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

DOCKET NO. 000824-EI

Submitted for Filing:
September 14, 2001

CONFIDENTIAL
REBUTTAL TESTIMONY
OF
CHARLES J. CICCHETTI, Ph.D.

ON BEHALF OF
FLORIDA POWER CORPORATION

DECLASSIFIED
9.15.03

CONFIDENTIAL

JAMES A. MCGEE
FLORIDA POWER CORPORATION
Post Office Box 14042
St. Petersburg, FL 33733-4042
Telephone: (727) 820-5184
Facsimile: (727) 820-5519

Gary L. Sasso
James Michael Walls
CARLTON FIELDS
Post Office Box 2861
St. Petersburg, FL 33731
Telephone: (727)821-7000
Facsimile: (727)822-3768
Attorneys for Florida Power Corporation

This docketed notice of intent was filed with Confidential Document No. 01607-02. The document has been placed in confidential storage pending timely receipt of a request for confidentiality.

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

DOCKET NO. 000824-EI

Submitted for Filing: September 14, 2001

CONFIDENTIAL
REBUTTAL TESTIMONY OF CHARLES J. CICCHETTI, Ph.D.

ON BEHALF OF FLORIDA POWER CORPORATION

JAMES A. MCGEE
FLORIDA POWER CORPORATION
Post Office Box 14042
St. Petersburg, FL 33733-4042
Telephone: (727) 820-5184
Facsimile: (727) 820-5519

Gary L. Sasso
James Michael Walls
CARLTON FIELDS
Post Office Box 2861
St. Petersburg, FL 33731
Telephone: (727)821-7000
Facsimile: (727)822-3768
Attorneys for Florida Power Corporation

Q PLEASE STATE YOUR NAME, BUSINESS AND ADDRESS.

A. My name is Charles J. Cicchetti. My address is Pacific Economics Group LLC (PEG), 201 South Lake Avenue, Suite 401, Pasadena, California 91101.

Q. DID YOU PREVIOUSLY FILE DIRECT TESTIMONY IN THIS MATTER?

A. Yes. I filed Direct Testimony on behalf of Florida Power Corporation (FPC).

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I am responding to the Direct Testimonies filed by certain witnesses for the Florida Office of Public Counsel (OPC), Intervener Publix, and Intervener Florida Industrial Power Users Group (FIPUG). Specifically, I will respond to the testimonies filed by Kimberly H. Dismukes (OPC), Donna Deronne (OPC), Sheree L. Brown (Publix), Theodore J. Kury (Publix), and Michael Gorman (FIPUG).

Q. HOW IS YOUR REBUTTAL TESTIMONY ORGANIZED?

A. For clarity, I will discuss each witness sequentially, starting with OPC witnesses and then concluding with Intervenor witnesses.

Q. THE WITNESSES THAT YOU MENTIONED HAVE TO ONE DEGREE OR ANOTHER CRITICIZED FPC'S PROPOSED REGULATORY PLAN. WHY DO YOU THINK THIS REGULATORY PLAN IS A GOOD DEAL FOR FPC RETAIL CONSUMERS?

A. We start with the revenue requirements associated with retail consumers. These retail revenue requirements are conservatively projected to be about $51.055 million per year less than they would have been without this merger. These savings are effectively gross benefits. Retail consumers would expect to find a reduction equal to this amount (mostly in reduced labor expenses) in their underlying cost-of-service and associated revenue requirements.

FPC is also seeking to recover about $25.31 million to repay transaction costs from these projected savings for 15 years. These transaction costs would be paid to Progress Energy by FPC in after tax dollars. Accordingly, FPC would use about $41.20 million of the gross benefits to recover $25.3 million (which represents about half the gross benefits) for Progress Energy to pay for its allocated share of the transaction costs incurred to bring about this merger. In addition, FPC would use $15.89 million of the gross savings to pay associated corporate income taxes.

The retail consumers would net about 24 percent per year more than they would have, if the merger had not occurred from this annual cost of $41.2 million in two forms. First, FPC would make a guaranteed payment of $5 million per year in reduced retail revenue requirements. This benefit is not dependent upon FPC actually achieving the projected synergies. This is equivalent to a fifteen year guaranteed annual return of 12.14% ($5 million from $41.2 million). In addition, the remaining conservative synergy estimates of gross revenue requirement benefits are about $46.06 million (i.e. $51.06 million - $5 million) in projected savings.

These are built into the cost-of-service determination. The cash payment of $25.31 million to Progress Energy (and corporate taxes of $15.89 million) would effectively be charged against $46.06 million in gross benefits. This would likely leave about $4.86 million in additional net benefits (reduced cost-of-service) for retail consumers. Here, the likely return is an additional 11.8 percent per year.

On a combined basis, there would be $5 million in guaranteed annual net benefits, through an annual retail rate credit, plus about $4.86 million in additional likely net benefits. These results demonstrate that there will be net synergy benefits.

On an aggregate basis, from the gross synergy benefits, FPC's retail consumers would repay about $379.65 million in transaction costs and interest ($25.31 x 15) to Progress Energy. This would be accompanied by about $238.35 million in corporate taxes ($15.89 x 15).

Gross benefits would, however, equal about $765.83 million for retail consumers. The net effect equals about $147.83 million in net ratepayer benefits.

To enhance the likelihood that customers will receive additional benefits from this merger, FPC's regulatory plan includes a progressive earnings sharing mechanism (ESM). Under FPC's progressive ESM, customers, in addition to the guaranteed $5 million retail rate credit, will have the opportunity to receive a greater share of the more easily attained cost reductions and savings. Conversely, FPC will receive a greater share of the more difficult to achieve savings. This progressive ESM will benefit customers in two ways. First, customers will receive the lion's share of the more easily attained, and therefore the most likely to be achieved, cost savings. Second, FPC will have the proper incentive to take extraordinary methods to seek the harder to achieve savings because it will retain a greater share of these savings. Under non-progressive plans, sharing bands lack such effective incentives. However, under FPC's progressive ESM, customer benefits will be maximized.

There are few opportunities in economics and finance where one can recover more than one spends, with more than half the gain guaranteed and the other half very likely. Yet, this is exactly what the proposed FPC regulatory plan would accomplish. Accordingly, I conclude that the merger related regulatory plan proposed by FPC is good for consumers in Florida.

OPC WITNESSES

Q. AT PAGES 6-7 OF HER DIRECT TESTIMONY, MS. DISMUKES ASSERTS THAT "FPC EXPECTS ITS CUSTOMERS TO PAY THE ENTIRE AMOUNT OF THE ACQUISITION PREMIUM." DO YOU CONCUR WITH HER CHARACTERIZATION?

A. No. First, it is important to recognize that, in utility mergers, an acquisition premium is typically thought of as the difference between the purchase price and the depreciated book value, sometimes known as goodwill. In this proceeding, Florida Power Corporation (FPC) is not seeking to recover from customers the $3.4 billion difference in what Progress Energy paid for Florida Progress and its depreciated book value.

Second, it is also important to realize that FPC is not seeking to recover from retail customers in Florida the difference between the amount paid to acquire the outstanding shares in for FPC and its then (pre-merger) current market price. As I discussed in my Direct Testimony, FPC is seeking to recover only a portion (30.9%) of the difference between what Progress Energy paid and FPC's then current market price.

Third, FPC is seeking to recover only those costs related to this transaction/merger. The significant net cost benefits, with more than one half of the net savings guaranteed, result in extraordinary gains for Florida's retail customers.

The specific percentage of the total transaction costs that FPC seeks to recover is based on the estimated percentage of synergy savings that FPC expects to achieve through this merger. The "net synergy" savings to cost recovery (including transition cost recovery) results in significant net consumer benefits in Florida. Thus, it is only a fraction (30.9%) of the difference between what was paid for FPC and its then current market price that FPC is seeking authority to recover through the savings/synergies that FPC projects will be generated by this merger.

This amounts to annual cost recovery of about $10 million annually, results in significant net cost benefits for consumers, with more than half of this guaranteed. This results in a positive benefit to cost ratio when comparing annual savings to annual transition plus transaction costs.

Q. WHAT IS THE BENEFIT TO COST RATIO?

A, There is a 1.24 to 1 benefit to cost ratio when comparing annual savings to annual transition and transaction costs. The fallacy inherent in Ms. Dismukes' position is apparent when one considers a simple analogy. Assume that a company owns a fleet of trucks. Some of the trucks are aging and in need of constant repair and have high fuel costs. New trucks can be purchased for $100,000. Suppose that if the new trucks are purchased, the company would save $124,000 in repairs and fuel. No one should argue that the $100,000 price was too high or unnecessary because the company had "old" trucks, when the expected savings exceed the price paid. Yet that is exactly the position that Ms. Dismukes and other witnesses take when they attack recovery of the fraction of the costs that yield the synergy savings that result in significant net cost benefits for customers, with more than half guaranteed.

Q. IS MS. DISMUKES CORRECT IN ASSERTING THAT THIS AMOUNT WILL BE RECOVERED FROM CUSTOMERS IN HIGHER PRICES?

A. No. Ms. Dismukes implies that retail prices will increase if customers are forced to pay what she calls an acquisition premium or acquisition adjustment. In reality, customers' rates will not be increased by the merger and the associated regulatory plan that FPC has proposed. In fact, as I testified to in my Direct Testimony, FPC is providing a guaranteed annual $5 million retail rate credit to customers for 15 years. This guarantees that customers will receive at least $5 million of FPC's estimated share of the synergy savings that arise from this merger, regardless of their being achieved. Under its proposed regulatory plan, FPC will recover its transaction and transition costs from the synergy savings that are generated by the merger and net about $10 million per year in cost reductions for Florida's consumes.

Q. DO YOU AGREE WITH MS. DISMUKES CHARACTERIZATION (AT PAGE 7 OF HER DIRECT TESTIMONY) THAT "ONE OF THE DRIVING MOTIVATIONS WAS NOT TO BENEFIT THE RATEPAYERS, BUT...TO INCREASE VALUE TO SHAREHOLDERS?"

