

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:
February 11, 2002

DECLASSIFIED *MR 9.15.03*
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**REBUTTAL TESTIMONY
OF
MARK A. MYERS**

**ON BEHALF OF
FLORIDA POWER CORPORATION**

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DOCUMENT NUMBER - DATE

01608 FEB 11 02

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1 **I. Introduction**

2 **Q. Please state your name.**

3 A. Mark A. Myers.

4

5 **Q. Did you submit Direct Testimony in this case on September 14, 2001 and**
6 **November 15, 2001?**

7 A. Yes, I did.

8

9 **Q. Have you reviewed the pre-filed testimony filed by witnesses sponsored by**
10 **the Office of Public Counsel (“OPC”) and the intervenors in this docket?**

11 A. Yes, I have.

12

13 **II. Purpose of Testimony**

14 **Q. What is the purpose of the testimony you are filing at this time?**

15 A. I am submitting this testimony to rebut the pre-filed testimony of OPC witnesses
16 Donna Deronne, David Dismukes, Kimberly Dismukes, and Steven Stewart;
17 FIPUG witness Michael Gorman; and Publix witness Sheree Brown.

18

19 **Q. Are you sponsoring any exhibits to your rebuttal testimony?**

20 A. Yes, I am sponsoring the following two rebuttal exhibits:

1 Exhibit MAM-8 calculates synergy savings after correcting for an error in Ms.
2 Brown's calculations.

3
4 Exhibit MAM-9 demonstrates that 2000 was an aberrational year and shows that
5 1998 provides a more appropriate baseline for making comparisons with the 2002
6 test year for the purpose of identifying synergy savings.

7

8 **III. Acquisition Adjustment**

9 **Q. Certain witnesses have argued that Florida Power is seeking to raise rates to**
10 **recover the entire amount of the premium that Progress Energy paid to**
11 **acquire Florida Power, while offering customers only \$5 million in benefits.**
12 **Is that a fair characterization of the Company's proposal?**

13 A. Absolutely not, for at least three reasons. First, our customers will not pay one
14 cent more in rates than they were paying before the merger as a result of recovery
15 of the acquisition premium. This is true because we are proposing to fund
16 recovery of the premium out of savings that were made possible by the merger in
17 recognition of the fact that bringing about these savings had a real cost. I can
18 illustrate this with a simple example:

19

20 Suppose customers of Acme Power are paying \$100 million in rates.
21 BestCo then buys Acme for a premium of \$10 million. As a result of
22 economies of scale, BestCo is able to reduce the operating costs of Acme
23 by \$15 million. If BestCo is permitted to recover the amount of its

1 premium out of the amount of those savings, Acme's customers will end
2 up paying \$95 million in rates after the merger. The net result of the
3 merger is that Acme's customers are \$5 million better off after the merger
4 than before the merger.

5
6 The same is true here. It is contrary to fact and logic to argue that Florida Power
7 is proposing somehow to raise its customers' rates to fund the acquisition
8 adjustment. That is like arguing that I'm charging you a nickel if I trade you a
9 dime for five cents. Very few rational people would reject that kind of trade.
10 However tempting it might be to keep the dime that is tendered and give back no
11 change, that would be over-reaching, and that is exactly what the intervenors and
12 OPC are proposing in this case.

13
14 There can be no question that if this merger took place in an unregulated
15 context the acquiring company could capture the entire difference between pre-
16 merger and post-merger operating costs (i.e., synergy savings) for the
17 shareholders of the acquiring company in order to defray the acquisition cost.
18 That is the way the competitive market operates, and that is what makes mergers
19 possible. In the case of a regulated utility operating in a cost-of-service
20 environment, we believe that it is reasonable to ask the Commission to recognize
21 that bringing about significant economies of scale has a real cost. We are asking
22 simply that this cost be netted against the benefits, and we are willing to share the
23 net benefits that remain with our customers, though in an unregulated context the

1 shareholders would reap all of those benefits as a reward for the risk they had
2 taken in bringing together the two companies. The bottom line is that, under our
3 proposal, our customers are made better off as a result of the merger.

