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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Review of Florida Power Corporation's Earnings, Including Effects of Proposed Acquisition of Florida Power Corporation by Carolina Power & Light

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DIRECT TESTIMONY OF MARK A. MYERS

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DIRECT TESTIMONY OF MARK A. MYERS
ON BEHALF OF FLORIDA POWER CORPORATION
(CONCERNING ADJUSTMENTS FOR
ACQUISITION COSTS AND CR 3)

I. <u>Introduction and Background</u>

Q. Please state your name and business address.

A. My name is Mark A. Myers. My business address is Florida Power Corporation ("Florida Power" or "the Company"), 100 Central Avenue, St. Petersburg, Florida, 33701.

Q. Please describe your educational and employment background.

A. I am a graduate of Florida State University, holding a degree of Bachelor of Business Administration, Accounting Major. In addition, I hold a Master of Business Administration from the University of Tampa. I joined Florida Power in 1983 as a financial auditor. Since then, I have held the following positions within either Florida Power or Florida Progress Corporation ("Florida Progress," the former parent company of Florida Power): senior financial auditor, manager of trust planning and administration, manager of investor communications, manager of investor relations, and director of financial analysis. In May 2000, I was selected to be vice president of finance for Florida Power once the merger between CP&L Energy, Inc. ("CP&L Energy," now "Progress Energy") and Florida Progress was completed. In addition to my work experience, I am a licensed certified public accountant in the state of Florida, a chartered financial analyst, and a certified internal auditor.

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Q. What are the responsibilities of your present position?

A. As vice president of finance, I am responsible for Florida Power's accounting policies and procedures and its general books and related accounting records, including the preparation of monthly, quarterly, and annual financial statements. I am responsible for regulatory accounting and pricing matters pending before the Florida Public Service Commission (the "Commission"), which includes preparation of the Company's monthly Rate of Return report required by the Commission under its continuing surveillance authority. I am responsible for the annual budget development and forecasting function for Florida Power. I am also responsible for the business operations function of Florida Power's Energy Delivery strategic business unit.

II. Purpose and Summary of Testimony

Q. What is the purpose of your testimony?

A. I am providing testimony at this time limited to discussing two pro forma adjustments that must be made in order to provide equitable treatment to Florida Power and its customers on two key issues. The first is an Acquisition Adjustment netting out certain of the costs of Progress Energy's recent acquisition of Florida Power against the economic benefits (synergies) that Florida Power will achieve as the result of its combination with Carolina Power & Light Company ("CP&L"). It bears emphasis at the outset that what we have termed an Acquisition Adjustment here is the difference between the price paid for Florida

Progress stock and the market price for that stock prior to the merger announcement. It is not what has customarily been thought of as goodwill, or the difference in the price paid to acquire Florida Power and the net book value of Florida Power. Florida Power is not seeking an adjustment to recover goodwill.

The second pro forma adjustment is the continuation of the adjustment to the Company's Common Equity to ensure that Florida Power's future earnings will not be impaired as a result of the Company's willingness to absorb higher fuel costs and operation and maintenance ("O&M") expenses associated with the extended outage of Florida Power's nuclear power plant, Crystal River Unit 3 ("CR 3").

Q. Please summarize your testimony.

A. *Acquisition Adjustment.* Going into its merger, Florida Power wanted to be sure, at a minimum, that the merger would not result in any harm to its customers. It is our understanding that the Commission and its Staff shares this concern. We are confident that we have met that goal and kept that commitment. In fact, as a result of the merger, Florida Power will be a stronger, more efficient company and will be positioned to provide better, more reliable service to its customers at lower costs for years to come.

In fact, we are pleased to be able to propose a rate reduction in this case as a result of the operating efficiencies made possible by the merger. Based on the net synergies arising from the merger, we are proposing to guarantee about $5 million annually in rate relief for 15 years and far greater benefits from that point forward. So far from harming our customers, the merger will benefit them.

As I will describe, Florida Power will achieve significant quantifiable and unquantifiable benefits from the merger in many areas, including increased quality of customer service; lowered operating costs; increased ability to attract capital and lower costs of capital through lower business risk; and more professional and experienced managerial, financial, technical, and operational resources. These benefits will more than outweigh the costs incurred to bring these synergies about. Nonetheless, the synergies we are obtaining through the merger were not free. In fact, Progress Energy incurred significant costs in order to bring about these benefits, consisting principally of about a $925 million premium paid to acquire Florida Progress above the market value of that company as a stand-alone concern. It is critical that the Commission net those costs against the benefits to get a true picture of the impact of the merger on both Florida Power's shareholders and its customers. Progress Energy must be given the opportunity to recover the costs incurred to bring about the benefits of the merger to avoid harming shareholders, which would, in the long run, increase Florida Power's cost of capital, impair the financial standing of the Company, and adversely affect the Company's ability to continue to provide reliable, superior service to its customers.