A. No. Ms. Dismukes attempts to project the notion that merging regulated utilities do not focus on retail customers. This is preposterous. This particular merger is predicated on an FPC regulatory plan in which there are net retail ratepayer benefits after paying FPC's share of transition and transaction costs Ms. Dismukes is guilty of attacking a merger that is good for shareholders and even better for retail customers. The FPSC should reject her biased and false conclusions.

Q. AT PAGES 12-14 OF HER DIRECT TESTIMONY, MS. DISMUKES CRITICIZES YOU FOR REFERENCING FPC'S ACQUISITION OF THE SEBRING SYSTEM AS AN EXAMPLE OF AN EXTRAORDINARY MERGER AND ARGUES THAT THIS MERGER IS NOT COMPARABLE

TO THE SEBRING ACQUISITION. PLEASE RESPOND TO HER CRITICISMS.

A. I never suggested that the Sebring acquisition was comparable to the merger that is the subject of this hearing. My intention was to explain that the Florida Public Service Commission (FPSC) had, in the past, allowed acquisition premiums, by which I mean goodwill (i.e., the difference between the purchase price and depreciated book value), to be included in rate base where it found that extraordinary situations existed. I also explained that the Commission specifically stated that the Sebring case was not intended to be used as precedent. However, I referenced the Sebring case for the proposition that the Commission recognizes that it is important to encourage mergers that yield significant customer benefits. The undisputed facts here demonstrate net annual projected savings of about $10 million per year for 15 years. To this end, if the Commission fails to allow merging companies to recover the costs necessary to achieve these levels of net consumer benefits, similar beneficial mergers are less likely to occur, which will be to customers' detriment in Florida.

Q. AT PAGE 13 OF HER DIRECT TESTIMONY, MS. DISMUKES DISCUSSES YOUR REFERENCE TO THE PEOPLES GAS COMPANY ACQUISITION BY SOUTHERN GAS COMPANY. PLEASE RESPOND TO HER DISCUSSION.

A. Again, I simply cited the People's Gas case for the proposition that the FPSC has allowed an acquisition premium to be included in rate base when it finds that extraordinary conditions exist. In that case, the Commission referenced five criteria as evidence of "extraordinary conditions." These are: (1) increased service quality; (2) lowered operating costs; (3) increased ability to attract capital for needed improvements; (4) lower overall cost of capital; and (5) more professional and experienced managerial, financial, technical and operational resources as factors evidencing extraordinary circumstances. Ms. Dismukes and I do not appear to disagree on what this particular case stands for.

I went further in my Direct Testimony, where I explained that although FPC was not asking for an acquisition or goodwill adjustment, or any portion thereof, to be included in rate base, this specific merger did offer extraordinary net benefits and opportunities for both shareholders and customers. I also explained in my Direct Testimony and at my deposition that all five tests have or will be achieved as a result of this merger.

Also, Ms. Dismukes, at pages 14-16 of her Direct Testimony, discusses the Jacksonville Suburban Utilities Corporation case, where the FPSC allowed the companies to recover an acquisition premium, although "both utilities were relatively healthy and not suffering from quality of service problems." Mr. Dismukes cites a dissenting opinion in that case by Commissioner Julia Johnson, who states that the FPSC's decision marks a "shift in Commission policy." Unlike Ms. Dismukes, I do not go so far as to suggest that the FPSC's policy with respect to acquisition premiums has changed and no longer requires that extraordinary circumstances be shown. To the contrary, I maintain that even though FPC is not asking that the Commission put any part of an acquisition premium in rate base, but is only asking for a regulatory plan that would allow FPC to collect a portion of the transaction costs it has incurred effectively by splitting the savings achieved that are made possible by the merger, this merger still meets the FPSC's criteria for exceptional circumstances, but rate base will not increase and base retail prices will likely be almost $10 million less annually than they would have been. Furthermore, FPC proposes a guaranteed $5 million retail rate credit.

Q. AT PAGE 18 OF HER DIRECT TESTIMONY, MS. DISMUKES ARGUES THAT "SUCH BENEFITS COULD HAVE TAKEN PLACE ABSENT THE MERGER. HOW MUCH WEIGHT SHOULD THE FPSC GIVE TO HER ARGUMENT?

A. None. In my experience, each of the merging company's Boards of Directors go to great lengths to segregate merger related synergy and stand-alone cost reduction and income enhancement. That said, it is simply a fact that the list of possible cost and quality improvement strategies that a regulated entity can pursue is relatively well defined and finite. Accordingly, critics can aver that when a merger causes specific cost reduction and quality improvements, these same cost reductions and quality improvements could have been accomplished absent the merger.

This sort of conclusion is very misleading. Further, the cost of accomplishing these objectives might very well be, and in my experience often is, less when accomplished through a merger than it would have been standing alone. Finally, different skill sets and experience are often shared by the merging companies, which makes the actual implementation better, less expensive, and of greater value to customers.

Q. AT PAGES 18-19 OF HER DIRECT TESTIMONY, MS. DISMUKES LISTS THE FIVE FACTORS THAT THE FPSC HAS CITED AS COMPRISING EXTRAORDINARY CIRCUMSTANCES AND THEN PROCEEDS TO ASSERT THAT NONE OF THESE FACTORS ARE PRESENT IN THIS MERGER. PLEASE RESPOND TO HER ASSERTIONS.

A. The first factor is increased service quality. Ms. Dismukes does not dispute that the merger will likely improve FPC's service quality, only that "many such improvements *could* have taken place without the merger." At best, Ms. Dismukes assertion is speculative. At worst, she does not even specify which service quality improvements would have taken place had the merger not been consummated. More to the point, she mixes up new spending to reduce transmission and distribution outage with the specific cost savings obtained through this merger.

The second factor is an increased ability to attract capital. Ms. Dismukes grudgingly admits that this effect "may be true." She then attempts to temper her admission by arguing that this one fact does not make the merger extraordinary. This is true. However, because all five factors are satisfied by this merger, the merger does meet the FPSC's criteria for being extraordinary.

The third factor is a lower cost of capital. Ms. Dismukes argues that this is true only at the Progress Energy level. She cites FPC's increased equity ratio and bond downgrade as evidence that FPC is not facing a lower cost of capital. Regardless, as the final regulatory decision (this proceeding) is put in place and the net savings are fully realized, I conclude that FPC's cost of capital will improve and FPC will attract capital more readily. Further, as merger savings are realized and regulatory uncertainty is removed, I fully expect that FPC's bond rating will improve.

The fourth factor is lower operating costs, which Ms. Dismukes dismisses as "remains to be seen." Labor and O&M reductions have already been realized and the projected savings are embedded in the budget. Ms. Dismukes misses the point that under the FPC regulatory plan, customers are guaranteed a $5 million rate credit, with the strong possibility of even greater savings based on the net cost recovery. Furthermore, FPC has strong incentives to exceed its synergy projections. The company's shareholders are at risk if the projected savings are not fully achieved, because it is only through these savings that the transaction costs will be paid. Customers are not at risk because they are guaranteed to receive the first $5 million in savings through the rate credit.

The fifth factor is improvements to FPC's managerial, financial, technical and operational resources. While Ms. Dismukes speculates that many of the improvements Mr. Myers referenced in his Direct Testimony could have been made without the merger, she fails to specify how these changes could have been made. To be sure, as Ms. Dismukes notes, FPC did have, prior to the merger a qualified staff. However, the merger of two successfully and efficiently run utilities allows the companies to pick the best of the best, thus improving both companies' staff. Furthermore, CPL has a deeper nuclear capability and expertise, which will add synergy to FPC.

Q. AT PAGE 19 OF HER DIRECT TESTIMONY, MS. DISMUKES ASSERTS THAT "...THERE IS NO TAX BENEFIT ASSOCIATED WITH THE ACQUISITION ADJUSTMENT AND FPC IS ASKING RATEPAYERS TO PAY THE FULL AMOUNT." PLEASE RESPOND TO HER ASSERTION.

A. I do not disagree with Ms. Dismukes that the annual transaction cost is not tax deductible. That is precisely why the annual payment must be grossed up for tax purposes. However, her pejorative statement that FPC is "...asking ratepayers to pay the full amount" does not follow from the tax treatment. The fact is the government takes about 40 cents out of every dollar in net revenue. As I discussed in detail earlier, FPC is seeking a regulatory plan that will enable it to be repaid its share of the transaction costs through savings enabled by the merger. Further, customers are guaranteed at least an annual $5 million retail rate credit and the likelihood of a net cost reduction through synergy after transaction and transition costs are netted against the projected synergies annually. FPC is simply asking to pay for a fraction of the merger's costs from a portion of the projected FPC savings generated by the merger. It is very important to remember that FPC's projected share of the merger will yield significant net cost benefits to consumers, with more than half guaranteed.

Q. WHAT IS YOUR REACTION TO MS. DISMUKES DISCUSSION AT PAGES 19-20 OF HER DIRECT TESTIMONY WITH RESPECT TO PROGRESS ENERGY'S HOPES TO PUSH NON-REGULATED REVENUE FROM 20 PERCENT TODAY TO 50 PERCENT BY 2004?

A. To accomplish such a result, a large regional Independent System Operator (ISO) with significantly increased wholesale purchases by incumbent utilities would first need to be accomplished. I put the likelihood of this at less than 50 percent in the aftermath of the California electricity crises.

The second factor that likely would have been behind such a forecast would have been a plan to grow electricity commodity trading and associated financial derivatives. The fallout from the recent Enron debacle now puts this potential source of revenue growth in doubt.

I understand that CEOs talk about growth strategies. They and their investor analyst audiences give more weight to the inherent strategic and business vision and less to actual growth projections. Recent events in California and at Enron demonstrate that while the vision may be strong, the growth projections are, at best, plans, not guarantees.

Q. AT PAGES 19-20 OF HER DIRECT TESIMONY, MS. DISMUKES ASSERTS THAT YOU CONTRADICT YOURSELF WHEN YOU STATE THAT THE COMPANIES' ESTIMATED SYNERGY SAVINGS ESTIMATE IS RELATIVELY CLOSE TO THE SYNERGY SAVINGS PREDICTED IN OTHER MERGERS. PLEASE RESPOND TO HER ASSERTIONS.

