   MR. KEATING: Staff would like to get a

1 late-filed exhibit of the terms of Florida Power

2 Corporation's variable rate bonds.

3   MR. McGEE: Any particular bonds, all of them?

4 What --

5   MR. KEATING: Those from 1993, issued in 1993.

6   COMMISSIONER CLARK: That will be Exhibit 22.

7   MR. McGEE: We will attempt to do that.

8 BY MR. KEATING:

9   Q   Mr. Schuster, on page 15 of your rebuttal

10 testimony you take issue with Public Counsel Witness Larkin

11 concerning whether the capacity costs under the contract

12 are known with certainty. Do you believe that these

13 payments are fixed?

14   A   I believe that they are far more fixed than

15 Mr. Larkin suggests. They are fixed obligations of the

16 company given performance by OCL. OCL has exceeded the

17 required performance to receive those capacity payments by

18 a wide margin thus far during the term of the contract, and

19 I would consider that to be a fixed obligation given the

20 very substantial escalation of those capacity payments over

21 time. The point that Mr. Larkin made yesterday where he

22 was suggesting there was some uncertainty was in reference

23 to the performance adjustment under the contract. I think

24 it's important to bear in mind that is a very tiny upwards

25 and downwards adjustment for performance relative to the

1 capacity payments, and it is a separate payment made to the
2 cogenerator apart from the face value of the capacity
3 payment.
4   Q   Are there any provisions in the contract to
5 protect ratepayers in the case of nonperformance by OCL?
6   A   Yes, there are.
7   Q   Could you describe those provisions?
8   A   There are performance provisions which require
9 that OCL provide an on-peak capacity factor in conformance
10 with the contract, and there are sanctions if they don't
11 meet that performance on a rolling 12-month basis; and
12 there are also provisions throughout the contract for them
13 to meet each and every one of the terms of that agreement
14 that affect their delivery of energy to Florida Power.
15   Q   If you could please refer to Composite Exhibit 4
16 containing your late-filed deposition exhibits.
17   A   Yes.
18   Q   On page 17 of that exhibit, I believe that's your
19 Late-filed Deposition Exhibit Number 8, this exhibit shows
20 the most recently updated base-case analysis of ratepayers'
21 savings; is that correct, or Florida Power Corporation's
22 most recently updated analysis?
23   A   One moment, please.
24   (WITNESS REVIEWED DOCUMENTS)
25   MR. McGEE: Which late-filed exhibit are we

1 referring to?

2   MR. KEATING: I'm referring to the Late-filed

3 Deposition Exhibit Number 8.

4   MR. McGEE: Eight?

5   MR. KEATING: Yes, sir.

6   MR. McGEE: Okay.

7   A   Yes.

8   Q   Would you agree that according to this analysis,

9 capacity payments under the contract total 458.989 million

10 dollars and make up approximately 65% of the contract costs

11 during the buyout years?

12   A   Yes.

13   Q   Does Florida Power Corporation expect any of the

14 capacity and energy to replace the last ten years of the

15 OCL contract?

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

17   Q   Does Florida Power Corporation expect to need the

18 capacity and energy to replace the last ten years of the

19 OCL contract?

20   A   Yes.

21   Q   Could you please explain why?

22   A   Well, it's our -- I guess I'd characterize this

23 as a base-case or a status quo analysis. Given that it's a

24 long-term projection, we're assuming continued customer

25 growth, continued need to add new capacity, replace

1 existing capacity as it retires; and that out in this time

2 frame, if we did not have deliveries from the OCL contract,

3 it would be necessary to replace that capacity and energy

4 with another source.

5   Q   Has Florida Power Corporation performed any

6 reliability studies which show that replacement power will

7 be needed during the buyout years?

8   A   No, Florida Power's normal projections are for

9 ten years. Occasionally we go out beyond ten years, but in

10 all honesty, the only thing you can do out in that extended

11 time frame is to assume a continuation of trends, so it

12 would indicate a need for capacity.