4
5 Second, Florida Power is not proposing to recover the entire amount of the
6 premium paid by Progress Energy for Florida Progress. Progress Energy has
7 allocated to Florida Power only a portion of the total acquisition price paid for
8 Florida Progress, erring on the side of the customers. This is true because the
9 allocation of the premium was determined in proportion to the allocation of
10 expected merger synergies, and Progress Energy has assumed that \$45 million of
11 the total estimated synergies of \$175 million are attributable to revenues that
12 Progress Energy might achieve through its unregulated businesses, such as the
13 development of electric power plants. It is highly likely that CP&L could have
14 developed these unregulated projects even without the merger. By including
15 these revenue goals in the total estimated synergies, Progress Energy has therefore
16 understated the amount of the purchase price fairly allocable to Florida Power and
17 fairly recoverable by the Company.

18
19 Third, we are not offering only \$5 million in benefits to our customers.
20 The customers are getting greater benefits in the short-term and the long-term. In
21 the short-term, the customers are benefiting from the fact that the Company will
22 have stronger managerial, operational, and financial resources with which to serve
23 its customers, the Company will be able to provide superior service, and it will be

1 better positioned to hold costs down. In the long-term, the merger enables the
2 Company to continue to provide superior service at lower costs and to offer the
3 opportunity for greater rate reductions (or lesser rate increases) after the
4 acquisition costs are recovered.

5
6 **Q. Certain witnesses argue that the driving influence for the merger was**
7 **Progress Energy's interest in improving its competitive position and**
8 **achieving non-regulated revenue enhancement, and therefore customers**
9 **should not be asked to subsidize the premium price paid for Florida**
10 **Progress. Is this contention well founded?**

11 A. No, it is not. This contention is based on an erroneous premise. These witnesses
12 have quoted selectively from certain statements made to shareholders to create the
13 misimpression that the combination of the regulated utilities was unimportant and
14 that non-regulated potential was the preeminent concern of the merging
15 companies. The documents do not support this. Progress Energy's emphasis, for
16 example, on becoming "bigger and stronger," "solidifying our role as a regional
17 total energy provider," "building on the success of our energy-related
18 subsidiaries," and developing an enhanced "post-closing organizational
19 framework" (Direct Testimony of K. Dismukes, pp. 16-18) apply with full force
20 to Progress Energy's regulated electric utility subsidiaries. These qualities
21 contribute directly to the synergies I discussed in my Direct Testimony filed
22 September 14, 2001, e.g., lower cost of capital, improved resources, economies of
23 scale.

1 What is equally important is that we have accounted for the non-regulated
2 component of synergies in making our proposal. As I just described, we assumed
3 that \$45 million of the total estimated synergies are attributable to non-regulated
4 initiatives even though CP&L could have pursued these revenue opportunities
5 without the merger. Separate consideration was paid by Progress Energy—in the
6 form of contingent value obligations (“CVOs”) valued at approximately \$49.3
7 million—for the value of Florida Progress’s non-regulated, four synthetic fuel
8 plants purchased by Florida Progress in October 1999. We are not asking for any
9 recognition of this additional acquisition cost for purposes of determining
10 appropriate treatment of merger costs.

11
12 Apart from its synfuel subsidiaries, what other value did Florida Progress
13 offer? The answer is obvious: Florida Progress’s main asset and operating
14 subsidiary was Florida Power, and the opportunity to acquire and combine that
15 regulated subsidiary supplied the value for that part of the consideration paid that
16 we are asking the Commission to consider. In fact, it defies reality to argue that
17 the non-regulated business interests of Progress Energy predominated before,
18 during, or after the merger. Florida Power was Florida Progress’s core business
19 interest, and the Carolina electric utility was CP&L’s core business interest. After
20 the merger, these regulated electric utilities continue to be the core business
21 interests of Progress Energy. Florida Power alone accounts for 35 percent of the
22 assets and personnel of Progress Energy. So it is quite reasonable and
23 conservative to claim 30.9 percent of the merger synergies for Florida Power. (As

1 I have explained, by erring on the conservative side in allocating these synergies,
2 Progress Energy has understated Florida Power's share of the acquisition
3 premium and thus reduced the amount that we seek to recover in this proceeding.)
4 To argue, as OPC and the intervenor witnesses argue, that the non-regulated
5 business interests of the merging companies drove the merger and account for the
6 real value of the transaction is to have the tail wagging the dog.