A. Ms. Dismukes is confusing and combining two separate issues. The fact that this is an extraordinary merger by the standards set by the FPSC is not related to whether the synergy savings estimates are reasonable in a relative comparison to past mergers. To be sure, the synergy savings will certainly play a part in establishing the factors the FPSC would look for in determining that a merger was extraordinary. However, the fact that FPC has estimated synergy savings that are similar to other merger savings estimated in mergers that have occurred in the past does not mean that this merger is not "extraordinary." There is no contradiction in finding that the synergy savings have been estimated in a reasonable and consistent manner (and are similar to the level of savings estimated in similar utility mergers) and this merger satisfies the FPSC's criteria for being extraordinary. Not every utility has merged. Self selection is not a cause to conclude that this merger is a normal or typical merger. Suppose that is true. The event itself (i.e., this transaction) has and will achieve extraordinary net benefits for Florida.

Further, there have been no other successfully completed mergers like this one in Florida. Thus, while the saving projected from this merger are in line with other mergers throughout the country, both the savings associated with this merger and the merger itself are extraordinary in Florida.

Q. AT PAGES 20-21 OF HER DIRECT TESTIMONY, MS. DISMUKES QUOTES STATEMENTS MADE BY MSSRS. KORPAN AND CAVANAUGH, IMPLYING THAT THE MERGER WAS UNDERTAKEN SOLELY FOR STRATEGIC REASONS, TO CREATE A REGIONAL POWERHOUSE ABLE TO RESPOND TO COMPETITIVE CHANGES IN THE ENERGY INDUSTRY. PLEASE RESPOND TO HER IMPLICATIONS.

A. Ms. Dismukes makes much out of the fact that when addressing shareholders, Mssrs. Korpan and Cavanaugh stressed the strategic benefits that would result from the merger and the long-term benefits to shareholders. I see nothing sinister or evil in this because their audiences were investors. Nowhere in the quotes selected by Ms. Dismukes does either Mr. Korpan or Mr. Cavanaugh imply that the merger will not benefit customers. Indeed, FPC had put forth a regulatory plan that will yield significant net savings to Florida's consumers.

It has also been my experience that when a utility is well run and has a clear strategic vision, both customers and shareholders benefit. The shareholder/customer relationship works best when it is based on mutual sharing. In other words, all stakeholders are much better off if neither side benefits at the expense of the other, and both sides benefit from their joint relationship. That is precisely what the FPC regulatory plan seeks to accomplish. Shareholders recover the costs of completing the merger to the extent that synergy savings are sufficient to cover the expense. Furthermore, FPC has strong incentives to beat this spread. Regardless, customers are guaranteed an immediate and recurring $5 million retail rate credit for 15 years. Because savings are greater than the amount of the transaction and transition costs, both sides are better off; a classic win-win situation based on "splitting the savings."

Q. AT PAGE 23 OF HER DIRECT TESTIMONY, MS. DISMUKES ASSERTS THAT $43.1 MILLION OF THE $175 MILLION IN PROJECTED SYNERGY SAVINGS ARE ATTRIBUTABLE TO PROGRESS ENERGY'S NONREGULATED AFFILIATES. PLEASE RESPOND TO HER ASSERTIONS.

A. It is not clear from Ms. Dismukes' testimony if she disputes or agrees with her own breakdown of the synergies attributable to Progress Energy's nonregulated operations. She is clear in her observation that FPC is getting the smallest share of synergies. However, she does not dispute Mr. Myers' testimony with respect to the way the synergy breakdown and allocation was developed. Further, Ms. Dismukes fails to recall that the percentage of the transaction costs that FPC seeks to recover from these savings is exactly equal to the percentage of synergies it expects to receive. In other words, if FPC is under represented on the savings side, it would similarly be under allocated on the transaction cost side. Ms. Dismukes does speculate that "it is possible that the premium paid for FPC's stock relates to the enhanced potential for profits from future unregulated operations." This is, to some extent, undoubtedly true. And it is also true that these same unregulated enterprises will be assigned the responsibility to recover 43.1% of the transaction costs.

Q. AT PAGES 24-25 OF HER DIRECT TESTOMONY, MS. DISMUKES STATES THAT IN ONLY ONE OF THE STATE ORDERS THAT YOU ATTACHED AS EXHIBIT CJC-2 DID THE COMMISSION PERMIT THE RECOVERY OF AN ACQUISITION PREMIUM. PLEASE RESPOND TO HER ASSERTION.

A. Ms. Dismukes is simply setting up a convenient straw person to knock down. Her entire discussion of acquisition premium recovery in other jurisdictions is misguided and irrelevant. First, I must point out that I offered Exhibit CJC-2 to show examples of states in which the respective state Commissions had followed a front-end loading transaction cost recovery principle in designing their regulatory plans to share merger savings. As can be seen from reviewing CJC-2, in most of these cases the Commission allowed the merging utility to keep a portion of (i.e., share) the merger savings to pay for the transaction costs associated with the merger. Thus, most of these regulatory commissions recognized the need to allow merging utilities the opportunity to recover their transaction costs in order to achieve customer benefits. These orders were certainly not offered as examples of the way in which various state commissions treated requests to include an acquisition premium in rate base. Again, I stress that an acquisition premium is sometimes defined as the difference between depreciated net book value and the purchase price (i.e., goodwill). This is not what FPC is seeking in this proceeding. Consequently, pointing to a series of Commission Orders from other states that mostly did not consider including an acquisition premium in rate base is simply not relevant. I conclude most merging utilities have not requested authority to add such premiums to their rate base on which they would be entitled to shareholder profit. Nevertheless, the regulatory commissions did approve plans in which synergy savings are shared between customers and shareholders in recognition that the latter group needs to recover their merger related costs, and in certain cases, their acquisition premium.

Q. AT PAGES 26-27 OF HER DIRECT TESTIMONY, MS. DISMUKES DISCUSSES THE KANSAS CORPORATION COMMISSION'S (KCC) DECISION IN THE FAILED WESTERN RESOURCES/KCP&L MERGER. SHE ASSERTS THAT THE KCC EMPHATICALLY DENIED RATE BASE TREATMENT OF THE REQUESTED ACQUISITION PREMIUM IN THAT CASE. DO YOU CONCUR WITH HER ASSESSMENT OF THAT ORDER?

A. No. I appeared in that proceeding as a witness sponsoring the Joint Applicant's regulatory plan and am very familiar with the case. Ms. Dismukes is accurate in reporting that the KCC did not allow rate base treatment of the acquisition premium paid in that case, which is as the KCC noted, the difference in the purchase price and the depreciated book value or goodwill. However, the KCC did order a four year rate freeze during which the companies would be allowed to keep all the merger savings (about $100 million per year) in order to "...permit the Joint Applicants the opportunity to recover a portion of the AP (acquisition premium) through retention of some of the savings that can be directly tied to the merger..."[1] Additionally, after the end of the four-year rate moratorium, the KCC ordered that the Joint Applicants be allowed to amortize 50% of the net merger savings over a 35 year time period. Thus, I find that, contrary to Ms. Dismukes assertions, the KCC did allow the Joint Applicants an opportunity to recover the acquisition premium, although it was not permitted rate base treatment. Thus, I find that the KCC Order in this case is not at all inconsistent with what FPC is requesting here. In fact, there are many common elements in both regulatory sharing plans.

Q. AT PAGE 27 OF HER DIRECT TESTIMONY, MS. DISMUKES QUOTES THE LOUISIANA PUBLIC SERVICE COMMISSION (LPSC) AS PROHIBITING ENTERGY FROM RECOVERING AN ACQUISITION

[1] 197 PUR 4th 175 (September 28, 1999).

PREMIUM FROM "RATEPAYERS NOW OR IN THE FUTURE." PLEASE COMMENT ON THE LPSC DECISION.

A. Ms. Dismukes has successfully extracted one sentence from a lengthy order, and in doing so misrepresents what that decision actually accomplished. First, the LPSC stated that it recognized that Entergy had not requested the ability to recover the acquisition premium. It is crucial to remember that the LPSC is here talking about recording the acquisition premium in rate base, analogous to goodwill. The LPSC specifically discussed that Entergy **was** seeking to recover "all or part of the premium it will pay for the stock through a mechanism for sharing the savings it expects to realize from the merger."[2] The LPSC had no problem with allowing Entergy to recover all or part of the acquisition premium through sharing merger savings. To effectuate this recovery, the LPSC instituted (1) a five-year rate ceiling based on GSU's current base rates; (2) a tracking mechanism to measure O&M savings; and (3) permitted the company to include 60 percent of the O&M savings actually achieved in any year as a **cost of service item**. The LPSC opined that this Order would "allow Entergy to recover all or part of the acquisition premium through a mechanism for sharing merger-related, non-fuel operation and maintenance cost savings." Clearly, the quote extracted by Ms. Dismukes references the LPSC's long-standing reluctance to put an acquisition premium in rate base. The LPSC had no problem whatsoever in approving a regulatory sharing plan that would allow an acquisition

[2] 196 PUR 4th 292 (May 3, 1993).

premium to be recovered through merger savings, a plan that is strikingly similar to FPC's proposed regulatory plan. In fact the LPSC stated that the approved regulatory plan would provide Entergy with "a reasonable opportunity to recover the premium included in their investment in GSU, without which there would be no merger savings."

Q. AT PAGES 27-28 OF HER DIRECT TESTIMONY, MS. DISMUKES DISCUSSES THE CONNECTICUT DEPARTMENT OF PUBLIC UTILITY CONTROL (CDPUC) DECISION IN THE NORTHEAST UTILITIES/CON ED MERGER. DO YOU CONCUR WITH HER DISCUSSION?

A. Only in part. I agree with her that the applicants never sought to include an acquisition premium in rate base. I agree with her that in extending a rate freeze through 2003, allowing a 50/50 sharing of earnings exceeding an authorized ROE, and allowing a 50/50 share of merger related costs, the CDPUC provided the applicants with an opportunity to recover at least a portion of its acquisition premium by sharing synergy savings between customers and ratepayers.