Florida Power is proposing that its customers and shareholders share "net" synergies resulting from the merger, which actually exceeds Florida Power's continuing commitment to hold customers harmless from any impacts from the merger. Specifically, we will guarantee customers an annual rate credit of $5 million, representing about one-half of the annual net synergies that we <u>expect</u> to achieve, whether or not we achieve our goal. In addition, we propose an earnings sharing mechanism to share even harder-to-achieve gains above a specified earnings limit. This will ensure that customers receive both quantifiable and unquantifiable benefits from the merger, while still providing an incentive to Florida Power to work hard to obtain greater and greater synergies through its combination with CP&L and other initiatives.

I wish to emphasize, as noted above, that Florida Power is not seeking to recover "goodwill," nor to increase its rate base as a result of the merger. Nor is it seeking to increase rates to cover the costs of the merger. To the contrary, we are proposing to <u>reduce</u> rates as a result of the merger. In exchange, we are seeking Commission approval of our proposal that we net merger costs against merger synergies and then establish an appropriate earnings sharing mechanism that will both benefit the customers and encourage Florida Power to continue to push to achieve greater and greater efficiencies.

CR 3 Adjustment. The Commission should continue to allow Florida Power to adjust its Common Equity balance to offset the charge the Company took several years ago when it agreed to absorb an after-tax charge of over $100 million to earnings to defray the cost of higher fuel costs and O&M expenses incurred during the extended outage of CR 3. Florida Power agreed to absorb this extraordinary charge on a one-time basis, so long as it would not suffer an adverse impact on future earnings. Unless Florida Power is allowed to continue this adjustment, it will be unfairly penalized in the future for its willingness to resolve a hotly contested dispute over the CR 3 outage by absorbing the expenses incurred at that time to cope with the outage.

III. <u>Acquisition Adjustment</u>

A. <u>Background</u>

Q. So that we can better understand your testimony about Florida Power's proposed Acquisition Adjustment, please describe the background and structure of the transaction between Florida Power and CP&L.

A. The essence of the transaction was that Progress Energy acquired Florida Power's parent company, Florida Progress Corporation, merging the operations of Florida Power with those of Progress Energy's electric utility, CP&L. The transaction brought together two strong Southeastern electric utilities to achieve economic and strategic benefits, including synergy cost savings through consolidated utility operations.

As the Commission is aware, Florida Power provides wholesale and retail electric service to approximately 1.4 million customers throughout a service area of approximately 20,000 square miles, located primarily in central and northern Florida. In the year 2000, Florida Power's total system energy supply was 41 billion kilowatt hours ("kWh"). CP&L generates, purchases, transmits, and distributes electricity to approximately 1.2 million customers in a 33,667 square mile area of North Carolina and South Carolina. In 2000, CP&L's total system energy supply was 56 billion kWh.

The merger closed on November 30, 2000. At that time, Progress Energy acquired all of the issued and outstanding shares of the common stock of Florida Progress for a purchase price of approximately $5.4 billion. Progress Energy paid cash consideration of approximately $3.5 billion and issued 46.5 million common shares valued at approximately $1.9 billion.[1] Progress Energy initially funded the cash portion of the acquisition with commercial paper, backed by a credit facility. It replaced a majority of the short-term financing with long-term senior notes during the first quarter of 2001. In addition, in the third quarter of 2001 Progress Energy issued approximately $488 million of new common equity as part of its ongoing effort to manage its capital structure and continue the funding of the merger. Progress Energy accounted for the acquisition by using the purchase method of accounting.

[1] In addition, Progress Energy issued 98.6 million contingent value obligations ("CVOs") valued at approximately $49.3 million, conferring the right to receive contingent payment based upon the net after-tax cash flow to Progress Energy generated by four synthetic fuel plants purchased by Florida Progress in

Significantly, Progress Energy paid a premium of approximately $925 million over the market price of Florida Progress stock to acquire the company based on the expectation that sufficient synergies would be achieved as a result of the merger to justify paying more for Florida Progress than it was valued at as a stand-alone company. Progress Energy now holds the stock of both CP&L, Florida Progress, and other affiliates. Progress Energy formed a service company, Progress Energy Service Company, LLC ("Progress Energy Service") to provide administrative, management, financial, and corporate services to CP&L, Florida Power, and other affiliates. In addition, other utility functions have been consolidated in the utilities themselves to achieve management and operational advantages and economies of scale.

B. <u>Customer Benefits from the Merger</u>

Q. What customer benefits will result from this merger?

A. The merger will enable Florida Power to achieve increased quality of customer service; lowered operating costs; increased ability to attract capital and lower capital costs due to lower business risk; and more professional and experienced managerial, financial, technical, and operational resources.

Q. Please explain how the merger has enhanced Florida Power's quality of service.

October 1999. We are not asking for any recognition of this additional acquisition cost for purposes of determining the appropriate regulatory treatment of merger costs.

A. As a result of evaluating the best practices of both companies, Florida Power is adopting various CP&L practices and business approaches that will increase the quality of service for Florida Power customers in two principal areas, namely, increased energy delivery system reliability and customer service.