7
8 Finally, to the extent that these witnesses ask this Commission to consider
9 what benefits, if any, the merger might provide to Florida Power or its parent in
10 the event of deregulation, this consideration is both speculative and out of line in
11 a rate case. Unless and until deregulation occurs, the Commission has neither the
12 policy directive nor the factual basis to make rate decisions based on conjecture
13 that deregulation will occur or about the consequences to any of the stakeholders
14 should deregulation occur. At this point in time, we have no idea when or if
15 deregulation will occur, or how restructuring legislation will treat the interests of
16 the various stakeholders if it does occur.

17
18 **Q. Ms. Brown argues, in particular, (at pp. 10-11) that Progress Energy expects**
19 **to achieve substantial shareholder benefits from power marketing**
20 **transactions that will outweigh benefits to the customers. What is your**
21 **response to this argument?**

22 **A.** She is mistaken about the facts. In making this argument, Ms. Brown relies on
23 documents that we provided in discovery that discuss activities by CP&L and

1 Florida Power trading centers. The problem is that she fails to recognize that (1)
2 regulatory treatment of power marketing transactions differs in North Carolina
3 and Florida, and (2) CP&L has greater access to transmission than Florida Power
4 does and thus has more opportunities to take advantage of market transactions.

5
6 When our integration teams studied the operations of the power trading
7 functions of the combined companies, they understood that Florida Power's
8 customers would benefit from the Company's efforts to optimize its generating
9 capacity. In contrast, shareholders will benefit from power sales in North
10 Carolina, subject to regulatory ROE limits. BEGIN CONFIDENTIAL. The
11 integration team estimated that power marketing might yield a margin of \$60
12 million, including \$40 million for shareholders. But this \$40 million represents
13 revenues from CP&L's regulated sales of power in addition to off-system non-
14 regulated trading. The remaining \$20 million represents customer benefit
15 attributable to sales from Florida Power's fleet that will flow through to our retail
16 customers through the fuel adjustment clause. In light of these facts, it is easy to
17 see that our goal of enhancing the Company's competitive position and
18 participating more actively in the generation market directly benefits our
19 customers by holding fuel costs down and creating credits to our customers
20 through the fuel adjustment clause. END CONFIDENTIAL.

21
22 **Q. Ms. Brown argues (at p. 11) that Progress Energy acknowledged in internal**
23 **statements BEGIN CONFIDENTIAL that it might use the firm transmission**

1 path from Florida Power to CP&L to generate \$2 million in profit. END

2 CONFIDENTIAL Is she correct?

3 A. BEGIN CONFIDENTIAL. Again, Ms. Brown misunderstands the facts. She
4 relies on concepts discussed tentatively prior to completion of the merger and
5 prior to FERC approval of the transaction, at a time when Progress Energy was
6 contemplating that it would have a 100MW transmission path between the two
7 utilities. FERC ultimately reduced the path to 50MW (which, all things being
8 equal, would reduce the margin expectation to \$1 million). Further, power market
9 prices have fallen. So the value has been reduced to virtually zero. We also need
10 to keep in mind that any margin (net of transmission expenses) achievable
11 through wheeling would flow through to Florida's retail customers. In fact, Ms.
12 Brown acknowledges that, in the documents she reviewed, "the Company did
13 note that the ownership of the transmission could require that these benefits go to
14 customers." In addition, the cost of the transmission reservation for the 50MW
15 contract path through Southern and Duke is being borne by CP&L. END

16 CONFIDENTIAL.

17
18 Q. Certain witnesses argue that, under the Company's proposal, customers will
19 pay for the original capital investment in the Company's assets and then will
20 pay again for those assets by subsidizing Progress Energy's acquisition costs.
21 Do you agree?