I disagree with Ms. Dismukes that this case in some way supports her position that FPC's proposed regulatory plan should not be approved. To the contrary, while not allowing an acquisition premium to be included in rate base (which is something that FPC is also not requesting), the CDPUC did provide the applicants with an opportunity to recover transaction costs from merger savings, which is what FPC is requesting here, with roughly the same projected sharing percentages.

Q. AT PAGE 28 OF HER DIRECT TESTIMONY, MS. DISMUKES CLAIMS THE PENSYLVANIA PUBLIC UTILITY COMMISSION (PPUC) DECISION IN THE GPU/FIRST ENERGY MERGER SUPPORTS HER POSITION. DO YOU AGREE WITH HER?

A. Again, I must emphasize two things. First, FPC is not seeking rate base treatment for an acquisition premium. Rather, it is seeking to have the opportunity to recover a part of its transaction costs, to be netted against projected merger savings. Second, the applicants in the GPU/FirstEnergy merger were likewise not seeking rate base treatment for their acquisition premium. That said, this case still does not provide her with support sufficient to even knock down the straw person she set up. While the PPUC did state that an acquisition premium would not be allowed in rate base, it did allow a six year rate cap extension and allowed transition costs to be amortized over that six year period. Thus, the Commission provided for and allowed recovery of the transaction costs and transition costs from merger savings, just like what FPC is requesting in this hearing.

Q. AT PAGES 28-29 OF HER DIRECT TESTIMONY, MS. DISMUKES CLAIMS THE NORTH CAROLINA UTILITY COMMISSION (NCUC) DECISION IN THE SCANA/PSNC MERGER SUPPORTS HER POSITION. DO YOU AGREE WITH HER?

A. Again, this is a case where the applicants were not even seeking to put an acquisition premium into rate base. The NCUC did state that an acquisition premium would not be included in customers' rates (i.e., included in rate base). However, in that case the NCUC did allow rates to be capped for a total of six years, which would allow the applicants to recover their transaction and transition costs ($495 million) from any merger savings that could be attained. Therefore, this case also supports FPC's proposed regulatory sharing plan. NCUC staff did acknowledge that acquisition premiums have "been allowed in a number of states to the extent that merger savings or other benefits are achieved to offset it."[3]

Q. AT PAGE 29 OF HER DIRECT TESTIMONY, MS. DISMUKES CLAIMS THE NORTH CAROLINA UTILITY COMMISSION (NCUC) DECISION IN THE MERGER BETWEEN FPC AND CPL SUPPORTS HER POSITION. DO YOU AGREE WITH HER?

A. No. In that case, the parties entered into a stipulated rate settlement. It was not an order after a contested rate case. Under the settlement, CPL essentially maintained its pre-merger rate levels, phasing in a $6 million rate decrease over three years[4]. Thus, the settlement in the NCUC case achieved essentially what FPC is requesting in this hearing.

Q. AT PAGES 29-30 OF HER DIRECT TESTIMONY, MS. DISMUKES GRUDGINGLY ADMITS THAT THE NEVADA PUBLIC UTILITIES COMMISSION (NPUC) ALLOWED AN ACQUISITION PREMIUM TO BE INCLUDED IN RATE BASE IN THE SIERRA PACIFIC/NEVADA POWER MERGER. PLEASE COMMENT ON THAT DECISION.

[3] 198 PUR 4^{th} 158 (December 7, 1999).

[4] The phased-in decrease resulted in a $3 million rate decrease in year one, $4.5 million in year two, and $6 million in year 3.

A. While FPC is not requesting that an acquisition premium be included in rate base, only that it be allowed the opportunity to recover transaction and transition costs from merger savings, the NPUC's decision is illuminating. In that decision, the NPUC instituted a three year rate freeze, during which time the applicants would keep all the savings from the merger and pay for transaction, transition and acquisition premium costs. At the end of this three year period, the acquisition premium was put into rate base and amortized over 40 years. The one caveat was that merger savings had to be demonstrated to be sufficient to cover the amortization costs, thus making the plan risk free for customers. This plan has elements similar to what FPC is proposing here, except that FPC's customers have more regulatory protection because the transaction costs will not be placed into rate base and the plan is 15 years, not 40 years, and customers are guaranteed $5 million per year in future retail rate credits.

Q. AT PAGES 30-33 OF HER DIRECT TESTIMONY, MS. DISMUKES CITES SEVERAL FPSC ORDERS FOR THE PROPOSITION THAT THE FPSC DOES NOT ALLOW TRANSITION COST RECOVERY. PLEASE RESPOND TO HER ASSERTION.

A. Again, I must stress that FPC is seeking the opportunity to recover its transition costs from the savings that will be enabled through this merger. The customers will not bear directly these costs through rate increases. In fact, the regulatory plan proposed by FPC accomplishes just the opposite, a guaranteed $5 million rate credit.

Q. AT PAGE 34 OF HER DIRECT TESTIMONY, MS. DISMUKES ASSERTS THAT "FPC'S PROPSED TREATMENT OF THE ACQUISITION PREMIUM AND TRANSITION COSTS AND RATE BASE TREATMENT ...IS A DISTINCTION WITHOUT A DIFFERENCE." DO YOU AGREE WITH HER ASSERTION?

A. No. Putting an acquisition premium in rate base would serve to reestablish a company's book value for ratemaking purposes. In contrast, FPC's proposed regulatory plan would not increase rate base. Placing an acquisition premium in rate base would likely increase future rates. Here, FPC's proposed regulatory treatment results in a guaranteed annual $5 million retail rate credit, with the possibility of even greater rate decreases if FPC achieves greater than projected savings. Here, FPC's customers' rates will not increase due to allowing FPC to recover its fractional net share of the transaction costs. Regulated rates will increase or decrease for various reasons. The merger sharing plan is not and will not be a factor that increases retail rates now, or in the future.

Ms. Dismukes' assertion that there is no distinction because "rates would increase due to the recovery from ratepayers of these costs" is also not true. If an acquisition premium is put into rate base, without question customers will be the direct source of the recovery of and on the amount put into rate base. However, under FPC's regulatory plan, FPC will recover its allocated share of the transaction and transition costs only to the extent that savings are sufficient. Further, under FPC's proposed regulatory plan, customers will receive significant net benefits, more than half of which are guaranteed with the very real possibility of even greater savings in the future. In my experience, this is a very good regulatory "bet" to make.

Q. DO YOU AGREE WITH MS. DERONNE'S CONCLUSIONS, AT PAGES 6-8 OF HER DIRECT TESTIMONY, RELATED TO DISTINGUISHING BETWEEN "SURVEILLANCE" REPORTING AND "RATE SETTING?"

A. No. These are effectively identical in their effect on cost of service determination under utility regulation

Q. IS THERE ANY SIGNIFICANCE TO MS. DERONNE'S FINDING, AT PAGES 6-7 OF HER DIRECT TESTIMONY, THAT "A SIGNIFICANT PORTION OF THESE PROJECTED COST REDUCTIONS WERE ALREADY INCORPORATED IN THE 2001 BUDGET AND BROUGHT FORWARD INTO THE 2002 BUDGET USED IN THE FILING?"

A. No. This merger took place in November 2000. Therefore, I would fully expect that merger related cost savings and/or other costs necessary to provide quality electricity service would combine to determine the projected 2002 budget. Ms. Deronne's attempt to find something unreasonable with any of this is disingenuous.

Q. AT PAGE 7 OF HER DIRECT TESTIMONY, MS. DERONNE ASSERTS THAT FPC'S REGULATORY PLAN WOULD ALLOW IT TO RECOVER

$58.7 MILLION THAT IT DOES NOT PLAN TO INCUR. DO YOU CONCUR WITH HER CONCLUSION?

A. No. The adjustment to which Ms. Deronne refers is simply designed to net the cost of obtaining the merger savings and benefits against the savings in order to obtain true net synergies. The savings projected, at a minimum, exactly offset this adjustment. If any business saves money, its costs are reduced, period. There is no ignoring the fact that if FPC saves about $50 million, its customers will be better off, even if they pay about $40 million to achieve this saving.

Q. AT PAGE 8 OF HER DIRECT TESTIMONY, MS. DERONNE SUGGESTS THAT IN EXHANGE FOR RECOVERING $58.7 MILLION IN COSTS, FPC IS GIVING A $5 MILLION RATE CREDIT. HOW DO YOU RESPOND TO HER STATEMENT?

A. As I explained above, the $58.7 million adjustment is simply an accounting projection of the projected savings FPC expects to be realized as a result of this merger. The implication that the company will charge customers $58.7 million in rates for costs that will not be incurred in exchange for a $5 million rate credit is an inaccurate portrayal of FPC's regulatory plan. What is true is that the acquisition adjustment will be paid for through the projected savings, and that the net synergy savings that will be identifiable through this adjustment methodology will be shared about equally with the customers. Further, customers are guaranteed the first $5 million in savings through the annual retail rate credit and FPC's proposed incentive regulation to encourage even greater savings for customers.

Ms. Deronne attempts to suggest that reducing costs by about $60 million per year is a trade-off for FPC's guaranteed annual retail rate credit of $5 million. Both are important aspects of consumer benefits. There is simply no "tradeoff" here and like it or not, the tax collectors will take their bite.

Q. AT PAGE 12 OF HER DIRECT TESTIMONY, MS. DERONNE ARGUES THAT RATEPAYERS SHOULD NOT PAY CHANGE IN CONTROL PAYMENTS. DO YOU AGREE WITH HER?

A. It is beyond dispute that when there are changes in control such as occur during a merger, there will be change in control payments made to executives in the companies whose services are no longer required. There will also be severance packages awarded to other employees whose services are no longer required I have found it to be an almost universal practice for valuable and key executives to have in place change in control provisions in their employment contracts that pay them multiples of their annual salaries if they lose their positions through a merger. Without such provisions, executives would either receive higher current compensation or they would be loath to explore merger opportunities that, despite their impressive net benefits for consumers, might cause these executives to lose their position. Consequently, with such provisions in place, key executives are encouraged to seek out and complete mergers that will benefit both shareholders and customers. Consequently, I disagree with Ms. Deronne that these transition expenses should not be recovered by netting them against the projected gross synergies of this merger. To the contrary, these transition costs are reasonable and necessary costs, without which this merger and other beneficial mergers would likely not occur.