(1) *Increased energy delivery system reliability.* Florida Power is increasing system reliability through several initiatives:

- *Increased investment in reliability.* Based upon an evaluation of the comparative practices of the combined utilities, Florida Power is increasing its annual investment in reliability initiatives. These initiatives will result in a reduced incidence of service interruptions to Florida customers. They include shortening the replacement intervals for parts with a high likelihood of failure; increasing the automation, coordination, and self-correcting capabilities of the system; further segmenting the system to improve our ability to isolate faults; and adding equipment to enable us to identify and locate faults quickly.

- *Improved Outage Response.* Florida Power has announced a special 1-800 number to enable customers to report outages promptly. CP&L has found that providing customers with a single toll-free number to report outages facilitates customer reporting and allows the company to manage the calls more efficiently. In addition, we are implementing new technology that will allow up to 1,000 additional phone lines to be available to our customers for outage reporting and outage information in the event of a major storm. We are also partnering with customer service centers in the Carolinas to share resources when major storms or outages occur, thus leveraging the resources of the combined companies to provide greater service to Florida customers. Through the implementation of common work practices, operational coordination, and operational resources, Florida Power will be able to call upon CP&L to provide back-up in the event of storms and other disasters. Employees from both companies will use compatible equipment and systems enabling CP&L workers to integrate seamlessly with Florida Power response teams.

- *New Fleet of Vehicles*. Based on our best practices evaluation, Florida Power plans to invest more than $60 million over the next three years for new energy delivery vehicles. By significantly decreasing the age of Florida Power's 2000-vehicle fleet, the Company will be able to reduce its annual vehicle O&M cost per mile. A newer fleet means less unscheduled maintenance and better reliability for Florida Power's work crews, which enhances overall customer service.

- *New Dispatch Radio System.* Florida Power will be investing $16 million in a new radio system for use throughout Florida Power's service territory. It will increase reliability and coverage and reduce interference from radio users, paging companies, and TV networks. More importantly, it will give the Company the ability to orchestrate talk groups for transmission and distribution crews during normal work assignments, while also providing the ability to change talk groups quickly, coordinating with CP&L back-up crews, during storm restorations to improve communications efficiency.

- *Regional Transmission Maintenance Organization.* We have created regional work groups in each of Florida Power's four geographic regions to manage transmission maintenance activities, basing this model on the organizational structure that CP&L has used successfully in its system. These work groups will have responsibility for all of the maintenance activities associated with transmission facilities in their assigned area. Use of these regional transmission maintenance organizations will improve customer service. In addition, we will dedicate crews to performing maintenance in assigned regions to enhance reliability.

- *Additional Operating Centers.* Adapting CP&L's best practices, four new operating centers will be added across the Florida Power service territory. These new centers will place Florida Power line, service, engineering, and management resources closer to customers, improving response time and reliability.

(2) *Customer service.* We are implementing a number of additional steps to enhance customer service, such as:

- *Automated metering technology.* As a result of economies of scale resulting from the merger, it will now be cost-effective for Florida Power to implement automated meter reading capability, which will reduce costs and improve customer service. For example, this technology will reduce meter reading estimates and errors from hard-to-read locations. It will further improve customer service by providing real-time information for billing and outage identification and virtual disconnection and reconnection of service thereby providing more timely customer information and greater access to and flexibility in service.

- *New payment locations.* By the end of this year, Florida Power will add about 150 new locations to the 50 pay stations that existed throughout Florida Power's service territory prior to the merger. These new locations will replace 33 business offices, which we are phasing out during 2001. Most new payment locations will include expanded hours, and some will be open around the clock. This customer service model has been successfully used by CP&L since 1996; both informal and formal survey results indicate customers find this approach much more convenient and easy to use.

- *New Software/Increased Web Enablement.* We have implemented new software that enables our customer service representatives to resolve billing inquiries during the initial customer contact. This new software allows the representative to analyze the customer's bill on the spot and to compare it directly with the recorded temperatures for the customer's specific area. CP&L has successfully used this software for several years. In addition, new applications will be available on the internet to allow our customers to complete requests on line. These include connect and disconnect requests and analysis of usage history. Our web application is now more robust, and we have placed emphasis on moving additional functionality to the web to give our customers greater choices in how they do business with us.

- *Combined Customer Service.* Although we will continue to handle the overwhelming majority of customer phone calls for Florida Power customers in Florida, CP&L and Florida Power have combined their customer service organizations in order to maximize knowledge and management oversight and to provide a consistent, customer-focused approach to the management of customer service. This combination now allows for more effective use of resources in the development of training programs and system and web application upgrades, and it allows us to leverage the combined needs of the two companies to procure more advantageous contracts with outside vendors for collections, outage reporting, payment management, etc.

Q. How will the merger enable Florida Power to reduce operating costs?

A. Progress Energy estimated that the merger of Florida Power and CP&L should result in annual synergies of $100 million to $175 million. Progress Energy has made the high end of this range its objective in its 2002 annual budgeting process. Florida Power will realize $58.7 million in synergies from the merger in 2002. These cost savings are real. In fact, the lion's share of these savings will result directly from the Company's ability to reduce payroll and benefit costs by consolidating functions and programs with CP&L, displacing approximately 675 Florida Power employees, more than 13 percent of our workforce. During the 1990s, over a period of years, Florida Power reduced its workforce about 20 percent, eliminating approximately 1,200 positions, in order to hold the line on costs. Were it not for the merger, the Company could not have reduced labor costs any further without compromising reliability and customer service. The merger has made further, increased savings possible.