22 A. Not at all. This would occur (and then only figuratively) if we were asking the
23 Commission to incorporate goodwill into the Company's rate base, which we are

1 not proposing. "Goodwill" is a term of art and should not be confused with the
2 subject of our proposal. Goodwill is the difference between book value and the
3 price paid, which in this case is about \$3.4 billion. If this goodwill were added to
4 the Company's rate base, the customers would permanently be expected to
5 subsidize a return of this investment and a reasonable rate of return for the
6 Company's shareholders on the entire, adjusted rate base, as though goodwill
7 were a part of the real capital assets of the Company. Our proposal is
8 fundamentally different. We are simply asking the Commission to recognize the
9 economic reality that there is no such thing as a free lunch. Every benefit has a
10 cost.

11
12 In this case, the benefit of being able to reduce the headcount at Florida
13 Power, achieve economies of scale, and bring about other cost reductions and
14 business improvements came at a very real price, namely, the expenditure of
15 significant transaction and transition costs. Rather than ask the Commission to
16 imbed \$3.4 billion of goodwill in our rate base, and to authorize a reasonable
17 return on that adjusted rate base, we are simply asking the Commission to
18 recognize the economic reality that the apparent "savings" must be netted against
19 the cost of bringing about those savings to come up with the true net savings
20 available to be shared with customers.

21
22 This may be illustrated by another simple example. Suppose Acme utility
23 buys a labor-saving machine that has operating costs of \$1,000 but, by doing so,

1 the utility is able to displace \$2,000 in labor costs. No one would contend that
2 revenue requirements should be lowered by \$2,000. Rather, they might be
3 lowered only by the net difference, namely \$1,000. That is the nature of the
4 proposal we are making.

5
6 Contrary to what OPC and intervenor witnesses argue, we are not seeking
7 a shareholder profit (return) on the merger transaction and transition costs. We
8 are not asking that any interest rate be applied to transition costs over the 15 years
9 that we propose to recover these costs. As for the transaction costs (Florida
10 Power's allocated share of the acquisition premium) we are asking to recover only
11 the 4.6 percent, after-tax interest carrying costs that Progress Energy is incurring
12 to finance this costs. Seen correctly, we are seeking a cost offset; not a
13 shareholder profit.

14
15 **Q. Your proposal has been criticized on the further ground that you have not**
16 **proven that all the synergy savings you claim would not have occurred “but**
17 **for” the merger. Is this a valid criticism?**

18 A. No, it is not. OPC and intervenor witnesses are attempting to hold the Company
19 to an impossible burden of proof while engaging in rank speculation themselves.
20 For example, without offering any proof whatsoever, OPC witness Kimberly
21 Dismukes conjectures that “many” of the service quality improvements that we
22 are achieving as a result of the merger “could have taken place” absent the
23 merger; that “many” of the improvements to Florida Power's managerial,

1 financial, technical, and operational resources “could have been initiated without
2 the merger,” and that lower operating costs “remain to be seen.” (At the same
3 time she acknowledges that Florida Power’s conclusion that the merger will
4 increase its ability to attract capital “may be true.”) (Direct Testimony of K.
5 Dismukes, pp. 14-15). The only substantiation she offers is that some of the
6 practices Florida Power has adopted as a result of the merger “existed at CP&L
7 prior to the merger.” (Id.) To that I say, precisely.

8
9 One of the central benefits of the merger is to enable a utility like Florida
10 Power to gain access to inside information about the workings and experience of
11 its merger partner and to adopt the best practices of both utilities suited to the
12 merged companies. Further, as I have explained part of the benefit of the merger
13 is that it has enabled the merging electric utilities to combine and integrate their
14 systems in a way that was not possible before, to achieve economies of scale, to
15 improve efficiencies, and to improve service quality, for example by enabling
16 work crews from each utility to back up each other to deal with major outages and
17 other operational issues. By definition, this type of integration could only be
18 achieved by combining two strong utilities.

