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January 28, 2002

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COMMISSION CLERK

- VIA HAND DELIVERY -

Ms. Blanca S. Bayó
Director of the Commission Clerk and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: Docket No. 001148-EI

Dear Mr. Bayó:

I am enclosing for filing in the above docket the original and fifteen (15) copies of the prefiled testimony and exhibits for the following Florida Power & Light Company ("FPL") witnesses:

Mark R. Bell	01061-02	K. Michael Davis	01067-02
M. Dewhurst	01062-02	Paul J. Evanson	01068-02
William W. Hamilton	01063	Steven P. Harris	01069-02
Dr. J. Stuart McMenamin	01064	Rosemary Morley	01070-02
Armando J. Olivera	01065	James K. Peterson	01071-02
John M. Shearman	01066	Samuel S. Waters	01072-02

FPL is filing these witnesses' testimonies today in accordance with Order No. PSC-02-0089-PCO-EI, dated January 15, 2002. FPL's witnesses sponsor and explain the MFRs FPL has previously filed in this docket. Together with the MFRs, their testimonies demonstrate that FPL's 2002 test year results do not support any reduction in FPL's base rates.

AUS ___
CAF ___
CMP ___
COM Stacy
CTR ___
ECR ___
GCL 1
OPC 1
MMS ___
SEC 1
OTH ___

Sincerely,

John T. Butler, P. A.

Enclosures
cc: Counsel of record (w/copy of enclosures)

RECEIVED & FILED
FPSC-BUREAU OF RECORDS

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that true and correct copies of the prefiled testimony and exhibits of Mark R. Bell, K. Michael Davis, M. Dewhurst, Paul J. Evanson, William W. Hamilton, Steven P. Harris, Dr. J. Stuart McMenamin, Rosemary Morley, Armando J. Olivera, James K. Peterson, John M. Shearman and Samuel S. Waters were served by hand delivery (*) or overnight delivery this 28th day of January, 2002 to the following:

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By: ____________________
John T. Butler, P. A.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 001148-EI
FLORIDA POWER & LIGHT COMPANY

JANUARY 28, 2002

IN RE: REVIEW OF THE RETAIL RATES OF FLORIDA POWER & LIGHT COMPANY

TESTIMONY & EXHIBITS OF:

M. DEWHURST

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

FLORIDA POWER & LIGHT COMPANY

TESTIMONY OF MORAY P. DEWHURST

DOCKET NO. 001148-EI

JANUARY 28, 2002

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

A. Moray P. Dewhurst, 700 Universe Boulevard, Juno Beach, Florida 33408.

Q. **What is your employment capacity?**

A. I serve as Senior Vice President of Finance and Chief Financial Officer of Florida Power & Light Company ("FPL" or the "Company").

Q. **Please describe your educational and professional background and experience.**

A. I have a bachelor's degree in Naval Architecture from MIT and a master's degree in Management, with a concentration in finance, from MIT's Sloan School of Management. I have approximately twenty years of experience consulting to Fortune 500 and equivalent companies in many different industries on matters of corporate and business strategy. Much of my work has involved financial strategy and financial re-structuring. I was appointed to my present position in July of 2001.

Q. **What is the purpose of your testimony?**

A. My testimony will support and supplement the testimony of Mr. Avera on the appropriate Return on Equity ("ROE") that should be established in this proceeding, the proposed ROE award of 30 basis points, the appropriate capital structure for the Company, and the need for an increase in the annual accrual for the Company's Storm Damage Fund.

Q. What MFRs are you sponsoring?

A. I sponsor or co-sponsor the following MFRs: A-12b, A-12c, C-21, C-28, C-50, D-1, D-3a, D-3b, D-4a, D-6, D-7,D-8, D-9, D-10a, D-10b, D-11a, and F-17.

Q. Please summarize your testimony.

A. Over the past several years, with the benefit of steady, predictable growth in customers and usage, and a stable planning environment, the Company has been able to keep costs relatively low while simultaneously improving customer service. Base rates have continued to decline in both nominal and inflation-adjusted terms. Today, however, the Company faces a more challenging economic environment, the continuing need to develop capacity resources to provide larger reserve margins than in the past, and an uncertain regulatory outlook.

FPL's current financial condition is strong; however, there are significant uncertainties as to the near-term future. The uncertainties center around several issues: the outcome of these proceedings, the speed and extent of the recovery from the present depressed overall levels of economic activity in our service area, as well as the possible course of electricity industry restructuring in Florida.

In September 2001, FPL's credit rating was downgraded by S&P from "AA-" to "A." We were disappointed with the downgrade; however, we believe it serves as an important signal of the need to maintain a strong financial position. Despite the downgrade, today FPL's financial ratios are within to slightly above the target ranges of an "A" rated utility for the financial indicators considered by the Florida Public Service Commission (the "Commission") in prior rate cases.