Further, these costs are a relatively minor part of a transaction that is likely to result in net retail benefits. This is a great deal for consumers. It would be unreasonable to eliminate one component of the expenses that make this possible.

As I stated in my Direct Testimony, if the FPSC does not permit companies to recover the costs expended to bring about beneficial mergers, utilities in Florida will be disinclined to pursue such beneficial mergers. If such a chilling effect occurs, customers will have less opportunity to share in merger savings from future mergers.

Q. ON PAGE 14 OF HER DIRECT TESTIMONY, MS. DERONNE ASSERTS THAT FPC'S REGULATORY PLAN WOULD RESULT IN FPC RECEIVING BOTH A RETURN OF AND ON THE TRANSACTION EXPENSE. PLEASE COMMENT ON HER ASSERTION.

A. Ms. Deronne is correct to the extent that the annual transaction cost recovery offset to synergy savings is collected over 15 years and carries an after-tax interest rate of 4.607 percent. This interest rate is not, however, a rate of return. Instead, this in an actual cost of debt based on

Progress Energy's merger related debt, which has been financed at about a 7.5 percent interest rate. Again, FPC's regulatory plan seeks only to recover the costs that were required to accomplish this merger, which results in about a 50/50 sharing formula.

Q. IS FPC, AS MS. DERONNE SUGGESTS AT PAGE 15 OF HER DIRECT TESTIMONY, SEEKING TO RECOVER A "PORTION OF ITS GOODWILL?"

A. No. Progress Energy needs to book goodwill at the parent company level. FPC is a subsidiary that will make cash payments to its parent. Ms. Deronne is unreasonably attempting to take the costs assigned to FPC that are associated with this transaction, while ignoring the higher benefits, and turn this net consumer gain into a partial goodwill payment by FPC. This reasoning is without merit and the FPSC should give it short shrift.

Q. AT PAGES 15-16 OF HER DIRECT TESTIMONY, MS. DERONNE ARGUES THAT THE TRANSACTION COSTS WILL BE INCLUDED IN BASE RATES. DO YOU AGREE WITH HER?

A. No. First, I would like to clarify a quote that Ms. Deronne attributed to me. She stated that I said "Importantly, FPC is not proposing an acquisition adjustment be included in base rates...". I actually testified that "FPC is not proposing an acquisition adjustment be included in rate base..." There is a distinction. Ms. Deronne herself testified as to the distinction in what FPC is proposing to do through its regulatory plan and including goodwill or an acquisition premium in rate base, when she acknowledged that the 4.607 pre-tax interest rate applied to the transaction costs are lower than the overall requested rate of return. Rate base treatment would receive the higher FPC cost of capital. In addition, I have explained that FPC proposes a mechanism that will reduce retail rates below what they likely would have been "but for" this merger. Further, the full context of the FPC regulatory plan is significantly different than what would occur with rate base treatment. For example, FPC will recover the transaction costs netted against the gross synergy savings. Net utility savings will then be given to customers through the immediate and guaranteed annual $5 million rate credit and through additional savings for regulatory cost of service and surveillance regulatory purposes, and through the earnings sharing mechanism (ESM) I described in my Direct Testimony.

Q. DOES FPC PROPOSE, AS MS. DERONNE SUGGESTS AT PAGES 16-17 OF HER DIRECT TESTIMONY, THAT RETAIL CONSUMERS SHOULD PAY FOR THE SAME UTILITY INVESTMENTS MORE THAN ONCE?

A. No. FPC makes no adjustment or increase in rate base. Further, the regulatory plan provides retail cost of service reductions and provides a guaranteed annual $5 million revenue credit for consumers.

Ms. Deronne either does not understand FPC's proposal or she intentionally mischaracterizes the proposal. Again, Ms. Deronne is confusing FPC's regulatory plan with including goodwill in rate base. FPC does not propose to mark up its rate base and create a new book value equal to the price paid to acquire FPC. Quite the contrary, FPC's regulatory plan will depend on achieving gross synergies to pay (i.e., to net against) the transaction costs associated with this merger. Ms. Deronne's concerns and comments are misguided. FPC's regulatory plan will not, as Ms. Deronne asserts, adversely affect the rates charged to FPC's customers. Ms. Deronne's fears are simply misplaced. This merger will reduce retail prices relative to FPC standing alone.

Q. AT PAGE 17 OF HER DIRECT TESTIMONY, MS. DERONNE ALLEGES THAT THE FPSC WILL SEND A "DANGEROUS SIGNAL TO OTHER ENTITIES SEEKING TO ACQUIRE UTILITIES IN FLORIDA." DO YOU AGREE WITH HER CONCERN?

A. No. Ms. Deronne's fear comes from misunderstanding FPC's proposed regulatory plan. As I have previously stated, under FPC's regulatory plan, recovery of the transaction and transition costs will be netted against merger savings. Customers will not see a rate increase to cover merger costs. To the contrary, customers are guaranteed an immediate annual $5 million retail rate credit and retail rates will be less than FPC standing alone. Furthermore, as I have also said, if the company is not permitted an opportunity to recover its transaction costs, there will be a chilling effect on future beneficial mergers in Florida, an unhappy circumstance that will deprive consumers in Florida the significant net benefits associated with such mergers.

Q. AT PAGE 18 OF HER DIRECT TESTIMONY, MS. DERONNE ASSERTS THAT THE FPSC HAS ALLOWED AN ACQUSITION PREMIUM IN ONLY RARE CASES, MOST OFTEN WHEN THE ACQUIRED UTILITY IS A TROUBLED UTILITY. PLEASE COMMENT ON HER TESTIMONY.

A. To a large extent, I agree with her that the FPSC typically does not allow an acquiring utility to include an acquisition premium in rate base. However, I also explained above that Ms. Dismukes cited one recent FPSC decision where the dissenting Commissioner suggested that this policy was being changed by the Commission's Order in that case. Regardless, the issue in simply not relevant here because FPC does not propose to include an acquisition premium in rate base. And, as I have testified to at length both in my Direct Testimony and here, this merger meets the FPSC criteria for an extraordinary merger, justifying allowing an acquisition premium is rate base. However, as I have stated, FPC is not asking for such regulatory treatment. It is simply asking for approval of a regulatory plan that would share the projected synergies by netting its transaction and transition costs against gross merger savings, while guaranteeing an annual $5 million retail rate credit, and providing the opportunity for additional retail rate relief and greater future savings.

Q. AT PAGE 19 OF HER DIRECT TESTIMONY, MS. DERONNE SUGGESTS THAT YOU CONTRADICT YOURSELF BY SAYING THAT THE MERGER SAVINGS ESTIMATED HERE ARE WITHIN THE NORM OF OTHER MERGERS, YET THAT THE MERGER OFFERS

EXTRAORDINARY BENEFITS TO CUSTOMERS. PLEASE RESPOND TO HER CRITICISM.

A. As did Ms. Dismukes before her, Ms. Deronne is mixing two distinct concepts. It is true that the relative merger savings estimated for this merger fall within the norm of merger savings estimated in other mergers. This is a good thing. It means that the company has used reasonable assumptions in estimating merger savings, not purposely under or over-estimating potential savings. Further, whether within the expected range or not, annual savings of $175 million are certainly extraordinary by any measure. The same conclusion is applicable for FPC's apportionment, which also exceeds its associated cost recovery.

The key point that both Ms. Deronne and Ms. Dismukes have missed is that there are also nonquantifiable benefits for consumers, such as increased service levels and increased choices in services that will emerge from this merger. These benefits would increase the savings to cost ratio that I discussed earlier in this Rebuttal Testimony. These, in addition to the five factors that qualify this merger as extraordinary under FPSC guidelines, mean that this is, indeed, an extraordinary merger.

PUBLIX WITNESSES

Q. AT PAGES 4-5 OF HER DIRECT TESTIMONY, MS. BROWN CHARACTERIZES YOUR AMORTIZATION OF TRANSACTION COSTS AS EFFECTIVELY A RATE BASE RECOVERY MECHANISM. DO YOU AGREE WITH HER?

A. No. As I explained, the 4.607 percent interest is the actual cost of debt related to this transaction. There is no return for shareholders here (i.e., no increase in net income).

More to the point, amortizing transaction costs simply annualizes these costs in order to match them against the $58.7 million projected annual cost of service reductions. FPC has done this in order to share benefits and costs, pay associated taxes, and guarantee retail rate relief for fifteen years. None of this is the equivalent of or similar to "rate base" recovery.

Q. AT PAGE 6, FOOTNOTE 1 OF HER DIRECT TESTIMONY, MS. BROWN STATES THAT YOU USE A TAX RATE OF 38.575% TO CALCULATE THE AFTER-TAX SAVINGS BUT USE A TAX RATE OF 38.699% TO CALCULATE THE NET PRE-TAX SYNERGIES. PLEASE EXPLAIN THE DIFFERENCE.

A. The correct tax rate to use is 38.575%. The grossed up pre-tax difference should be $9.851 million, not the $9.871 million shown in Table 1 of my prefiled Direct Testimony at page 11.

Q. AT PAGE 6 OF HER DIRECT TESTIMONY, MS. BROWN ASSERTS THAT FPC'S REGULATORY PROPOSAL DOES INCREASE RATES PAID BY CUSTOMERS. DO YOU AGREE?

A. No. As I explained in my Direct Testimony and earlier in my Rebuttal Testimony, FPC has included the $58.7 million to represent the projected synergy savings that will be achieved in Florida through this merger. In this way, FPC will net the transaction costs against the projected synergy savings. Customers' rates will not increase as a result of this methodology because the increased cost is more than offset by the savings. Ms. Brown is not correct in her allegation that customers' rates will increase under FPC's proposal as a result of this merger. As I stated earlier, FPC customers will enjoy an immediate and guaranteed $5 million annual rate credit under the regulatory plan proposed by FPC. Additionally, the accounting and incentives provided under the regulatory plan will mean and encourage FPC to gain even greater synergy savings, which will provide even more rate reduction savings to the customers. Ms. Brown seems to ignore the fact that this proceeding is a "rate case" and other cost of service changes that would have occurred without this merger are also "in play" in this proceeding.