19
20 Ms. Dismukes is quick to say that “[c]ertainly, FPC did not hire and retain
21 an unqualified staff prior to the merger.”” (Id.). I agree with that, too, and it helps
22 prove our point. Prior to the merger, Florida Power was in fact competently and
23 prudently managed, and we were in fact diligent in looking for and acting upon

1 opportunities to control or lower costs and to maintain or improve service quality.
2 To that end, the Company initiated a substantial reduction in force in the mid-
3 '90s, reducing headcount as much as feasible without compromising service
4 quality. The Company reorganized, seized every opportunity to lower costs, and
5 was constantly alert for opportunities to improve efficiency and quality. Despite
6 these efforts, there were limits to what we could achieve as a stand-alone
7 company. We were not privy to the kind of proprietary and detailed information
8 that we learned about CP&L in the course of the merger, and we did not enjoy the
9 kind of scale and scope that we obtained through the merger.

10
11 As for the point that lower operating costs "remain to be seen," my
12 response is that, in 2001, we met and exceeded our expectations about our ability
13 to lower operating costs through the merger, and we have seen every indication
14 that we will achieve our target of \$58.7 million in merger savings in 2002.
15 Moreover, we have imbedded this figure in our budgets. This means that we
16 lashed ourselves to the helm and are fully committed to staying on course to
17 achieve significant cost savings through the merger.

18
19 Would we have been able to achieve these savings absent the merger?
20 The answer is definitely no. As I have explained, we tried but could not do it as a
21 stand-alone company based on the resources and information we were able to
22 marshal. To identify these synergies, we deployed integration teams from CP&L
23 and Florida Power, the very existence of which was a merger synergy. These

1 teams enjoyed the extraordinary benefit of being able to draw on the experience,
2 expertise, resources, and innovation of both companies to forge a new way of
3 doing business that was better, stronger, leaner, and more efficient than either
4 utility was able to achieve previously. They engaged in a rigorous process, poring
5 over every aspect of every business unit in the Company to look for ways to
6 reduce headcount; consolidate, integrate, and improve operations; and to exploit
7 best practices to maximum advantage. Based on their analysis and reports, we
8 imbedded the projected savings into our budgets and tasked our managers with
9 the job of making these projections a reality, which they are on track to achieve.
10 We were not on a track to achieve these savings or to implement these initiatives
11 absent the merger.

12
13 Are these synergy savings real? As I have explained, they are imbedded
14 in the budgets that we operate under day in and day out. Some of them have been
15 painful to achieve, including the displacement of many, many employees in
16 Florida. We can see, feel, and touch these savings. They are very real.

17
18 Certainly, with the benefit of hindsight it is easy to assert that somebody
19 could have thought of the light bulb sooner. Certainly, there were many able
20 individuals who had the brains and motivation to invent one. But sometimes it
21 takes an extraordinary person, an extraordinary catalyst, or extraordinary
22 resources to effectuate innovation and improvements. In this instance, that
23 extraordinary catalyst was the merger.

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Q. Certain witnesses insist that the claimed cost synergies are illusory because they are offset by significant cost increases. Is that true?

A. No, it is not. The reduction of 675 jobs in Florida is not illusory. The consolidation of numerous functions and the closing of numerous facilities are not illusory. Progress Energy’s economies of scale are not illusory. These are all tangible business synergies.

OPC and intervenor witnesses are making this argument by pointing to false comparisons and ignoring important facts. Principally, they compare O&M costs for 2001 with O&M costs for 2000, the year the merger was being consummated. For example, Publix witness Brown asserts that, putting administrative and general (“A&G”) O&M expenses on a comparable basis as 2000 and 1999, the Company’s costs go up \$37 million from 2000 to 2002, amounting to 22 percent per year (and 35.5 percent per year if no synergies had been achieved). She further states that Florida Power’s benefits were brought into line with CP&L’s, increasing costs by \$4.7 million. There are a number of problems with these arguments.

First, in making her calculations, witness Brown excludes the credit in FERC account 92200 of \$15.68 million from her analysis of the 2002 budget. This is an incorrect assumption because the offsetting debit for the reclass entry is FERC account 92020, another A&G account. To compare apples to apples, we

1 cannot exclude the amount in 92200. The impact of making this correction is to
2 reduce the supposed \$37 million increase in A&G expenses from 2000 to 2002 to
3 \$21 million.