We have been able to serve an increasing number of customers, with increasing levels of reliability and quality, while decreasing base rates and providing customers with annual refunds. We believe the successful results of the past few years have been due to the superior efforts of the Company's management, operating within a balanced and stable regulatory framework provided by the Commission. We believe that it is important, where possible, to maintain stability in the regulatory and planning framework. Thus, despite the fact that we anticipate increasing financial pressure, as indicated by our 2002 test year filings and the information provided for 2003, we are not seeking an increase in base rates at this time, although one certainly may be justified. As Mr. Evanson noted, we plan to monitor our situation very closely.

Notwithstanding that FPL is not seeking an increase in base rates at this time, the Commission should prospectively adjust FPL's authorized ROE to be consistent with the best projections of the cost of capital in the test year and beyond. I concur with Mr. Avera's finding that the current cost of equity for FPL is approximately 12.85%. The Commission should also provide tangible recognition for the superior results FPL has achieved by adding a performance award of 30 basis points to the current cost of equity. Thus the midpoint of FPL's authorized ROE should be set at 13.15%. Because we are not requesting an increase in base rates at this time and our projected ROE is forecast to be 11.83% in 2002, the upward adjustment of our authorized ROE, or an ROE award for superior results, would function as an incentive rather than as the set point for base rates.

Q. Please characterize the significance of any Commission action in these proceedings.

A. To stay abreast of the growing number of customers and their growing electricity needs, we will have to continue to expand our distribution and transmission network as well as increase the generation resources available to us. We are mindful of the need to maintain the excellent reliability and customer service record that we have demonstrated over the past several years. To meet these challenges it will be vital for us to remain a strong company in the eyes of the investment community, which will only come by continuing to earn a reasonable, stable return and maintaining a strong equity position to accommodate current and future uncertainty. Any actions that adversely affect investors' perceptions of the financial strength of the Company will be detrimental to our ability to sustain the superior performance we have provided customers over the past decade. In addition, we believe it will be very important to investors to remove the uncertainty surrounding the Company's revenues as a result of this proceeding.

SECTION I – FPL'S CURRENT FINANCIAL CONDITION

Q. What measures of financial integrity do you recommend the Commission consider when evaluating the financial condition of the Company?

A. In evaluating our financial condition, the Commission should consider the same indicators of financial integrity that are considered by the financial community. Any company is only as strong as investors understand it to be, and recent events have clearly shown how quickly a company can shift from being financially secure to being unable to execute the most fundamental business processes if investors lose confidence in its financial strength. Different standards must necessarily be applied to different circumstances, but the core measures of financial strength are common.

The most basic measures of financial strength that investors look to are profitability and capital structure. Profitability captures the essential requirement of being able, over time, to provide investors with a fair return on the capital they have placed at risk, while capital structure addresses the requirement to be able to absorb unexpected shocks. We submit that with respect to both types of measures, investors are currently more demanding of companies in our industry than they have been in the recent past. It is clear from recent events that companies whose profitability and/or capital structure are perceived by investors to be at risk of significant weakening in the future become highly vulnerable. Many companies in our industry have suffered significant adverse effects from rapid declines in investor sentiment associated with uncertainty as to their financial strength.

Specific measures that capture a company's profitability are many. Perhaps the most comprehensive is a company's return on equity, since it is indicative of the company's ability to cover the risk-adjusted return expectations of all classes of investors. Other things equal, a higher or lower ROE represents greater or lesser financial security to both equity and debt holders. Similarly, measures of capital structure are many, but the ratio of debt to total capital, appropriately defined and measured, is a reasonable general indicator. Other things equal, a lower debt ratio represents greater ability to absorb the effects of transient financial "shocks," and vice versa. In addition to these broad indicators, investors also may look to more specific measures of financial security as part of their overall assessment of a company's health.

Q. Are there additional, specific measures of financial integrity that are reviewed by financial rating agencies which you believe the Commission should consider in evaluating FPL's financial condition, and what do those indicators show for FPL?

A. Standard & Poors considers several financial ratios that the Commission should consider. Adjusting out the temporary impact caused by the collection of FPL's unusually large fuel underrecovery, FPL's performance relative to those financial ratios for the 2002 test year are:

	2002 FPL	S&P "A" Targets
Total debt to total capital:	43.7%	43.0 - 49.5%
Funds from operations to average total debt :	32.1%	24.5 - 30.5%
Funds from operations interest coverage:	5.3x	3.8 - 4.5x
Pretax interest coverage:	4.3x	3.3 - 4.0x

FPL's ratios are within or slightly above the targets established by Standard & Poors for an "A" rated utility, though it should be noted that numerical ratios are not the only factors that S&P or investors consider in determining overall financial strength. It should also be noted that S&P's target ratios were published in June 1999, and a higher interest rate assumption is embedded in the targets than FPL has experienced. This explains why FPL's funds from operations interest coverage ratio of 5.3x is higher than the target, while FPL's funds from operations to average total debt ratio of 32.1% is more consistent with the target range. Since interest rates can change rapidly, somewhat more weight is likely attached to the debt ratios.