13   Q   Would you agree that an analysis of the buyout

14 assuming no replacement power can be viewed as an upper

15 bound to the expected ratepayer benefits resulting from the

16 buyout?

17   A   I would say in general yes. I'm not fully sure

18 of the implications of that assumption, but I'll say yes.

19   Q   Under your Late-filed Deposition Exhibit 8, what

20 would the net present value be if no replacement power is

21 required?

22   A   It would be 109,810,000.

23   Q   Would you agree that this estimate is dependent

24 on Florida Power Corporation's coal price forecast and

25 discount rate assumption?

1   A   Yes.

2   Q   Mr. Howe asked you if there would be a rate

3 impact for ratepayers over the next five years if the

4 buyout is approved. Do you recall that?

5   A   Yes.

6   Q   Have you estimated the rate impact for a typical

7 one thousand kilowatt hour residential customer's monthly

8 bill?

9   A   Yes, we have.

10   Q   And what is that impact?

11   A   It's estimated to be in the range of 30 cents per

12 megawatt hour over the five-year period.

13   COMMISSIONER CLARK: What does that mean in terms

14 of the bill of somebody who purchases a thousand kilowatt

15 hours?

16   WITNESS SCHUSTER: It would be -- well, for --

17 It would be about 30 cents per month.

18   COMMISSIONER CLARK: Okay.

19   Q   Alll right. Going back to my -- going back a

20 couple of questions. I asked that referring to your

21 deposition, your Late-filed Deposition Exhibit 8, I asked

22 what the net present value would be if no replacement power

23 is required.

24   A   Yes.

25   Q   Did you take into account the buyout costs?

1   A   No, I did not. I just eliminated the capacity

2 and energy from the contract case.

3   Q   Okay. Taking into account the buyout costs,

4 would you agree subject to check that the net present value

5 would be 69.521 million dollars?

6   A   Yes, I would.

7   Q   Thank you.

8   MR. KEATING: Staff has no more questions.

9   COMMISSIONER CLARK: Redirect?

10   MR. McGEE: Just one.

11   REDIRECT EXAMINATION

12 BY MR. McGEE:.

13   Q   Mr. Schuster, you were asked some questions by

14 Mr. Howe regarding the purpose of back-end loading the

15 revenue stream from QF contracts under the value of

16 deferral methodology, and I think you indicated that the

17 risk of nonperformance was one of the reasons that was

18 taken into account in adopting this back-end loading

19 feature. Are there other reasons?

20   A   Yes, there are. The value of deferral

21 methodology in my opinion, which is the reason why the

22 capacity payments have the pattern that they do, was not

23 developed in the first instance to account for risk. It

24 was developed to provide a pattern that provided low rates

25 for customers in the near term and embodied I guess what I

1 would describe as a constant purchasing power concept to

2 the capacity payment stream. It has the effect of

3 providing an incentive to the cogens to operate under their

4 contract for the full term, but that was, that effect was

5 not the primary nor the exclusive reason for patterning the

6 capacity payments that way.

7   MR. McGEE: That's all I have, Madam Chairman.

8   COMMISSIONER CLARK: Exhibits.

9   MR. McGEE: We'd ask for the admission of

10 Exhibits 20 and 21.

11   COMMISSIONER CLARK: No, I think yours are 19 and

12 20.

13   MR. McGEE: Oh, right, I had them backwards,

14 excuse me.

15   COMMISSIONER CLARK: Okay. Without objection,

16 Exhibits 19 and 20 are admitted.

17   MR. KEATING: Staff moves Exhibit 21.

18   COMMISSIONER CLARK: It will be admitted without

19 objection.

20   Just to go over the exhibits, I have Exhibit,

21 what was identified as Exhibit 3 was withdrawn. What is

22 identified as Exhibit 9 is a late-filed exhibit, as is

23 Exhibit 22. What date can we look for the late-filed

24 exhibits, Mr. McGee?