4
5 Second, she states that the synergy amount for A&G is \$24.8 million, and
6 then she adds this amount back into total A&G expenses to show what the
7 increases would have been without synergies. But a large portion of the synergies
8 are in the benefits area, and she excludes this area from her analysis. So using the
9 \$24.8 million amount is not valid. This should be reduced by the amount of
10 synergies arising from the Company's conversion from a defined benefit plan to a
11 cash balance plan, or \$15 million.

12
13 Third, although we have increased the cost of employee benefits by \$4.7
14 million, costs in this area remain well within the Public Service Commission
15 benchmark despite rising costs in the medical insurance area. These dollars
16 represent enhancements to the employee benefit package, aimed at attracting and
17 retaining the employee base needed to support our customers.

18
19 Finally, it is not appropriate to benchmark using the year 2000. The actual
20 financial data for 2000, and 1999 for that matter, reflect O&M costs that are
21 artificially low due to employee departures after the merger was announced.
22 After we consummated the merger, we moved to achieve appropriate staffing and
23 cost allocation to reflect more accurately the ongoing needs and costs of running

1 the Company. A more appropriate comparison is between 1998 and 2002. The
2 year 1998 represents the last calendar year period before the merger was
3 announced and its impact (employee attrition) began to impact O&M costs. I am
4 including an exhibit (MAM-8) to show the synergy savings in total A&G costs,
5 using the proper adjustment described above. I am also including an exhibit
6 (MAM-9) demonstrating that 2000 was an aberrational year and showing that
7 1998 provides a more appropriate baseline for making comparisons over periods.
8 In Exhibit MAM-9, we have shown that synergies have been achieved from our
9 ongoing O&M costs when properly adjusted for inflation, new power plant costs,
10 pension costs impacted by stock market performance, and the additional Energy
11 Delivery reliability programs we have initiated. The savings are real, and Florida
12 Power is on track to realize its synergy target for 2002.

13
14 **Q. OPC witness Deronne asserts that the Company should not be able to claim**
15 **\$58.7 million in merger savings because a large portion of this cost reduction**
16 **has already been achieved and the Company is seeking to recover from**
17 **customers costs that it does not plan to incur. Do you agree?**

18 **A.** Definitely not. I do not follow the logic of her argument, and I do not accept its
19 factual premise. We are claiming \$58.7 million in merger synergies because these
20 are the savings that we expect to realize annually. So we hope that we have
21 achieved savings at or near that magnitude in 2001. The fact that we have done
22 so, however, does not diminish the fact that we will achieve that level of savings
23 again in the 2002 test year and each year thereafter. Contrary to what witness

1 Deronne contends, we are not seeking to recover costs that we do not plan to
2 incur. Rather, we are seeking to recover costs that have in fact been incurred by
3 Progress Energy, and are being incurred by Progress Energy annually in the form
4 of debt service, to bring about the merger savings. The linkage to the \$58.7
5 million is that this amount represents the reduction in O&M costs of Florida
6 Power made possible by the amortized and allocated portion of acquisition and
7 transition cost incurred to bring about the merger.

8
9 **Q. FIPUG witness Gorman, however, argues that Florida Power might have**
10 **achieved the claimed cost reductions some other way, such as by outsourcing**
11 **certain of its functions. Do you agree?**

12 A. No, I do not. I confirmed after my deposition that Florida Power has in fact
13 explored outsourcing various functions over the years and generally rejected this
14 option, with few exceptions (which the Company pursued). For example, we
15 explored outsourcing numerous administrative and general functions, including
16 remittance processing, accounting (including accounts payable, payroll, and
17 benefits accounting), meter reading, investor services (we did in fact outsource
18 most activities in this area), and management of our savings plan. In fact, we
19 have constantly considered various options to reduce costs and improve
20 efficiency, including outsourcing various functions and services. In this
21 connection, we participated in benchmarking studies conducted by Andersen
22 Consulting in the early to mid-'90s to help us assess whether we had opportunities
23 to reduce costs and improve operations. We were not able to obtain satisfactory

1 assurance that we would improve either our cost efficiency or service quality by
2 resorting to outsourcing options. Among other negatives associated with
3 outsourcing services or functions, we were concerned that we would lose the
4 advantage of control, ownership, and the use of common systems, while
5 subsidizing whatever profit the provider of services would command. I have
6 every confidence that we were doing the best we could as a stand-alone utility,
7 and that it took this merger to get us to the next level.