Q. What conclusion should the Commission draw from FPL's projected performance on each of these indicators?

A. Our current capital structure provides adequate financial strength to accommodate the inherent uncertainties of the industry, taking due regard of the risk factors affecting the industry and the Company today. Any weakening in any of these areas would clearly be perceived by investors as a decline in our overall financial strength. As discussed later in my testimony, this would be detrimental to customers, since it would ultimately undermine our ability to provide highly reliable service at costs below industry averages.

SECTION II - RETURN ON EQUITY

Q. What is your recommendation for a return on equity?

A. FPL's projected ROE in 2002 of 11.83% is below Mr. Avera's projections of what the cost of equity will be in 2002 and beyond, and is less than fully competitive under current market conditions. I concur with the judgment of Mr. Avera that the best estimate of the Company's cost of equity is 12.85%, and I submit that a premium of 30 basis points to recognize the Company's superior performance, and to provide an incentive for future performance, is fully warranted on the merits, and is consistent with the Commission's prior decisions. Adding this premium yields a mid-point for allowed ROE of 13.15%. In keeping with prior Commission policy, a 1% band should be established on either side of the mid-point, resulting in a return on equity range of 12.15% to 14.15%.

Q. Do you concur with Mr. Avera's recommendations?

A. Yes. I have reviewed his work in this proceeding and concur with his recommendations. I believe the Commission should establish the cost of equity for FPL at 12.85% and then add an award for our superior performance of 30 basis points.

Q. What should the Commission consider in determining the Company's ROE?

A. A company's ROE is an important indicator both of the economic return that the company can provide to its equity holders and, as I have discussed earlier, of the overall financial strength of the enterprise. It is axiomatic that any company must provide a prospective return to shareholders that is at least as good as the return that the shareholders could expect to earn on an investment of equivalent risk characteristics. Failure to do so will result in a loss of equity value and the inability to access capital markets at a reasonable cost. As I understand the Commission's task, it is, among other things, to look at risk through the eyes of current and potential equity investors and to set an allowed ROE that, if achieved by the Company, will induce the needed level of investment at the lowest reasonable cost and fairly compensate the historical equity holders for the utilization of their assets. This level of ROE, if achieved by the Company and coupled with prudent management of the capital structure, will also satisfy investors' requirements for financial strength.

Investors' requirements at any particular point in time are set both by general conditions and risks and by company-specific conditions and risks. Virtually all conditions affect both debt holders and equity holders; however, they may affect these classes of investors differentially. In setting an allowed ROE, therefore, the Commission should look to all the risk factors affecting a company but should emphasize those that have the greatest impact on equity holders. In the following responses I have addressed these factors.

Q. What general economic risk factors should the Commission consider in determining the Company's ROE?

A. Two major factors affect the entire utility industry today that have not been present in recent years and that tend to increase investors' perceptions of risk. First is the currently depressed level of economic activity at both the state and national level. The over-all level of economic activity directly affects the Company's sales revenues and thus explains the downward revisions in our sales forecast in the test year. However, current economic events also induce a degree of uncertainty that has not been present for many years. The current economic slowdown is the first recession since 1990-1; it also has shown a pattern very inconsistent with prior post-WW II slowdowns. On top of the general uncertainty associated with the slowdown must be placed the specific uncertainties associated with the effects of the terrorist attacks in September 2001. These have had a disproportionate effect here in Florida, a tourist dependent state, which relies greatly on intangibles like consumer confidence as a driver of economic activity.

The second general factor that has increased the uncertainty and risk associated with the utility industry overall is the continuing theme of restructuring at the wholesale and retail levels. While Florida has not taken any action in this area beyond an in-depth study of the issues, we are not immune to the increase in risk *as seen through investors' eyes.* From an investment perspective *all* geographies have witnessed an increase in uncertainty both because the future path of regulation is unclear and because the likely effects of a particular regulatory scheme are now understood to be much less predictable than previously thought. From an investor perspective, the fact that a particular state has put on hold plans for restructuring does not reduce the level of uncertainty beyond the very short term and in some respects actually increases uncertainty and, therefore, risk.

Q. Please identify and describe company-specific risk factors that are important in determining FPL's ROE.

A. There are five company-specific risk factors that I will discuss.

Growth

The interaction of general economic uncertainty and the underlying strong growth of our service territory creates a particular set of risks for FPL. We expect to continue to experience growth in the number of customers moving into our service territory; however, recent economic events have forced us to lower our expectations and at the same time increase the range of outcomes that we must prepare for. While our expectations for customer growth in the short-term have been reduced, significant capital expenditures are still forecasted over the next few years to meet customer growth and increased demand. Due to the long-term construction cycle of building utility assets, a strong balance sheet is needed to counter adverse market conditions that may arise during the construction period. To ensure access to capital markets for the necessary capital to meet growth, FPL will have to provide a fair return on equity to investors today, and over the extended period when the Company is active in the capital markets.