Using my own department as an example, Florida Power's Finance Department had 65 full-time equivalent ("FTE") positions before the merger in 1999. As a direct result of the merger, we will be able to cut these positions in half over the next couple of years. Specifically, in 2001 and 2002, our department will have 46 and 30 FTEs, respectively. We will be able to achieve this substantial reduction primarily by shifting accounts payable and payroll functions to Progress Energy Service and converting to common financial systems for both CP&L and Florida Power that can be supported with fewer employees.

The sum total of Florida Power's merger-related budgeted cost reductions for 2002 may be broken down into several areas as follows (dollars in millions):

Shared Corporate and Administrative Services	$ 24.8
Power Operations	15.8
Transmission & Distribution	7.1
Customer Service	5.9
Nuclear Operations	4.1
Energy Ventures	1.0
Total	$ 58.7

I would like to explain each of these items in greater detail:

- *Shared Corporate and Administrative Services*. By virtue of the merger, Progress Energy is able to integrate key corporate and administrative functions that Florida Power previously had to manage and pay for on a stand-alone basis. Progress Energy is able to accomplish this goal through the formation of its new service company. Progress Energy Service provides certain management, administrative, and corporate support services to Florida Power and CP&L in such areas as strategic planning, treasury and finance, tax and accounting, payroll and benefits management, risk management, legal and regulatory compliance, investor relations, human resources, information technology, and public relations. This integration allows the combined companies to reduce the number of redundant functions where staffing levels are relatively fixed and do not vary directly with an increase or decrease in the number of employees or customers. This significantly reduces costs previously borne by Florida Power and CP&L as stand-alone utilities. Likewise, Progress Energy Service will be able to lower costs by integrating many previously separate programs, including employee benefits, investor services, fleet systems, travel programs, purchasing practices, facilities management, security, and insurance. As a result of this consolidation, Florida Power will enjoy increased purchasing leverage and other economies of scale.

- *Power Operations.* In much the same manner, Progress Energy is able to improve and streamline utility management of power plants by eliminating or reducing redundant functions and programs where staffing levels need not vary directly with an increase or decrease in the number of power plants managed. By benefiting from best practices and process improvement initiatives identified through the merger, Florida Power is able to reduce its respective costs associated with engineering, maintenance and construction support, financial operations, environmental services, resource planning, and consolidation of combustion turbine operations.

- *Transmission and Distribution.* Florida Power is also able to reduce redundant energy delivery functions in the same way. Through the integration and consolidation of functions and programs and the implementation of best practices and process improvement initiatives, the Company is able to reduce costs and improve customer service in distribution and transmission operations; commercial, industrial, and governmental support.

- *Customer Service.* Consolidation of functions allows Progress Energy to reduce the number of redundant functions where the staffing levels are relatively fixed and do not vary directly with an increase or decrease in the number of customers. As a result of the merger, Florida Power is implementing a number of best practices and process improvement initiatives to improve customer service and lower costs in the areas of new payment locations, high bill inquiry, call center management, and collections management.

- *Nuclear Operations.* Progress Energy is likewise able to reduce redundant nuclear functions and programs where staffing levels do not depend on the number of power plants managed. The Company is now able to benefit from spreading fixed, nuclear administrative and general ("A&G") costs across multiple nuclear plants.

- *Energy Ventures.* Progress Energy also consolidated redundant energy trading functions, producing efficiency gains in this area, too.

Q. Please explain how the merger will increase Florida Power's ability to attract capital and how it will lower the Company's overall cost of capital.

A. This will occur for several reasons:

- *Increased capitalization.* The combined companies' equity market capitalization is approximately $9.3 billion (218.7 million shares x $42.50 per share), more than twice Florida Progress's capitalization as a stand-alone company. Increased market capitalization enhances a company's ability to attract capital by increasing the liquidity of its common stock. As a large-capital utility, Progress Energy will be in a position to attract very large institutional investors that are otherwise limited by their investment restrictions from making substantial investments in smaller capitalized companies.

- *Consolidation of borrowing facilities.* The combined company is now able to finance the operations of both Florida Power and CP&L more efficiently. In accordance with its December 12, 2000 Financing Order issued by the Securities and Exchange Commission, Progress Energy has established utility and nonutility money pools to manage its short-term cash and working capital requirements more efficiently. In addition, Progress Energy can combine borrowing facilities and thus reduce the overall costs of these programs. This, in turn, will lead to a lower overall cost of capital.

- *Greater operational diversification.* The merger created greater diversity in key operational areas, including customer mix and fuel mix. This increased diversification will reduce business risk and thus reduce the combined company's overall cost of capital.