Q. AT PAGE 6 OF HER DIRECT TESTIMONY, MS. BROWN NOTES THAT YOU ARE PROPOSING THAT FPC EARN A 7.5% RETURN OF THE UNAMORTIZED BALANCE OF THE TRANSACTION COSTS. PLEASE EXPLAIN THE BASIS FOR THIS RETURN.

A. As I explained earlier in this Rebuttal Testimony, one purpose of FPC's regulatory plan is to provide the company with the opportunity to recover the costs it expended in completing the merger. The transaction costs are a portion of those costs. Those transaction costs were borrowed. Therefore, interest expense accrues on the borrowed funds. By allowing FPC to recover 7.5% interest on the transaction costs (Progress Energy's actual cost of the money), the company will be provided the opportunity to recover the amount it actually expended to bring about the merger's successful completion. And, as pointed out by OPC witnesses, the interest charge is actually lower than FPC's requested cost of capital. Regardless, these cost estimates are used to net against projected synergy savings and not to increase rate base.

Q. AT PAGE 7 OF HER DIRECT TESTIMONY, MS. BROWN EXPRESSES DISBELIEF AT YOUR NOTION THAT ALLOWING UTILITIES TO RECOVER THEIR TRANSACTION AND TRANSITION COSTS IS NECESSARY TO ENCOURAGE FUTURE MERGERS. PLEASE EXPLAIN YOUR POSITION.

A. The basis for Ms. Brown's disbelief seems to stem from the fact that Progress Energy should have petitioned the Commission prior to the merger to assure that the costs would be recoverable. There is, however, a flaw in her logic. If the Commission chooses to disallow the transaction and transition costs reasonably incurred in this merger, it will establish a chilling precedent for all other utilities that are or may be considering future mergers with Florida utilities. Such an inhospitable regulatory climate would cause other utilities to think twice about merging with a Florida utility. Petitioning the Commission formally prior to completing this merger would have injected an unnecessary procedural step that could have increased transaction costs. Such action was not required. However, this in no way diminishes my opinion that disallowing transaction and transition costs in this case will have a chilling effect on future mergers, to the detriment of customers in Florida who would be denied the type of net benefits found in this merger in any future mergers in Florida.

Q. AT PAGE 7 OF HER DIRECT TESTIMONY, MS. BROWN ASSERTS THAT "CP&L OBVIOUSLY ANTICIPATED MERGER BENEFITS THAT WOULD ACCRUE TO SHAREHOLDERS." PLEASE COMMENT ON HER OBSERVATION.

A. Her statement is, quite obviously, true. No Board of Directors would voluntarily undertake actions that would harm shareholders. Utility mergers are, nevertheless, undertaken to benefit both shareholders and customers. As I explained before, there is a mutual relationship between shareholders and customers that works best for both stakeholders when it is marked by a common purpose and sharing plan as found here. In my opinion, regulation should emulate a competitive market recognizing this mutual relationship and attempting to structure results that benefit both stakeholder groups. This is precisely the sharing result that the proposed FPC regulatory plan would accomplish.

Q. AT PAGE 14 OF HER DIRECT TESTIMONY, MS. BROWN ASSERTS THAT THE METHODOLOGY YOU EMPLOYED TO ALLOCATE SAVINGS TO FPC DOES NOT RECOGNIZE THE VALUE PAID BY CPL FOR ACQUIRING UNREGULATED SUBSIDIARIES. DO YOU AGREE WITH HER

A. No. As I testified in my deposition, I am satisfied with the company breakdown and allocation of merger savings to FPC. The amount that is allocated to unregulated subsidiaries is relevant to the extent that transaction and transition cost recovery responsibility is also allocated based on the same percentage allocation of merger savings. The allocation of the merger savings has no direct relation to the value paid for the unregulated subsidiaries and is not relevant to the issues before the Commission in this hearing.

Q. AT PAGE 8 OF HER DIRECT TESTIMONY, MS. BROWN ASSERTS THAT "ISOLATING THE TRUE MERGER RELATED SAVINGS FROM SAVINGS THAT COULD HAVE BEEN ACHIEVABLE EVEN WITHOUT THE MERGER IS AN INACCURATE EXERCISE." DO YOU AGREE WITH HER?

A. I cannot quibble with her that the exercise lacks surgical precision. This is especially true as time passes. That is why the proposed FPC regulatory plan does not suggest or require that merger savings be precisely tracked and allocated. Rather, an informed and educated estimate has been made and a regulatory plan has been proposed to fairly allocate the net savings to customers and shareholders, with the additional assurance that customers will receive a guaranteed $5 million annual retail rate credit. Further, the ESM that I proposed will provide greater incentive to the company to exceed estimated savings, which will also increase the customer benefits flowing from this merger.

Q. **AT PAGE 8 OF HER DIRECT TESTIMONY, MS. BROWN CLAIMS THAT "BASED ON THE CHANGES IN FPC'S OPERATING AND MAINTENANCE COSTS SINCE THE MERGER, THE CLAIMED MERGER SAVINGS HAVE BEEN MORE THAN OFFSET BY INCREASES IN OTHER COSTS." PLEASE RESPOND TO HER COMMENT.**

A. Two points are relevant. First, any increased costs that result in offsetting merger savings will not affect the guaranteed annual $5 million rate credit to customers. Therefore, whether or not there are any net merger related savings, customers are better off. Second, it is telling that Ms. Brown does not attribute the increased O&M costs to the merger itself. Presumably, these were costs that would have necessarily been incurred by FPC standing alone (i.e., if the merger had not been completed). Consequently, but for the merger, FPC customers would have likely seen a rate increase due to these specific increased costs. However, with the merger, and under FPC's proposed regulatory plan, customers will see an immediate and guaranteed $5 million annual rate credit for fifteen years along with projected additional savings <u>which exceed</u> the associated transaction and transition cost of this merger by nearly $5 million, plus incentives to exceed this amount.

Q. **AT PAGES 8-9 OF HER DIRECT TESTIMONY, MS. BROWN DISCUSSES CPL'S PUBLIC STATEMENTS WITH RESPECT TO THE**

DRIVING FORCES BEHIND THE MERGER. PLEASE COMMENT ON HER STATEMENTS.

A. The reasons provided publicly and cited by Ms. Brown are most telling. They include (1) increasing customer choices by offering a broad variety of low-cost, quality energy-related services; (2) greater cost efficiencies and lower unit costs; and (3) lower cost structure for the regulated utility business. These are all things that benefit FPC's customers. The fact that the merger will strengthen the company's competitive position in increasingly competitive markets also benefits customers, by offering the promise of even lower prices in the future and more retail customer options and choices.

Q. AT PAGE 9 OF HER DIRECT TESTIMONY, MS. BROWN STATES THAT A FINANCE COMMITTEE PRESENTATION INDICATED THAT THE MERGER WAS ANTICIPATED TO BE ACCRETIVE IN THE FIRST FULL YEAR AFTER CLOSING. IS THIS RELEVANT?

A. Certainly. It seems that Ms. Brown is faulting the company for putting together a deal that improves the company's financial position. However, it is beneficial for customers when the utility and its parent are financially healthy. Healthy companies have lower risk and will qualify for stronger credit ratings, which should result in reduced capital costs. Larger companies also attract other investment opportunities. These are some of the stated benefits that will result from this merger. Ms. Brown implies that it is bad for consumers if the merger is accretive. This is wrong. Just the opposite is true.

Q. AT PAGES 9-10 OF HER DIRECT TESTIMONY, MS. BROWN QUOTES PUBLIC STATEMENTS MADE BY THE COMPANY HIGHLIGHTING COMPANY PLANS THAT EMPHASIZE ITS NON-UTILITY BUSINESS. IS THIS RELEVANT?

A. No. This hearing involves the utility portion of the merged company. The non-regulated businesses will have no adverse effect on customers' prices in Florida. As the company stated, these plans are intended to help the company's competitive position. This is a positive thing, not a negative as Ms. Brown implies.

Q. AT PAGES 11-13 OF HER DIRECT TESTIMONY, MS. BROWN DISCUSSES THE COMPANY'S GOALS TO ENHANCE ITS COMPETITIVE POSITION AND PARTICIPATE MORE ACTIVELY IN THE GENERATION MARKET. PLEASE DISCUSS HER ASSERTION THAT THE FPSC SHOULD TAKE INTO ACCOUNT THE BENEFITS THAT THE COMPANY WILL GAIN FROM THESE ACTIVITIES WHEN IT CONSIDERS THE REGULATORY TREATMENT OF THE TRANSACTION AND TRANSITION COSTS.

A. Ms. Brown mostly has it right. One reason for this merger is to allow the companies to position themselves to be a strong regional player in an increasingly competitive market. Part of this will occur through wholesale power marketing functions conducted by non-regulated Progress Energy subsidiaries. As recognized by Ms. Brown, FPC will also be able to make wholesale market sales. This practice will generate an estimated $1 million in retail customer value and lower retail prices. However, the unregulated power marketing activities of other Progress Energy companies are beyond the FPSC's jurisdiction and have nothing to do with FPC's proposed regulatory plan. That plan does not seek to recover anything other than FPC's allocated share of the transaction and transition costs. Ms. Brown would have the FPSC look to benefits that accrue to non-regulated portions of Progress Energy to offset the FPC share transactions and transition costs. However, she fails to note that these same non-regulated businesses (and CPL) have already been assigned responsibility for almost 70 percent of the transaction costs associated with the merger. Ms. Brown's proposal to consider the merger benefits associated with these other companies overlooks this fact.

Q. AT PAGE 11 OF HER DIRECT TESTIMONY, MS. BROWN ARGUES THAT THE MERGER'S COST SAVINGS GOAL WERE NOT DESIGNED SOLELY TO PROVIDE BENEFITS TO THE CUSTOMERS, BUT WERE DESIGNED ALSO TO PLACE CPL AND FPC IN A BETTER COMPETITIVE POSITION ONCE DEREGULATION OCCURS. DO YOU AGREE WITH HER?