Customer Base

The majority of our revenues come from our residential and commercial customers. Compared to utilities in other states, Florida has a low industrial load. From an investor perspective this reduces risk. Our customer mix has not greatly changed over the last few years; thus there should be no unusual change in this risk factor.

Volatile Economy

As indicated earlier, the Florida economy has been particularly affected by the current economic uncertainty, in large part because of the heavy reliance on tourism. As service providers, we naturally absorb the consequences of this uncertainty, which, from an investor perspective represents additional company-specific risk.

Nuclear Generation

FPL has four nuclear generating units, Turkey Point Units 3 and 4 and St. Lucie Units 1 and 2. Together, these contribute 16.6% of available capacity and approximately 26% of actual supply, owing to their high reliability and their low-cost position in the economic dispatch. FPL has the highest percentage of generation from nuclear resources of any utility in the state. While our customers have enjoyed cost savings over the years from these units, the investment community assigns a higher level of risk to a utility that has nuclear units in its generating portfolio. In addition, as the plants age, there is an increasing maintenance risk, as illustrated by the recent need for reactor vessel head penetration inspections. On balance, the trade-off has been an excellent one for our customers. On a total cost basis (i.e., including depreciation and a fair allowance for capital recovery and assuming a risk premium for nuclear) our cost per kWh for nuclear-produced power is significantly less than the equivalent cost for fossil-fueled plants. Recent estimates of fuel cost savings alone, comparing the fuel costs of our nuclear and natural gas units, show that the nuclear units save approximately $750 million per year in fuel cost. It would be inconsistent to take advantage during the rate-setting process of the very large customer savings in variable cost without also compensating equity holders for the risk premium associated with nuclear power.

Geographic Position

Florida's geographic location exposes our electrical systems to a higher likelihood of adverse weather events. Although we plan for this contingency with our Storm Damage Fund, all other factors being equal, it increases risk.

Florida's geographic position also exposes the Company to certain additional risk factors. As a peninsula, with limited physical connection to adjacent geographies, Florida is more exposed to fuel supply disruptions. While we have compensated for this in part through significant use of fuel-switching capability, which has had the additional benefit of keeping fuel costs lower than they otherwise would have been, the risk associated with our peninsular position has increased somewhat recently with the increasing uncertainty surrounding future natural gas prices.

Q. What conclusion should the Commission draw from these qualitative risk factors?

A. I believe it is important for the Commission to be aware of these risk factors as it considers both the appropriate level of ROE and the capital structure that we have maintained at FPL. In my judgment, Mr. Avera's analysis has appropriately considered these factors insofar as it is possible to incorporate them quantitatively. A 12.85% ROE would fairly incorporate these risk factors. As noted earlier, the addition of a proposed 30 basis point performance award recognizing the superior management performance that the Company has achieved over a sustained period of time leads to our recommendation of a mid-point allowed ROE of 13.15%. The Commission's customary practice is to establish a 1% band on either side of the mid-point. We see no reason to depart from that standard practice in this proceeding. Therefore, I recommend a range of return on equity of 12.15% to 14.15%.

SECTION III - CAPITAL STRUCTURE

Q. Is there a relationship between your recommendation on the allowed ROE and the Company's capital structure?

A. Yes. My recommendation of the appropriate ROE assumes the Company's current capital structure. Taken together, the current capital structure and the recommended ROE satisfy the criteria described earlier – offering a fair, prospective, risk-adjusted return for shareholders, and ensuring the financial integrity of the Company. Were the Commission to adopt the position that the Company's balance sheet is currently under-leveraged, I would have to increase the recommended ROE to compensate for the increased financial risk that such a position would contemplate.

Q. What is your specific recommendation for an equity ratio for FPL for regulatory purposes?

A. I recommend continuing the adjusted equity ratio of 55.83%, which was established in FPL's 1999 Stipulation and Settlement Agreement (the "Revenue Sharing Agreement") between FPL and the Office of Public Counsel that was approved by the Commission. As provided in the Agreement, the adjusted equity ratio equals common equity divided by the sum of common equity, preferred equity, debt, and off-balance sheet obligations. Nothing has happened in the interim that would suggest that the ratio should be reduced, and in fact the changes that have occurred more recently would tend to drive the required ratio in the opposite direction. While I believe, as indicated above, that the combination of a 12.15%-14.15% allowed ROE band and a 55.83% adjusted equity ratio is appropriate for the current environment, I also believe it would be inconsistent for the Commission to seek to reduce the financial strength of the Company at a time when all the key risk drivers point to a period of increased risk.

Q. What is FPL's current equity ratio?

A. Since the Revenue Sharing Agreement took effect in 1999 we have maintained our equity position, on an adjusted basis, near the capped level of 55.83%.