- *Improved competitiveness.* As a larger company, Progress Energy has been able to strengthen its competitive position through improved economies of scale. The electric utility industry is a capital-intensive industry and is currently undergoing significant consolidation. Spreading costs over a larger customer base can improve a company's competitive position through lower unit costs. A strong competitive position reduces business risk and thus the cost of capital.

- *Geographic diversification.* Progress Energy will represent a more geographically diverse entity, which will mitigate changes in economic, competitive, or climatic conditions in any given sector of the combined service territory. This diversity will reduce business risks and the overall cost of capital.

Q. How has the merger improved Florida Power's managerial, financial, technical, and operational resources?

A. The merger has brought about improvements in these areas in numerous ways:

- *Managerial/personnel.* The size, scope, and improved competitive position of the new company create greater opportunities for Progress Energy, and Florida Power in particular, to recruit and retain top-flight managers and other key employees. As one example, CP&L has four nuclear power stations while Florida Power has one such unit (CR 3). The large nuclear staff at CP&L will complement and support the staff of Florida Power's CR 3 nuclear facility and give Florida employees professional development and career opportunities that did not previously exist.

In some cases, we are recruiting new employees from outside the two companies in order to bring in new or enhanced skills. Florida Power will benefit from CP&L's college recruiting and military recruiting efforts to augment the candidate pool for positions in Florida.

Progress Energy's leadership development program will be extended to Florida to provide additional leadership training and development opportunities. The combined companies will work through a consolidated Supervisor Assessment Center to select employees working at the two electric utilities who have supervisory potential. New supervisors will progress through a three-course series progressively building their management skills. Experienced managers in Florida will be selected to participate in the management and executive development programs developed specifically for Progress Energy in partnership with leading universities.

Florida employees will benefit from other programs made possible by the merger. With the advantage of economies of scale, the combined companies are now able to offer additional employee benefits, such as merit scholarships and college degree recognition, to current and future employees. By offering these programs, Florida Power will be better able to develop in its managers and employees the skills and motivation needed to ensure high-level performance of their professional responsibilities and quality service to Florida customers. In addition, we are designing benefit plans that will accommodate the transfer of employees between the Carolinas and Florida, thus expanding skill development and professional opportunities throughout the combined company. This, in turn, will lead to greater service enhancements to customers.

Further, we have been able to eliminate redundant positions and to identify and fill the optimum number of professional and managerial positions in Florida, relying on the back-up and support services, as needed, from other areas of the combined company.

- *Financial resources.* As I have already explained, the combined company will have an improved ability to raise capital and debt financing. Beyond that, we will enjoy economies of scale that will not only reduce operating costs, but that will enable the combined companies to finance programs, initiatives, and employee benefits that might not otherwise be feasible. We will also benefit from the combined financial expertise of managers, professionals, and consultants associated with both utilities.

- *Technical resources.* CP&L was recognized as one of the top information technology innovators in the recent *InformationWeek500* annual survey of the country's top IT users. CP&L will bring this expertise to our customers in Florida. CP&L also has been recognized by the Edison Electric Institute for having the best emergency response program of any utility in the country for the past two years. The highly trained and well-equipped CP&L staff will be able to render rapid assistance to Florida Power in the event of wide-scale power outages caused by hurricanes or other emergencies.

More generally, the combined companies are able to draw upon the best practices employed by the respective electric utilities and to take advantage of the most advantageous, relevant, and effective programs, procedures, and personnel practices to solve problems and improve operations and customer service in Florida and the Carolinas. In fact, shortly after the acquisition was announced, the combined companies conducted a thorough review of all business practices to accomplish these objectives. I have described above some of the programs and practices that we are undertaking to implement at this time.

- *Operational resources.* The merger has made possible the creation of common work practices, operational coordination, and the sharing of operational resources between the Carolina and Florida utilities. This will increase Florida Power's operational efficiency and effectiveness. For example, in the event of a major storm, Florida Power will be able to call upon the resources of CP&L, whose employees will use the same radio equipment and systems employed in Florida and who will integrate seamlessly with Florida Power workers in responding to and addressing our customers' needs during the crisis. We are also now able to achieve a more efficient utilization of the planning resources of each utility. For example, all of Progress Energy's nuclear and steam operations are centrally managed, increasing efficiency, concentrating and enhancing expertise, and creating opportunities for economies of scale. The ability of each utility to provide managerial and operational back-up to the other is enhanced by the compatibility of the two utility systems.

C. <u>The Costs of Bringing About the Merger Synergies</u>

Q. *Please discuss the costs that have been incurred to bring about these synergies.*

A. These costs fit into several categories. Certain of these costs have already been netted out from the synergy savings that I have described. Others have not. The costs that have already been netted out are the costs that we are incurring directly to implement the specific programs and initiatives I have described. These ongoing costs include, among others, an estimated $25 million in information system costs, benefit plan consolidation costs, and facilities costs that the merged companies have had to incur to implement and capture the cost saving initiatives I have described. These costs are already embedded in our calculation of synergies.