A. I agree that there are many factors that make this a good merger, one that will benefit customers and shareholders alike. I am glad to see that Ms. Brown apparently recognizes the benefits to customers. However, given the state of deregulation in the industry, I think that it is very uncertain when, or even if, deregulation will actually occur at the retail level. Certainly, the California experience has put a damper on retail deregulation initiatives across the country. Furthermore, deregulation is not a precise concept. Most now realize that the "devil is in the details" of any deregulation transition plan.

Q. AT PAGE 13 OF HER DIRECT TESTIONY, MS. BROWN STATES THAT THE EXECUTIVE SEVERANCE PAYMENTS WERE NOT REASONABLE. DO YOU AGREE?

A. No. It is customary for valuable and key executives to have in place change in control provisions in their contracts that pay them multiples of their annual salaries if they lose their positions through a merger. Without such provisions, executives would demand higher current compensation and would be loath to explore merger opportunities that might cause them to lose their position. Consequently, with such provisions in place, key executives are encouraged to seek out and complete mergers that will benefit shareholders and customers. Consequently, I disagree with Ms. Brown that these transition expenses are unreasonable. To the contrary, these are reasonable and necessary costs, without which this merger and other beneficial mergers would likely not occur.

Q. AT PAGES 13-14 OF HER DIRECT TESTIMONY, MS. BROWN ARGUES THAT THE ALLOCATION OF MERGER SYNERGIES SHOULD REFLECT THAT ABOUT $31.5 MILLION OF THE MERGER

RELATED GENERATION SAVINGS ACCRUE TO SHAREHOLDERS. DO YOU CONCUR WITH HER STATEMENT?

A. No. First, the $31.5 million in savings that Ms. Brown asserts accrues to shareholders reflect the fact that income taxes capture 38.575% of gross synergy. Second, these after-tax cost saving synergies are being used to pay the transaction and transition costs associated with the merger. These are costs that have been incurred. The key to understanding FPC's proposed regulatory plan is to focus on the net synergy savings, those savings that remain after paying all the costs necessary to secure the savings. FPC's customers are guaranteed an annual $5 million rate credit, and have additional opportunities to receive even greater savings under the ESM that I recommended in my Direct Testimony.

Q. **AT PAGE 14 OF HER DIRECT TESTIMONY, MS. BROWN ALSO SUGGESTS THAT GREATER REVENUE SYNERGIES ARE SUPPORTED BY THE PRODUCTION FUNCTION AND THAT ADDITIONAL TRANSACTION AND TRANSITION COSTS SHOULD BE ALLOCATED TO THE SHAREHOLDERS TO RECOGNIZE THIS SUPPORT. SHE FURTHER ASSERTS THAT SHARED SERVICES SUPPORTS THE PRODUCTION FUNCTION, MEANING THAT ADDITIONAL TRANSACTION AND TRANSITION COSTS SHOULD BE ASSIGNED TO THIS FUNCTION. PLEASE COMMENT.**

A. I disagree with Ms. Brown. FPC personnel have gone to great lengths to fairly allocate the synergies to the business units where the savings will occur. I am satisfied that this has been done accurately and appropriately. Consequently, the allocation of transaction and transition costs that follow from the synergy allocation is reasonable. No further adjustments are warranted.

Q. AT PAGE 14 OF HER DIRECT TESTIMONY, MS. BROWN IMPLIES THAT A DETAILED BREAKDOWN OF SYNERGIES ATTRIBUTABLE TO FLORIDA PROGRESS' UNREGULATED BUSINESSES SHOULD BE COMPLETED. DO YOU THINK THAT THIS IS NECESSARY?

A. No. As I explained above, I am satisfied that the synergy savings attributed to FPC is appropriate. Consequently, it is not relevant how the remaining synergies are allocated between CPL and unregulated enterprises, including Electric Fuels or Progress Telecomm.

Q. AT PAGES 15-16 OF HER DIRECT TESTIMONY, MS. BROWN SUGGESTS THAT THE TRANSACTION AND TRANSITION COSTS BE ALLOCATED BETWEEN THE UNREGULATED AND REGULATED PORTIONS OF FLORIDA PROGRESS BASED ON THE SALOMON SMITH BARNEY ANALYSIS OF THE VALUE OF THE VARIOUS PARTS OF FLORIDA PROGRESS. DO YOU AGREE WITH HER?

A. No. As I stated above, I find that the way in which FPC allocated synergies and transaction and transition costs to be appropriate. Ms. Brown's approach would assign 30% of the transaction and transition costs to the unregulated businesses and then allocate the remainder between FPC and CPL based on the each utility's respective share of the synergy savings. I fail to see the logic in assigning transaction costs to unregulated business units based on a financial value of respective worth and then assigning cost responsibility to regulated units based on the their respective shares of synergy savings. FPC's approach is both symmetric and logical. Consequently, I see no reason to change FPC's proposed regulatory plan based on one financial analyst's breakdown developed in a different context.

Q. AT PAGE 25 OF HER TESTIMONY, MS. BROWN DETAILS HER RECOMMENDED ADJUSTMENTS TO THE TRANSACTION AND TRANSITION COSTS. PLEASE COMMENT.

A. Her first adjustment is to amortize the transition costs over 20 years rather than 15 years as the company has proposed. I chose 15 years to be consistent with what I propose to use for transaction cost recovery that is based on the 1993 revisions in the Federal Tax Act for amortizing premiums paid over book value for assets. I continue to think that this is appropriate.

Ms. Brown's second adjustment is related to her allocation between regulated and unregulated businesses that I discussed above. Although she never explains how she determined this percentage, Ms. Brown would assign 30% of the transaction cost to the unregulated businesses and then, using the savings breakdown supplied by FPC, allocate 30.9% of the remaining 70% to FPC. This is not reasonable because the 30.9% is based on an allocation that includes a projection for unregulated synergies. Therefore, Ms. Brown is double counting or double allocating the non-regulatory percentage.

Ms. Brown's two-step process reduces the allocated portion of transaction and transition costs to FPC to about $200 million from the $285 million that FPC derived by simply applying the 30.9% allocation factor based on synergy shares to the $924 million transaction price. As I stated above, there is no logical reason to "double" the non-regulated piece using Ms. Brown's tortured two-step process. I find it more equitable to assign cost responsibility based on savings.

Ms. Brown's third adjustment is to amortize the transactions costs over 40 years rather than the 15 years I suggested. While 40 years might be an appropriate depreciation schedule for a base-load power plant, I find that it is too long for recovering transaction costs associated with a merger.

Q. AT PAGES 18-19 OF HIS DIRECT TESTIMONY, MR. KURY CRITICIZED YOUR ESM PLAN. PLEASE RESPOND TO HIS CRITICISM.

A. Mr. Kury's criticism seems to be centered on his concern that the company's return on equity "may increase for many reasons, many out of its control." He seems mostly concerned with the earnings bands that are featured in my ESM because they "assign a majority of the benefits of an increased return on equity to the Company." I fear that Mr. Kury misunderstands my ESM proposal. The bands contained within my ESM mark it as a progressive ESM, where customers gain the greater share of excess earnings when the easier to achieve savings are realized. The company receives a progressively greater share of the harder to achieve savings, encouraging the company to go the extra mile to maximize savings. Further, the ESM that I designed insures that customers enjoy a larger portion of the most easily attained savings now and, to the extent the company can exceed projections, allows consumers to enjoy additional current and higher future retail rate reductions than they would otherwise. Mr. Kury does not explain how he thinks a more traditional ESM would eliminate the "problems" he perceives or would offer customers any greater benefits.

Q. DO YOU SHARE MR. KURY'S CONCERN THAT THE ESM CAN BE AFFECTED BY NON-MERGER FACTORS SUCH AS WEATHER, LOAD SHIFTING, ETC.?

A. No. The ESM provides incentives to achieve all types of consumer benefits and cost reductions. This proposal is not simply a merger-related regulatory proposal. As FPC expands its efforts consumers will receive additional benefits. Mr. Kury's concerns are misplaced.

Q. WHAT DOES MR. KURY RECOMMEND?

A. Mr. Kury, at page 19 of his Direct Testimony, recommends that earnings over the allowed ROE be shared equally between customers and shareholders. This is effectively the same sharing that FPC proposes for its net synergy sharing between customers (in the form of projected cost of service reductions) and shareholders (in the form of transaction and transition cost recovery). Mr. Kury further recommends that the company's portion of the shared earnings be used to accelerate recovery of the Transition and Transaction Costs associated with the merger. As I discussed at length in my Direct Testimony, a progressive ESM offers greater incentives to the company to exceed projections. Thus, the FPC proposal provides customers with greater opportunities for future retail rate reductions than does the more simplistic ESM offered by Mr. Kury. Furthermore, FPC's plan reflects the specific tax treatment of the retail sharing of synergy and merger cost recovery.

Further, I disagree with his suggestion that earnings under the ESM be earmarked for any particular purpose. To do so would provide a disincentive for the company. This is the antithesis of how a well designed ESM would work. I find Mr. Kury's recommendations to be unreasonable and unnecessary.

FIPUG WITNESSES

Q. AT PAGE 5 OF HIS DIRECT TESTIMONY, MR. GORMAN RECOMMENDS THAT THE TRANSACTION COSTS BE DISALLOWED. DO YOU AGREE WITH HIM?

A. No. Mr. Gorman asserts that the transaction costs should not be allowed for the following reasons, all of which have no merit: (1) FPC has not proved that the savings could not have been achieved without the merger;

(2) O&M costs have increased; (3) Progress Energy can achieve a fair rate of return without receiving the transaction costs; and (4) FPC's proposal does not share the savings reasonably.

Mr. Gorman argues on page 6, that outsourcing might have produced greater savings than does the merger, and that FPC has failed to produce any analysis addressing his concerns. However, as I have testified, I find that the company has done a thorough job in estimating synergies that are likely to be attained. Further, as I testified in my Direct Testimony, both my regression and ratio analyses demonstrate that the savings estimated by the company are within the range that previously announced mergers have estimated. My experience has been that merging utilities go to great lengths to avoid including potential stand-alone savings in their merger savings estimates. Thus, I find no merit in Mr. Gorman's assertion that FPC has not "proved" the merger savings.