25   MR. McGEE: I may need to ask the witness on the

1 time that would be involved in putting together Late-filed

2 Exhibit Number 9.

3   WITNESS SCHUSTER: We can have those in just a

4 couple of days.

5   COMMISSIONER CLARK: All right. Why don't we say

6 they'll be filed close of business November 7th.

7   MR. KEATING: That would be fine.

8   COMMISSIONER CLARK: All right. Is there any

9 matter we have to take up now?

10   MR. SJOSTROM: Commissioner, OCL at the outset of

11 the hearing had identified several proffered exhibits and

12 one substantive exhibit that it wished to offer without a

13 sponsoring witness. I believe Mr. Childs identified those

14 as being identified in the prehearing order. They are not

15 in the prehearing order; they are in OCL's prehearing

16 statement. We would like to get those marked and offered

17 into the record at this time. The exhibits are the FPSC

18 review of ten-year site plans dated December 26th, 1996 and

19 the December 26th, 1996 staff recommendation in this

20 docket; those are the two exhibits that pertain to the

21 proffer. And the substantive exhibit is Florida Power

22 Corporation's petition for approval of QF contracts in

23 Docket 910401, which includes the OCL contract. I believe

24 there is no objection, or that the objections have been

25 ruled upon.

1   COMMISSIONER CLARK: All right. You are asking

2   me to assign each of those exhibits a number, and we'll

3   note that -- each of those items a number as an exhibit and

4   that we'll note that they are being proffered by OCL?

5   MR. SJOSTROM: Yes, commissioner.

6   COMMISSIONER CLARK: All right. Do you have

7   copies for the court reporter?

8   MR. SJOSTROM: I do.

9   COMMISSIONER CLARK: All right. Start with your

10   first one again.

11   MR. SJOSTROM: The first one, there are two

12   proffer exhibits, two exhibits that pertain only to the

13   proffer. The first one is Florida Public Service

14   Commission review of ten-year site plans dated December 26,

15   1996.

16   COMMISSIONER CLARK: What was the date again?

17   MR. SJOSTROM: December 26, 1996.

18   COMMISSIONER CLARK: Okay. We'll mark that as

19   Proffered Exhibit 23.

20   MR. SJOSTROM: The second proffer exhibit is the

21   staff recommendation with respect to the PAA order in this

22   docket also dated December 26, 1996.

23   COMMISSIONER CLARK: That will be identified as

24   Proffered Exhibit 24.

25   MR. SJOSTROM: And the final exhibit which is not

1 part of the proffer is Florida Power Corp's petition for

2 approval of QF contracts in Docket 910401 dated March 19,

3 1991.

4   COMMISSIONER CLARK: Well, what am I supposed to

5 do with that? I mean if they're not proffered, what are

6 they?

7   MR. SJOSTROM: It would be substantive evidence

8 that we could argue in our briefs.

9   COMMISSIONER CLARK: Well, all right, so you're

10 asking for another exhibit that would not be sponsored by

11 any witness?

12   MR. SJOSTROM: That's correct. We have certified

13 copies. It's a self-authenticating document, and we

14 believe that the relevance of the document appears on the

15 face of the document.

16   COMMISSIONER CLARK: Staff, have you had an

17 opportunity to look at this?

18   MR. KEATING: Yeah. Just for the record, staff

19 would like to have an objection to the exhibits that were

20 proffered. I don't know if you specifically ruled on those

21 yet.

22   COMMISSIONER CLARK: Right, I'm allowing them to

23 proffer them. I note that you've objected to them, and

24 I've overruled the objection, okay?

25   MR. KEATING: Okay.

1   COMMISSIONER CLARK: But I'm focusing now on what

2 is identified as 25, and OCL is asking that it simply be

3 offered and accepted as an exhibit. Is there any objection

4 to that? Mr. Howe.