There are two other cost items that must be taken into account, which are shown in the table in my Exhibit MAM-1. First, Progress Energy paid a premium of approximately $925 million to purchase Florida Progress. Progress Energy financed this premium and is now obligated to make payments of principal and interest on that amount. Although the cost of the acquisition premium is not carried on the books of Progress Energy's electric utilities, Progress Energy incurred this cost in order to produce the cost savings and other synergies I have described that inure directly to the benefit of these regulated electric utilities.

The second cost item that we must take into account is about $70 million in merger transition costs incurred by Florida Power and booked initially in 2000. This represents severance payments made by Florida Power to employees displaced by the merger and is a direct outgrowth of Progress Energy's efforts and opportunities that I have described above to consolidate functions and programs and to eliminate and reduce redundancy. Incurring these costs was thus necessary to produce ongoing benefits in the form of improved operations and reduced operating costs. That being the case, the amortized portion of these costs must be netted out against the estimated annual gross synergy amount, like all other direct costs incurred to implement the merger and achieve these synergies.

Q. **Are you proposing that the Commission double-count the severance benefits booked in 2000?**

A. No. Under generally accepted accounting principles ("GAAP"), we had to book the entire amount of the severance benefits in 2000, the year the "contingent loss criteria" for these expenses were met. We then reversed that entry for purposes of our 2000 calendar-year surveillance reports and calculated our ROE without it, demonstrating that the Company was operating within its ROE that calendar year without taking into account these severance costs. Although we believe that the preferred ratemaking treatment is to allocate the transition costs ratably over the period that the benefits will be realized, we did not have the discretion to make this adjustment without Commission approval. We then added those expenses back in 2001 to serve as a temporary surrogate for the acquisition adjustment that would ultimately be determined by the Commission. Florida Power proposes to replace this surrogate with the final acquisition adjustment approved by the Commission for the 2001 calendar year.

As Dr. Charles Cicchetti will explain more fully in his Direct Testimony, we are proposing in this proceeding that the Commission authorize an adjustment for ratemaking and surveillance reporting, beginning in 2001, on account of the merger. This adjustment would reflect an annual amortization of the acquisition premium and the severance costs, which together would replace the severance costs reported in 2001.

Q. Why did Progress Energy incur these merger costs?

A. These costs are very common to merger transactions like this one. The reason for merging companies is to create a whole that is greater than the sum of its parts, and this cannot be achieved without paying a premium and incurring transition costs. It is important to recognize, however, that companies are willing to incur such costs only if the benefits are expected to exceed the costs, after the costs are "netted" out against the resulting benefits. In this instance, we believe that the merger synergy benefits to customers and shareholders will exceed the costs incurred to bring about these synergies.

Q. How much of those merger costs and related synergies are allocable to *Florida Power?*

A. I have made this calculation in my Exhibit MAM-1. The bottom line is, the amount of the acquisition premium fairly allocable to Florida Power's retail business equals $25 million. Florida Power's share of synergies must be reduced by the ratable amount of transition costs (severance payments) incurred to produce those synergies. The adjusted retail synergies total $31 million annually. When the retail acquisition premium of $25 million is netted against the adjusted retail synergies of $31 million and presented on a revenue requirement basis, the resulting net synergies are approximately $10 million.

Q. If Florida Power is not carrying its share of the cost of the acquisition premium on its financial statements, why should it be treated as a cost to Florida Power?

A. Although Progress Energy incurred these costs, this has practical implications for Florida Power. No rational company should enter into a merger unless it could, at a minimum, recoup the costs of the merger. Accordingly, Progress Energy expects Florida Power to pay sufficient dividends to the parent each year to enable Progress Energy to recover Florida Power's share of these costs. Only after Progress Energy has recouped these costs, can it be in a position to earn a return on its investment. Here, Progress Energy expects Florida Power to contribute sufficient dividends to defray the merger costs fairly allocable to Florida Power.

D. <u>Proposed Acquisition Adjustment</u>

Q. Are you proposing that the Commission permit Florida Power to make an Acquisition Adjustment for ratemaking and surveillance reporting purposes to take into account the Company's recent merger?

A. Yes, but only in a limited sense. It is my understanding that the Commission sometimes uses the term "Acquisition Adjustment" to refer to an adjustment to a utility's rate base to reflect the fact that the utility's assets were purchased for more than or less than book value. We are not proposing that the Commission adjust Florida Power's rate base, and we are not asking to recover the difference between Florida Power's book value and the price paid (which amounts to about $3.4 billion in goodwill). What we are asking is that the Commission recognize that the significant economic benefits, or synergies, resulting from the merger come with a cost—consisting primarily of Florida Power's share of the acquisition premium and the transition (severance) costs that the Company incurred to bring these benefits about. As I have described, the synergies we are projecting will exceed these associated costs, producing true net synergies that should be shared between Florida Power's customers and shareholders.