8
9 **Q. Publix witness Brown contends that the Company's internal documents from**
10 **a 2000 Strategic Planning meeting prove that Florida Power would have**
11 **proceeded to implement a number of the same initiatives if the merger fell**
12 **through. Is that correct?**

13 A. It is neither correct nor pertinent. Witness Brown is referring to a document titled
14 BEGIN CONFIDENTIAL "Implications if Merger Falls Through." As its name
15 suggests, this was a contingency planning document that was prepared in 2000
16 after merger integration discussions had already occurred but before the closing,
17 and with the benefit of merger integration discussions. The document does not
18 speak to what Florida Power was planning to do before it commenced discussions
19 with CP&L, and it does not provide either a detailed or firm commitment
20 concerning what the Company would actually do if the merger did not occur.
21 Rather, the document set forth some very broad concepts for discussion purposes,
22 without any dollars attached or plans for implementation developed. END
23 CONFIDENTIAL.

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The fact is, absent the merger, the Company was not able or committed to bring about the synergy improvements it has been able to achieve through the merger. Without combining with CP&L, Florida Power would have had neither the scale nor the scope to achieve these savings. BEGIN CONFIDENTIAL. Certain of the ideas in the planning document bear a general resemblance to initiatives implemented after the merger, e.g., closing our retail stores. But to explore that example, the Company had specifically considered and rejected that strategy before CP&L came along because we were uncertain of how this might impact customer service. With the benefit of our integration discussions with CP&L, however, we were able to learn that CP&L had in fact successfully implemented this strategy, and it had resulted in an improvement in customer service. That is what encouraged the Company to pursue this approach again. END CONFIDENTIAL.

It is artificial and unfair to cite examples of initiatives that Florida Power learned about through its integration efforts to argue that Florida Power could have achieved these initiatives even without the merger. That is like saying anybody could design a light bulb after talking to Thomas Edison about how to do it. The fact is, Florida Power and its customers benefited enormously from the Company's ability to undertake these integration efforts with CP&L, the point of which was to effectuate the merger (not steal ideas from CP&L and then break off

1 discussions). And in point of fact, the merger did not fall through, and the
2 Company was able to achieve these initiatives because of the merger.

3
4 **Q. OPC witness Kimberly Dismukes argues that the Progress Energy merger**
5 **does not present “extraordinary” circumstances warranting recognition by**
6 **the Commission of the costs of acquisition, principally because Florida Power**
7 **was not a “troubled utility.” How do you respond to that?**

8 A. I disagree with her contention. She recognizes that the Commission has approved
9 acquisition adjustments in the case of mergers between healthy utilities, and she
10 also recognizes that the Commission defines “extraordinary” by the presence of
11 the five factors that I discussed in my Direct Testimony of September 14, 2001.
12 As I explained in that testimony, each of those five attributes is present in this
13 merger. So this merger meets the “test.”

14
15 In addition, I would like to point out three big-picture facts that the
16 intervenor witnesses tend to overlook or minimize in this discussion. First, the
17 Commission has set the high hurdle of showing “extraordinary” circumstances
18 when a utility is seeking to adjust its rate base to add goodwill. Here, goodwill
19 amounts to \$3.4 billion. We are not seeking to add that to rate base, and we are
20 not seeking a shareholder profit on that amount. What we are asking for is much
21 more modest, and, correspondingly, the hurdle for gaining favorable regulatory
22 treatment should not be set as high. Although we believe that all the indicators of
23 an “extraordinary” merger are present here even under the Commission’s test for

1 making rate base adjustments, it stands to reason that we have shown more than
2 enough to obtain the lesser regulatory treatment that we are requesting in our
3 proposal.