5   MR. HOWE: We have discussed this, and I have no

6 objection.

7   COMMISSIONER CLARK: Okay.

8   MR. KEATING: Could you please tell me again what

9 25 is?

10   MR. SJOSTROM: 25 is Florida Power Corp's

11 petition for approval of QF contracts, including the

12 Orlando Cogen contract dated March 19, 1991.

13   MR. KEATING: Okay. I don't think we have an

14 objection to that.

15   COMMISSIONER CLARK: All right. We'll admit that

16 in the record as Exhibit 25 without objection. Anything

17 else?

18   (NO RESPONSE)

19   COMMISSIONER CLARK: Thank you all very much.

20 This hearing is adjourned.

21   MR. KEATING: Commissioner Clark, could we

22 quickly go over the date for the briefs?

23   COMMISSIONER CLARK: I am sorry, yeah. It's

24 appropriate for us to go over the dates for the briefs in

25 the transcript. Go ahead, Mr. Keating.

1   MR. KEATING: We have scheduled right now
2   transcripts due on November 14th and briefs due on December
3   1st.
4   COMMISSIONER CLARK: All right. Any objection or
5   problem with that?
6   (NO RESPONSE)
7   COMMISSIONER CLARK: All right. Thank you.
8   MR. McGEE: Madam Chairman, one minor item that I
9   was just reminded of, at the prehearing conference you
10 deleted our Proposed Issue Number 3 that related to
11 identifying a standard for intergenerational fairness and
12 said that we could include our position on that into issue
13 number 2 because it was subsumed.
14   COMMISSIONER CLARK: Okay.
15   MR. McGEE: I'd like to ask you if just for Issue
16 Number 2, when the briefs are filed, if we can expand the
17 50-word limit that we have on stating our position for that
18 since we need to incorporate what is in effect our position
19 on a whole new issue?
20   COMMISSIONER CLARK: I don't see any reason to do
21 that.
22   MR. McGEE: Okay.
23   COMMISSIONER CLARK: If you find it absolutely
24 necessary, go ahead and do that and then just file a
25 motion --   I guess, Mr. McGee, you know, if you get beyond

1   50 words on a position, I don't know what good it does you.

2   MR. McGEE: Okay.

3   COMMISSIOINER CLARK: Is there any objection to

4   him having more than 50 words on his position on Issue 2?

5   MR. HOWE: No.

6   COMMISSIONER CLARK: Go ahead.

7   MR. McGEE: Thanks.

8   COMMISSIONER CLARK: Thank you all.

9   (WHEREUPON, THE HEARING WAS ADJOURNED)

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1 STATE OF FLORIDA)
             :   CERTIFICATE OF REPORTERS
2 COUNTY OF LEON)

3   We, JOY KELLY, CSR, RPR, Chief, Bureau of
Reporting, ROWENA NASH, Official Commission Reporters,
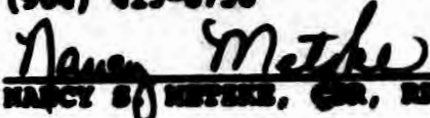4 and NANCY S. METZKE, CSR, RPR,

5   DO HEREBY CERTIFY that the hearing in Docket
No. 961184-EQ was heard by the Florida Public Service
6 Commission at the time and place herein stated; it is
further
7
       CERTIFIED that we stenographically reported
8 the said proceedings; that the same has been
transcribed under our direct supervision; and that
9 this transcript, consisting of 563 pages, Volumes 1
through 4, constitutes a true transcription of our
10 notes of said proceedings and the insertion of the
prescribed prefiled testimony of the witnesses.
11
       DATED this 13th day of November, 1997.
12

13 _____
JOY KELLY, CSR, RPR
Chief, Bureau of Reporting
14 (904) 413-6732

15 _____
ROWENA NASH
16 Official Commission Reporter
(904) 413-6736
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18 NANCY S. METZKE, CSR, RPR

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