In fact, based on our projection of net synergies, we are prepared to guarantee that Florida Power's customers will receive an annual rate credit of $5 million for a period of 15 years, totaling $75 million, representing 50 percent of expected net synergies. During that period, Florida Power should be able to make an adjustment permitting recovery of the amortized cost of the acquisition premium and severance payments. At the end of the 15-year recovery-period, of course, the Company's customers would enjoy even greater benefits from the merger. Also, we are asking that the Commission authorize an earnings sharing mechanism ("ESM") that would reward both Florida Power's customers and shareholders in the event that Florida Power is able to achieve extraordinary earnings, through harder-to-achieve synergies or other initiatives. Dr. Cicchetti has developed a proposal for accomplishing these objectives, which he describes in his Direct Testimony. Florida Power adopts Dr. Cicchetti's proposal and asks that the Commission approve it as the most appropriate regulatory treatment of the costs and benefits resulting from Florida Power's merger.

Q. Can you explain how Florida Power has accounted for the Acquisition Adjustment you are proposing in the Company's Minimum Filing Requirements ("MFR") schedules?

A. Yes. In an effort to simplify the analysis of any revenue requirement surplus or deficiency, Florida Power has made an adjustment equal to the level of synergies incorporated into its budget. This serves two purposes. First, it presents the MFRs and the resulting revenue requirement on a pre-merger basis allowing for a more focused analysis of ongoing operations. Second, this treatment allows the Commission to evaluate the Acquisition Adjustment presented in testimony, and overlay its final decision on the results produced from the Company's MFRs.

Q. Will the limited Acquisition Adjustment you describe create a windfall to Progress Energy's shareholders?

A. Not at all. To the contrary, if Florida Power were not able to make sufficient earnings to provide for recovery of its fair share of the acquisition costs, Progress Energy's shareholders would actually be penalized for the companies' decision to merge, even though the merger will result in numerous, demonstrable benefits to Florida customers. This is true because Progress Energy could not recoup the cost of the merger and thus would not be in a position to provide a positive return to shareholders. The merger will prove to be beneficial to Progress Energy's shareholders only <u>after</u> the point is reached where Progress Energy has recouped the cost of bringing the merger about. If Progress Energy and its shareholders were <u>not</u> able to recover the costs of the merger, this would have an adverse financial impact on both and would strongly discourage behavior that benefits Florida customers. This, in turn, would create a powerful disincentive for utilities ever to engage in cost-saving mergers in Florida again.

Q. What if the Company does not achieve the level of synergies projected? Wouldn't the customers suffer if the Commission permitted Florida Power to make the *Acquisition Adjustment* it is requesting?

A. No. The downside risk will fall only on our shareholders' shoulders, while customers and shareholders will share in any upside benefits. To explain, if Florida Power is unable to achieve the synergies we are projecting, this will create a shortfall in our earnings, and we will not have the opportunity to generate additional earnings that might be available to offset the costs of the acquisition. It is important to recognize that we expect to recover the acquisition premium and merger transition costs through synergies resulting from the merger. At the same time, if we exceed projected synergy levels, improve operations, or even just generally manage our business extremely well, our customers will share in the upside benefit under the approach we are proposing. That is because Florida Power will be generating even more earnings than currently projected, and our proposal explicitly provides for the sharing of higher earnings between customers and shareholders.

IV. <u>The CR 3 Adjustment</u>

Q. **Turning now to the CR 3 adjustment, are you proposing to continue the adjustment you have been making to the Company's Common Equity relating to the extended outage of Florida Power's nuclear unit?**

A. Yes.

Q. **Please explain the origin of this adjustment.**

A. The Company placed its nuclear unit, CR 3, into an extended outage in October 1996 in order to make modifications needed to maintain compliance with precautionary safety requirements of the Nuclear Regulatory Commission ("NRC"). This came about when Florida Power engineers, with the benefit of hindsight, were first able to identify a remote safety contingency (associated with the capability and configuration of the plant equipment) that had a probability of occurring less than once in 11.6 billion years (more than the age of the sun), sufficient nonetheless to trigger NRC regulatory concerns. During the outage, Florida Power incurred significant, related O&M expenditures and higher fuel costs relating to higher-priced fuels needed to generate power while CR 3 was out of service.

During the extended outage, the Commission commenced a review of management prudence concerning the outage. Both the Office of Public Counsel ("OPC") and Florida Power engaged expert witnesses, as the case was heading to hearing. At that time, Florida Power negotiated with several parties, including OPC, a stipulation that included a number of rate-related components. While resolute in its belief that its actions relating to CR 3 were reasonable and prudent, Florida Power nonetheless faced the prospect of years of expensive, disruptive, and uncertain litigation. Accordingly, Florida Power agreed to settle this dispute in large measure by accepting a straightforward tradeoff: specifically, the Company agreed not to recover from customers the majority of replacement fuel costs and increased O&M expenses incurred as a result of the outage, but only if the Company's future earnings would not be affected.