Q. What are the benefits to FPL's customers of a strong equity ratio?

A. A strong equity ratio promotes a strong capital structure. The primary benefits of a strong capital structure are flexibility and security. With respect to the first, it is clear from the discussion of the qualitative and quantitative risk factors that go into the determination of the return on equity that flexibility is a crucial element of FPL's ability to manage risk. The statutory obligation to serve all customers at their desired level of demand, coupled with the uncertainty inherent in unforeseen events, means that FPL must go to the capital markets as service needs dictate rather than at the point in time that might be the most advantageous from a market perspective. The inability to time market entry is somewhat offset by a strong equity position. Balance sheet strength and flexibility are also manifested in the ability to absorb unexpected financial shocks.

Recent examples of the customer benefiting from a strong equity ratio include: (1) the Company's ability to access the short-term debt markets and carry some of the approximately $600 million in fuel under-recovery for a period of several years and; (2) the Company's ability to carry $222.5 million associated with the Osceola and Okeelanta contract buy-outs for a one year deferral, followed by recovery spread over a five year period. We were able to implement these alternatives, which spared customers "rate shocks," because of our strong equity ratio. Our ability to consider a wide range of financing alternatives to deal with unexpected financial events, and to present them to the Commission for consideration, is directly linked to our strong equity position.

A strong capital structure also provides security. In this respect it acts much like insurance to provide security against relatively low odds but high negative outcome events. While balance and judgment are always required, it is imprudent to operate any business without proper protection against the downside. As noted earlier, recent events have demonstrated how quickly strong positions can deteriorate in our industry. I believe customers benefit from a strong equity ratio in the same way they benefit from insurance.

Q. Please explain your reference to FPL's equity position on an adjusted basis.

A. In evaluating the adequacy of the capital structure of any company, investors will take into account major financial commitments, whether these are reflected on the balance sheet or not. In the case of a utility that has an obligation to serve its customers, the financial community commonly takes into account obligations associated with purchased power agreements ("PPAs"). This fairly acknowledges the fact that a long-term contractual commitment to purchase firm capacity behaves economically much like debt, imposing fixed charges independent of a company's revenues and, thus, should be accounted for in evaluating the financial strength of the company.

In the case of FPL, we have several long-term purchase contracts that supply about 20% of the energy we sell to our retail customers. In addition, FPL has a long-term lease for nuclear fuel. These obligations significantly increase the fixed charge leverage of the Company and are generally understood by the investment community. They are explicitly evaluated by the rating agencies, who examine each contract and assign it a rating that dictates how much of the nominal total value of the contract will be added to FPL's debt obligations for rating purposes. The net effect is to increase the relative share of debt and debt-like instruments in the capital structure. Accordingly, FPL will need to maintain a higher unadjusted equity ratio to attain the same level of financial security with PPAs than without.

Different contracts have different characteristics. A "take-or-pay" contract, for example, imposes more effective leverage than does a contract that leaves FPL with options as to when or how much to take. Similarly, a fixed obligation for power is more onerous than a capacity contract with a variable energy call option. The rating agencies (Standard & Poor's and Moody's Investor Service) that perform these analyses will not disclose their specific calculations. They publish their ultimate conclusion but do not reveal their assessments of individual contracts. In addition to individual company evaluations, however, they do offer general guidelines. Working with these two pieces of information I believe that the off-balance sheet adjustment made by the rating agencies for FPL's current obligations is in the 7-8% range.

Q. Do you believe an adjustment of this type is appropriate?

A. Yes. In general I agree with the judgment of the financial community that an adjustment for off-balance sheet obligations should be made in assessing the financial condition of a utility, particularly in view of the impact of the obligation to serve on the market timing issue. In addition, while our own calculation of the appropriate amount to include might be different, I believe that the rating agencies' overall assessment fairly represents the general investor viewpoint and is thus directly relevant. It is therefore reasonable for the Commission to make a comparable adjustment when it evaluates the financial strength of FPL.

Q. Why is it important that regulatory policy be consistent with the perspective of the financial community on this issue?

A. There are two reasons. First, as I understand the goals of regulatory policy, one of the Commission's tasks is to set rates such that investors have the prospect, though not the guarantee, of earning a reasonable rate of return. In doing so, the Commission must look to capital markets for evidence of investor requirements. Rating agencies, acting as independent risk assessors on behalf of investors generally, are an important source of evidence in this regard. The fact that they include off-balance sheet obligations should be strong evidence of the relevance of these obligations to financial risk.

In addition, however, there are sound fundamental economic reasons for viewing purchased power obligations as part of the financial profile. These obligations are similar to debt from a financial perspective. Moreover, they represent avoided capacity – capital expenditures and rate base that would otherwise have been included like other assets – but with a fixed obligation. Whereas all other assets are supported by a cushion in the form of the most junior financial claim (common equity), which bears the ultimate risk of financial fluctuations, these PPAs have no such support. The Company is required to meet these obligations and cannot, in a weak year, return less than the contractual commitment. From the Company's perspective, it is as though the capacity represented by these contracts were 100% financed by debt. The major bond rating agencies include a portion of the present value of these contracts as debt in their analysis. Logically, this effect should be incorporated into the overall assessment of financial structure.