Second, as I discussed earlier in this Rebuttal Testimony, the fact that non-fuel O&M expenses have increased for other reasons is also not relevant. The better inquiry is to ask by how much more would they have increased without the savings opportunities provided by the merger.

Third, Mr. Gorman's assertion that Progress Energy was able to attain a reasonable rate of return without recovering the costs associated with the merger's completion is just plain wrong. Although it is true that FPC booked the transition costs in 2000, these costs were backed out of the surveillance report and were not charged to customers. Thus, these transition costs are not reflected in year 2000 and are not relevant to FPC's rate of return for that year. These transition costs were put back in the 2001 Surveillance Report as a placeholder until the FPSC rules on FPC's regulatory plan. These facts demonstrate that Mr. Gorman's assertions are wrong. Further, as I explained earlier, if the FPSC denies transactions and transition cost recovery in this case, it will likely have a chilling effect on future mergers. This will deprive Florida consumers the benefits that those future mergers might generate.

Mr. Gorman's fourth point is equally misguided. He asserts that shareholders keep 91.5% of the estimated savings. He also ignores various income tax effects. Most importantly, he overlooks the costs that were paid by shareholders to bring about the merger that facilitated synergy savings. Without this cost expenditure, there would have been no savings to share with customers. Mr. Gorman wants to avoid discussing the net savings, which are the relevant savings to discuss. Had he done so, he would be forced to realize that customers are guaranteed an annual $5 million rate credit. Shareholders are guaranteed nothing.

Q. HAS MR. GORMAN CORRECTLY CHARACTERIZED YOUR TESTIMONY WHEN HE ASSERTS THAT YOU STATE THAT COST RECOVERY NORMALLY OCCURS OVER 3 TO 7 YEARS?

A. No. Mr. Gorman fails to recognize the important difference between FPC's proposed regulatory plan and the many other merger regulatory plans. Other merger plans often give shareholders effectively all the early synergy benefits. This is called front-loading. In contrast, FPC proposes to share benefits with retail consumers from the very outset, as I have already explained. Therefore, the recovery here is somewhat longer than other recovery plans, but by no measure is this unique or unreasonable.

Q. AT PAGE 9 OF HIS DIRECT TESTIMONY, MR. GORMAN ASSERTS THAT YOUR CONCLUSION ABOUT THE REASONABLENESS OF THE COMPANY'S MERGER SAVINGS ESTIMATES IS "HIGHLY QUESTIONABLE." PLEASE RESPOND TO HIS CRITICISM.

A. Mr. Gorman makes his assertion because, he alleges, that my "analysis is based on utilities' original <u>expected</u> merger synergies, not <u>actual</u> synergy savings estimates." His point is, I think, that I did not analyze the actual savings and cost reductions that were achieved by these mergers. That is an accurate representation. In many cases, such information is simply not available.

However, in my experience, in most mergers (and this merger is not an exception), labor savings comprise the dominant portion of merger savings. In my experience, these labor savings are generally achieved and often surpassed. Here, the labor savings have already been achieved and the test year budget reflects these projected savings. Further, the point of my analysis was to assess whether the companies' projections were reasonable given what other mergers had estimated. As I testified in my Direct Testimony, I found that the estimated synergy savings in this merger were comparable to the estimates presented in other mergers that had taken place. Furthermore, FPC has strong incentives to exceed its estimates of synergy.

Q. AT PAGE 9 OF HIS DIRECT TESTIMONY, MR. GORMAN ASSERTS THAT FPC'S PROPOSED 15 YEAR RECOVERY PERIOD CREATES RISK FOR CUSTOMERS. DO YOU AGREE WITH HIS RISK ASSESSMENT?

A. No. I do not. Mr. Gorman fails to explain how the 15 year recovery period creates risk for customers. In fact, FPC's proposed regulatory plan is virtually risk free for customers, who are guaranteed an annual $5 million rate credit and provided the opportunity for even greater cost reductions through my proposed ESM. Mr. Gorman seems to also think that the 15 year recovery period is above the norm typically allowed in mergers, thus indicating the cost is excessive relative to the savings. Again, Mr. Gorman offers no support for his bald allegations. In fact, as explained earlier, the merger savings will be <u>greater than</u> the amount of the costs expended to achieve the savings. Any rational person would spend $1 to get back more than a dollar (i.e., net savings). (This is like helping a stranger who needs to feed a parking meter, but only has a dollar. The stranger exchanges his dollar bill for the three quarters in your pocket, which puts $1 in your pocket for the 75 cents you spent). And as I showed in my Direct Testimony, the estimated savings are within the range that would be expected for a merger with the Progress Energy characteristics. The fifteen year period I chose is consistent with the 15 year recovery period set forth in the 1993 Federal Tax Act. It is also interesting that Publix Witness Ms. Brown does not share Mr. Gorman's fear that extending the recovery period increases customer risk because she favors increasing the recovery period from 15 years to 20 and 40 years for transition costs and transaction costs, respectively. Mr. Gorman must be shaking in his boots if he has read Ms. Brown's recommendations.

Q. AT PAGE 10 OF HIS DIRECT TESTIMONY, MR. GORMAN ASSERTS THAT FPC'S PROPOSED REGULATORY PLAN IS NOT A BALANCED APPROACH BECAUSE IT RETAINS THE "LION'S SHARE OF EXPECTED MERGER SYNERGIES FOR THE BENEFIT OF SHAREHOLDERS." DO YOU CONCUR WITH HIS CONCLUSION?

A. No. Again, Mr. Gorman is incorrectly focusing on gross, not net, synergy savings. As I have explained in this Rebuttal Testimony, customers are guaranteed an annual $5 million rate credit, plus the opportunity for significant future rate reductions. Shareholders will have the opportunity to recover their transaction and transition costs to the extent that synergy savings are sufficient. Then under the ESM I have proposed, customers will also receive the majority of the most easily achieved cost reductions. I find that this approach is balanced and provides the correct incentives for the companies to achieve even greater than projected savings, which will benefit both customers and shareholders.

Q. AT PAGES 10-12 OF HIS DIRECT TESTIMONY, MR. GORMAN SUGGESTS THAT PROGRESS ENERGY MIGHT BE FULLY

COMPENSATED FOR ITS INVESTMENT IN FLORIDA PROGRESS WITHOUT RECOVERING THE TRANSACTION AND TRANSITION COSTS IT HAS INCURRED. PLEASE RESPOND TO HIS ASSERTION.

A. Mr. Gorman's assertion are purely speculative. To be sure, I fully expect that the merger will reduce the business and financial risk in the combined companies. A larger entity also finds it easier to attract capital. However, I do not concur with Mr. Gorman's assertion that this will necessarily result in an increase in Progress Energy's stock price, thus fully compensating Progress Energy without the need to allow it an opportunity to recover the costs it expended to complete the merger, which will ultimately benefit consumers. Value and share prices depend largely on cash flow. Mr. Gorman ignores this simple fact. As I said before, if the FPSC denies FPC the opportunity to recover transaction and transition costs, there will be a chilling effect that might very well cause merger activity in Florida to cease, to the detriment of consumers who will be denied the benefits of these future mergers. This chilling precedent will not be overcome by asserting that if the merged company is successful in reducing its business and financial risk, its stock price will go up. Such reasoning is the ultimate Pollyanna view of corporate finance.

Q. AT PAGE 40 OF HIS DIRECT TESTIMONY, MR. GORMAN ARGUES THAT AN ESM IS NOT APPROPRIATE UNLESS THAT COMPANY CAN FIRST PROVE THAT THE SAVINGS CAN BE ACHIEVED ONLY THROUGH THE MERGER. DO YOU AGREE WITH MR. GORMAN?

A. No. I have discussed at length why I think that Mr. Gorman is incorrect in his speculation that the merger savings could be obtained through other methods such as outsourcing. As I explained, I am satisfied that the companies' savings projections were based on a thorough analysis and reasonably did not include savings that could have been obtained absent the merger. Mr. Gorman goes on to state that he thinks that the company's "proposed return levels within its earnings sharing band are excessive." However, he never explains the basis for his conclusion. As I testified in my Direct Testimony, the ESM sharing bands are designed to provide the company with added incentives to maximize its efforts to achieve the greatest possible cost-cutting measures possible. Therefore, the progressive ESM plan that I have designed is not excessive, but provides incentives that will maximize consumer benefits and rate reductions.

Q. DOES MR. GORMAN SUGGEST AN ALTERNATE SHARING MECHANISM?

A. Yes. He suggests, at page 41 of his Direct Testimony, that the revenue sharing mechanism approved for Florida Power & Light in Docket No. 990067-EI might be a suitable ESM.[5] In that case, the FPSC established a cost of equity range of 10-12 percent. Revenues above the range needed to achieve a 12 percent ROE are shared between customers and shareholders. Two sharing bands were established by the FPSC for retail rate base revenues. Revenues within the first band are to be shared, with

[5] 1999 Fla. PUC :LEXIS 518, 99 FPSC 3:368 (March 17, 1999).

1/3 going to shareholders and 2/3 going to customers. Excess earnings above this first band are all refunded to customers.

I explained in detail in my Direct Testimony why FPC's progressive ESM provides better incentives than does the ESM approach favored by Mr. Gorman. FPC's proposal provides customers with a greater portion of the low hanging fruit, the easiest to achieve cost savings. FPC's ESM plan provides FPC with a greater share of the hardest to attain savings and cost reductions. This greater reward will encourage FPC to go the extra mile to try to exceed its savings and cost reduction projections. Under an ESM, like the one in place for Florida Power & Light, if FPC was to achieve extraordinary success in achieving cost savings that exceeded its projections, it would receive nothing in return for its efforts. In contrast, FPC's progressive ESM provides customers with the largest share of the most easily achieved savings. If the company can achieve even greater savings through its extraordinary efforts, it will be rewarded with a higher share of these harder to achieve savings. This provides the company with an incentive to try to beat its projections. Therefore, I think a progressive ESM like the one FPC has proposed provides the company with the right incentive to achieve as much as it can. Maximizing savings will also maximize customer benefits. Therefore, I recommend that the FPSC approve FPC's proposed progressive ESM.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

---

[5] 1999 Fla. PUC :LEXIS 518, 99 FPSC 3:368 (March 17, 1999).