Thus, in 1997, Florida Power agreed to absorb approximately $82 million in fuel costs and $100 million in O&M, totaling approximately $109 million in after-tax losses. This extraordinary charge resulted in lower earnings per share in 1997 and reduced the Company's retained earnings and thus the shareholders' Common Equity balance. If no corresponding adjustment were made to Florida Power's Common Equity in future years, this would have had the effect of inhibiting the amount that Florida Power could permissibly earn each subsequent year. This would have the effect of compounding the loss that Florida Power agreed to absorb. Accordingly, Florida Power negotiated the right to make an adjustment to its Common Equity offsetting this charge for purposes of determining whether Florida Power was overearning in the future (i.e., for surveillance purposes). The Commission approved the parties' settlement in Docket No. 970261-EI, Order No. PSC-97-0840-S-EI, finding that the stipulation "achieve[d] a reasonable balance between stockholder and ratepayer interests."

Q. Did Florida Power or the Commission provide for terminating this adjustment at a date certain in the future?

A. No. The stipulation and Order provided for an indefinite adjustment. In fact, the Commission's Order stated that the stipulation was "silent with respect to how long this adjustment will be made," and that "[t]he parties indicate it is contemplated within the Stipulation that this adjustment may continue beyond the four year amortization period." During the Agenda Conference when this matter was discussed, Florida Power acknowledged, and the Commission reflected in its Order, that the Commission would be entitled to review the issue in Florida Power's next rate case, whenever that might occur. But that does not mean that Florida Power contemplated that the Commission should terminate the adjustment as the <u>outcome</u> of the next rate case, and we do not believe that it would be appropriate to do so as an outcome of this proceeding.

There might be a circumstance where termination of the adjustment would be a proper outcome. Thus, if it appeared in the course of a rate case that Florida Power were able to achieve its desired capital structure without making this adjustment, then the need for the adjustment might become moot and the Commission and Florida Power could discontinue the adjustment without impairing permitted earnings. But that is not the case here.

To the contrary, even with the adjustment, Florida Power currently lags significantly behind the other investor-owned utilities ("IOUs") in Florida with respect to the relationship between equity and debt in its capital structure (having less equity than the other IOUs) (see my Exhibit MAM-2); thus, disallowing the adjustment would have the effect of unduly suppressing Florida Power's equity level in relation to its peer utilities. This would bring about exactly the result that the adjustment was developed to prevent, namely, penalizing Florida Power's future earnings on account of Florida Power's willingness to step up to the plate (without a finding of management imprudence and in a case where that was hotly disputed) and absorb the immediate costs incurred during the outage.

Q. Should the adjustment be continued?

A. Yes. In fairness, for the reasons I have given, Florida Power must continue to be permitted to make the CR 3 adjustment for purposes of ratemaking and surveillance reporting.

V. Conclusion

Q. Does this conclude this portion of your direct testimony?

A. Yes, it does.

Docket No. 000824-EI
Exhibit MAM-1
Witness: Mark A. Myers

Florida Power Corporation
Calculation of Net Synergies

(In millions, except per share amounts)

Line No.	Description	Amount
1	Florida Progress Stock per share	$54.000
2	Pre-merger price per share	44.625
3	Premium per share	9.375
4	Total shares	98.617
5	Total stock premium	924.534
6	Prorata share to Florida Power (1)	30.9%
7	Premium Allocated to Florida Power	285.681
8		
9	System Annual Acquisition Adjustment (2)	26.797
10	Retail allocation	94.45%
11	Retail Annual Acquisition Adjustment	$25.310
12		
13		
14	Pretax Synergies	$58.700
15	Merger Transition Costs (3)	4.645
16	Pretax Adjusted Synergies	54.055
17	Retail allocation	94.45%
18	Retail Pre-tax Synergies	51.055
19	Inverse of Statuatory Tax Rate (1-.38575)	61.425%
20	Retail After tax Synergies	$31.361
21		
22	Net Synergies - After tax (Line 22 - Line 13)	$6.051
23	Net Synergies (Available for sharing) - Pretax	$9.871

(1) Florida Power's prorata share of synergies $54/$175 = 30.9%

(2) Based on a after-tax merger related debt of 4.607% (7.5%*.61425) and a term of 15 years

(3) Merger transition costs $69.676/15 years = $4.645

Docket No. 000824-EI
Exhibit MAM-2
Witness: Mark A. Myers

Capital Structure of Florida IOU's On an Average FPSC Adjusted Basis
As of June 2001

Line No.	Description	RETAIL - FPSC CAP STRUCTURE	
1		Common	All Other
2		Equity	Debt/Equity
3			
4	Florida Power Corporation	44.53%	55.47%
5			
6	Florida Power & Light *	47.03%	52.97%
7			
8	Tampa Electric Company *	49.07%	50.93%
9			
10	Gulf Power Company *	42.10%	57.90%
11			
12			
13			
14			
15		RETAIL - FINANCIAL CAP STRUCTURE	
16		Common	All Other
17		Equity	Debt/Equity
18			
19	Florida Power Corporation	51.00%	49.00%
20			
21	Florida Power & Light *	54.91%	45.09%
22			
23	Tampa Electric Company *	58.25%	41.75%
24			
25	Gulf Power Company *	50.71%	49.29%

*(Including an estimate of retail Off-Balance Sheet Obligations)