Q. How does an adjusted equity ratio of 55.83% compare with the recommendations of the financial community?

A. Taken together with all the other indicators of our current financial and risk profiles, the adjusted 55.83% equity ratio puts us within the range expected by the financial community for "A" rated utilities. Achieving an equity ratio within this range means that it is not likely to form the basis for a decision to change the credit quality of the Company. This would also send a signal to the capital markets of the Commission's continued commitment to support the financial integrity of the service providers subject to its jurisdiction.

A decision on rates that leads to a reduction in this ratio would put further pressure on FPL's financial standing. It is perhaps worth noting that the consequences of a downgrade from the "A" band to the "BBB" band are typically more significant than those from the "AA" to "A" downgrade that we experienced last year. In addition, the rating agencies are typically much slower to upgrade ratings than to downgrade them – in other words, a short period of time in poor standing tends to lead to a downgrade, but a disproportionately longer period is needed at an improved standing before the improvement is acknowledged in upgraded ratings.

Q. Does the Company have any evidence of the effects of changing equity ratios from its past experience?

A. Coincident with the remarkable improvements in operating performance over the past ten-plus years that other witnesses have demonstrated, FPL has also directly witnessed the linkage between rating agency assessments and capital structure. In the early 1990s, we had much lower equity ratios – and correspondingly lower ratings, given the then-prevailing rating agency methodologies. As we improved performance, reduced costs and regained financial flexibility, we saw ratings improve. Today, the standards that the rating agencies apply are rather more stringent, reflecting the increased perceptions of risk for the industry as a whole, but the relationship between relative financial strength and relative rating performance remains.

Clearly, the Commission has enabled the Company to strengthen its financial position in terms of its reduced rate base and stronger capital structure as a result of its flexible, incentive-driven regulation since 1995, while at the same time lowering customer rates. It would, I submit, be perverse for the Commission to recognize the benefit that customers have already received from the Company's performance improvements through lower rates while simultaneously seeking to reintroduce the financial inflexibility and lack of security that investors experienced in the late 1980s and early 1990s.

Q. **What would the consequences be if the Commission reduced the Company's adjusted equity ratio below 55.83% for regulatory surveillance purposes?**

A. The immediate consequence would be a need to adjust the actual equity ratio to correspond with that on which rates were set. The Company could not afford to have equity capital tied up with no prospect of an appropriate return. Thus, equity would be withdrawn from FPL and replaced with debt. The debt would likely be long maturity, to match as best as can be the essentially infinite maturity of the equity it was replacing.

A second consequence would be an increase in risk associated with the new capital structure. Rates of return required to compensate investors of all classes appropriately would increase. These increases in risk-adjusted rates of return would diminish whatever apparent savings came from reducing the initial equity ratio. The net reduction in revenue requirements would be modest, and offset by the impact of the additional risk created by the more highly leveraged capital structure.

It is well established in financial theory that changes in capital structure have very little effect on overall firm value in competitive markets within the typical range found among companies operating in the same line of business. This is because increases in leverage are offset by increases in risk, and the net economic cost of the increase in risk offsets the apparent benefit of the lower superficial cost of debt. If this were not the case, we would observe increases in a company's stock price whenever debt ratios increase. Empirically, this does not occur. Unfortunately, in the rate-setting process it is easy to overlook the offsetting risk effect, because the costs of extra risk, though real, are not directly observable, while the differences between the formally applied allowances for the costs of equity and debt are very obvious.

Despite this complexity, both sound regulatory principles and common fairness suggest that the Commission must seek accurately to reflect the increased risk that comes with greater leverage. We believe that the Commission has done this well in the recent past and that, especially in light of the greater uncertainties surrounding the future of the industry today, it would be most unwise to impose greater risk on investors and, ultimately, customers. It will be much harder to recover from adverse economic circumstances, as the experiences of several companies in our industry, both regulated and not, clearly indicates.

SECTION IV - ROE AWARD

Q. Please explain the ROE award sought by the Company in this proceeding.

A. We believe that FPL has compiled a superior record of performance improvement over the past decade or so. The ultimate test, of course, is that we have been able to reduce our rates, while increasing our reliability and quality of service and increasing the number of customers we serve and the overall level of their demand. We believe an appropriate acknowledgment of this superior performance would be to adjust the mid-point of our allowable ROE band upward by 30 basis points to 13.15%. This would have the effect of providing an incentive and sending a strong signal to other companies.

Q. In what specific ways has the Company earned the opportunity for an incentive of this nature?

A. The Commission should evaluate the end result, that is, our base rates, and our performance in three key areas:

1. Reliability of Service
2. Quality of Service
3. Reduction in O&M Costs.

Other witnesses in this proceeding will testify in detail about the Company's specific achievements in each of these areas. I will indicate who these witnesses are with a brief comment and then go on to discuss the magnitude of the award and the potential impact on our earnings. I should point out that there is an independent source that the Commission should consider when examining these areas, namely Mr. Shearman's testimony.

Q. Please comment on the Company's achievement in improving reliability.

A. The focus here should be on the improved reliability of our generating units, that is, the improvement in their availability rates, and the results of our work on the distribution system, which has resulted in a reduction in the duration and frequency of outages at the distribution level. In their testimony, Mr. Waters and Mr. Olivera provide the specifics of these achievements within their respective areas.

Q. What about the Company's achievement in quality of service?

A. FPL has improved an already excellent record of customer service with, for example, our state of the art Customer Care Centers. This is detailed in the testimony of Mr. Hamilton, and is supported by the reactions of our customers at our service hearings at the beginning of this proceeding.

Q. Please comment on the reductions in O&M costs FPL achieved throughout the 1990s.

A. As fully outlined in the testimony of Mr.Evanson and Mr. Shearman, FPL achieved unprecedented reductions in operating expenses during the decade of the 1990s. FPL's non-fuel O&M cost per kWh in 2000 was almost 40% lower than in 1991. These improvements were made possible by the Company accepting substantial short-term risks. As it turns out, both the Company and customers benefited from FPL's approach.

Q. Doesn't the Company expect an increase in its O&M expenses in 2002?

A. Yes, but O&M costs per kWh is still at low levels. The current and prospective cost pressures – driven to some extent by unusual economic circumstances – should not obscure the much larger overall point, which is the huge magnitude of the overall performance improvement since FPL's last rate case. Had FPL not undertaken these extraordinary expense reductions, the level of expense included in test year calculations would have been much higher. What FPL seeks to be acknowledged for is the exceptionally low base on which test year expenses are built.

Q. What is the relationship between the O&M benchmark test and the ROE adder FPL seeks?

A. As shown and described in Mr. Davis' testimony and Document KMD-8, with two minor exceptions, FPL passes the Commission's O&M benchmark test with flying colors for the years leading up to and including the test year. Thus it is entirely appropriate and consistent for the Commission to recognize the Company's achievements in this area with an increase in the allowed rate of return.

Q. Why do you recommend a 30 basis point award?

A. While it is partly a matter of art rather than science, the magnitude of the award is meant to be consistent with the Commission's actions in previous dockets in which ROE awards or penalties have been given. The level should be large enough to motivate FPL's continued performance improvement – recall that, absent a rate increase, there is no guarantee that FPL can attain its authorized ROE – but not so large as to effectively undermine the Commission's oversight function.

Q. What would be the impact of the award on FPL and other companies subject to the Commission's jurisdiction?

A. As shown in MFR A12b, with no change in base rates FPL is projected to earn 11.83% in the test year, or the very bottom of the range recommended by Mr. Avera. An award that shifted the allowed range up 30 basis points would be a very challenging incentive for the Company. At the same time an award to FPL would be an important signal to other companies as to both the Commission's willingness to recognize extraordinary achievement and the level of effort required to receive an award. In addition, however, such an award would provide the prospect - absent major changes in capital market conditions - of several years of stability in the planning and pricing environment, which is highly desirable if FPL is to develop future performance improvements.

SECTION V - STORM DAMAGE FUND

Q. How does FPL plan to pay for repairs to its system caused by storm damage?

A. Since 1993, FPL has utilized a self-insurance approach to address the cost necessary to repair its system in the event of hurricane or storm damage.

Q. Why did FPL choose to utilize a self-insurance approach?

A. The substantial losses associated with Hurricane Andrew in 1992 essentially eliminated the commercial market for storm insurance in anything like the amounts needed to provide adequate protection to FPL's extensive network of assets and its ability to quickly restore reliable service. Due to the unpredictability of major storms and the damage that results from them, a storm fund reserve is necessary under a self-insurance approach, just as a commercial insurance company maintains surplus to be ready to pay against claims. This approach allows FPL to minimize costs to customers for repairs to its transmission and distribution (T&D) system and for non-T&D windstorm damage insurance deductibles.

Q. Has the Commission previously approved a self-insurance approach?

A. Yes. By Order No. PSC-93-0918-FOF-EI, the Commission concurred that FPL should implement a self-insurance approach for the cost of repairing and restoring its system in the event of hurricane or storm damage.

Q. What financing mechanisms does FPL use for its self-insurance?

A. FPL has a funded reserve and lines of credit up to $1 billion which will be used to pay for repairs. The funded reserve, which is 100% dedicated to this purpose and may not be used for any other purpose, is invested conservatively, so that the funds are readily available at short notice.

Q. How is the reserve funded?

A. FPL makes contributions to the fund on an after-tax basis based on an annual accrual of $20.3 million per Order No. PSC-95-1588-FOF-EI.

Q. Is the $20.3 million annual accrual still appropriate?

A. No. Based on December 2001 data, since FPL's last storm fund filing in 1997, the annual accrual of $20.3 million plus the fund earnings has not been sufficient to offset the costs incurred to restore service following storms that have occurred since then. The annual accrual should be increased to $50.3 million.

Q. What was the storm fund reserve in FPL's last filing and what is it today?

A. At December 1997, the amount considered in the last filing, the storm fund reserve balance was $251.4 million. At December 2001, the balance had declined to $234.7 million. This represents erosion of $16.7 million, despite a currently authorized annual accrual of $20.3 million. We believe the five-year target level for the reserve should be set at $500 million, because it is a reasonable balance between the uncertainty of losses and the risk that rates would have to be immediately increased to finance the restoration of service.

Q. Has FPL performed a study to determine the reasonableness of the annual accrual and an appropriate reserve level?

A. FPL commissioned studies addressing the reasonableness of the level of its storm fund reserve and annual accrual. The studies were prepared by and are being sponsored by Mr. Harris of ABS Consulting.

Q. What direction was provided by FPL to ABS Consulting in the preparation of the studies?

A. FPL requested that ABS Consulting determine what levels of losses the Company is statistically exposed to and to develop recommendations for an appropriate annual accrual and a target reserve balance to be achieved over five years considering certain fundamental regulatory objectives.

Q. What are the fundamental regulatory objectives?

A. FPL believes that the regulatory objectives should be: (1) achieve lowest long-term customer costs; balanced with (2) dampened volatility of the reserve (i.e., reduced reliance on special assessments/rate increases); and (3) cover the costs of most storms, but not those from the most catastrophic events. ABS Consulting's analysis suggests that strictly from a cost perspective larger reserves are better. However, FPL recognizes that the cost objective must be balanced by other considerations.

Q. Please summarize the study results.

A. ABS Consulting recommended that, given the objectives noted above, the annual accrual should be in the range of $45 - $55 million with a five-year target reserve level of between $400 - $500 million.

Q. What annual accrual amount and target reserve level is FPL requesting?

A. Assuming that the Commission does not reduce FPL's base rates, FPL requests an increase to the annual storm fund accrual, commencing January 1, 2002, by $30 million to $50.3 million and the establishment of a corresponding storm fund reserve objective of $500 million to be achieved over five years.

Q. Why do you believe these levels are appropriate?

A. First, FPL realizes that the current level of its reserve is too low and that the resulting risk of fund inadequacy is too great. In FPL's last storm proceeding, the Commission concluded that the reasonable level for the reserve was $370 million in 1997 dollars (Order No. PSC-98-0953-FOF-EI). However, as I have indicated, the reserve balance has actually declined with the current funding level of $20.3 million per year, despite a period of relatively low losses from actual storms, relative to what statistically could have been expected.

Second, the current annual accrual plus expected fund earnings are substantially less than the expected annual loss to be charged against the Reserve. Therefore, with an annual accrual of only $20.3 million, the actual Reserve balance will not increase except over the short term with abnormally low storm activity.

Finally, as stated by the Commission in Order No. PSC-95-1588-FOF-EI: "The annual accrual needs to be sufficiently low so as to prevent unbounded storm fund growth and yet large enough to reduce reliance upon emergency relief mechanisms in the event of catastrophic weather events." From a public policy viewpoint, minimizing emergency relief funding mechanisms, whether through rate increases or special assessments, is preferable since during post catastrophic storm periods consumers have the least resources to support these extraordinary costs.

The use of a target of $500 million achieves a reasonable balance between the uncertainty of losses and increases the chances that special assessments will be avoided.

Q. How can the Company ensure that the requested annual accrual of $50.3 million would prevent unbounded growth?

A. FPL proposes to file updated studies at least every five years for review by the Commission. Based on the ABS Consulting analysis, it is highly unlikely that the reserve would exceed $500 million within 5 years.

Q. Has the Commission allowed for a 5-year review of other funded reserves?

A. Yes. For example, the Commission currently requires FPL to file a study that allows the Commission to review its nuclear decommissioning costs at least every five years.

Q. Can FPL change its storm fund accrual without Commission authorization?

A. No.

Q. What would be the impact of your recommendations concerning ROE, capital structure, the ROE award and the storm fund accrual on the Company's financial performance?

A. Implementation of my recommendations would result in no change to our key indicators since no change in rates is proposed. It would therefore keep FPL in a strong financial position, able to protect our credit rating, able to attract equity investment on reasonable terms, able to finance system expansion at a reasonable cost, and able to respond with the flexibility we need to unforeseen events. We would have an incentive that encourages us to build on the superior performance results we have achieved thus far. Finally, my recommendation on the storm fund will allow FPL to achieve and maintain a reasonable plan for responding to major storms in our service territory. In the long run, all of these things add up to delivering reliable, adequate electric service at the lowest reasonable costs to our customers.

Q. Does this conclude your direct testimony?

A. Yes.