4
5 The second big-picture point is: How many mergers like this have taken
6 place in the electric utility industry in Florida in the last 20 years? The answer is
7 none. This truly is an extraordinary merger precisely because it concerns two
8 substantial, healthy utilities. Bringing these utilities together and integrating them
9 to achieve the synergies I have described was a daunting task.

10
11 Finally, we should not lose sight of the central question the Commission
12 must resolve in determining whether to approve our proposal, which is, should the
13 Commission act to encourage or discourage mergers of this nature? The meaning
14 of any “test” will ultimately depend upon the context in which it is used. As I
15 understand it, the Commission’s central concern in the context of deciding
16 regulatory treatment of merger costs is whether the transaction is sufficiently
17 beneficial to customers and to the regulated functions of the utility as to warrant
18 regulatory encouragement. We have shown that this merger has had and will
19 continue to offer considerable benefits for Florida Power’s customers and for the
20 Company’s regulated functions. There is no good reason for the Commission to
21 adopt a regulatory stance that, at best, penalizes the Company for bringing about
22 these benefits, and at worst, impairs the financial standing of Florida Power and
23 affirmatively discourages other utilities from pursuing this kind of merger.

1

2 **Q. Publix witness Brown maintains that, if Progress Energy really needed to**
3 **obtain recovery of its merger costs to encourage the merger, Florida Power**
4 **would have petitioned the Commission prior to the merger for favorable**
5 **regulatory treatment. Is she right?**

6 A. No. That would not have been feasible. As witness Kimberly Dismukes reports
7 in her testimony, the Commission told us at the time of the Sebring merger that it
8 did not ordinarily “preapprove” acquisitions or acquisition adjustments “outside a
9 rate case.” (Direct Testimony of Kimberly Dismukes, p. 11, quoting Order PSC-
10 92-1468-FOF-EU). Attempting to initiate a process for which this state has no
11 laws, rules, or established procedures in the context of a merger of the size and
12 scope of the Progress Energy merger, and possibly triggering a full requirements
13 rate case in the middle of the proceeding, would have jeopardized our ability to
14 complete an already incredibly complicated transaction that promised very
15 substantial short-term and long-term benefits for our customers. At a minimum,
16 this would have significantly delayed our ability to bring home the synergies to
17 our Company and our customers. We had to trust that the Commission would
18 agree with us that the merger was a true win-win for the Company and its
19 customers, and that it would recognize the true economic costs of bringing about
20 these benefits.

21

22 **Q. Focusing specifically on the “transition” cost (e.g., severance payments)**
23 **component of what you are seeking to recover, witness Kimberly Dismukes**

1 suggests that Florida Power had given assurances that certain transition
2 costs, **BEGIN CONFIDENTIAL** arising out of “agreements . . . between
3 **Florida Progress and its executives”** **END CONFIDENTIAL** would not be
4 borne by Florida Power’s customers. (Direct Testimony of K. Dismukes, pp.
5 26-27). Are you renegeing on that assurance?

6 A. No. We have excluded cost of control severance payments made to Florida
7 Progress executives from the transition costs that we are seeking to recover.

8
9 **Q. Ms. Dismukes argues (at pp. 24-26) that Florida Power’s proposal to recover**
10 **severance payments made to terminated Florida Power employees conflicts**
11 **with the Public Service Commission’s stated policy prohibiting the**
12 **capitalization of merger transfer costs. Is she correct?**

13 A. No, she is not. None of the orders she discusses involved severance payments.
14 The orders merely make clear that the Commission will not allow a utility to
15 capitalize organization costs associated with a merger, particularly where
16 ratepayers do not benefit from the transaction. We are not seeking to capitalize
17 (i.e., add to rate base) any merger transition costs, and, in any event, we have
18 shown that our ratepayers will clearly benefit from our merger.

19
20 **Q. OPC and intervenor witnesses argue that customers should not be expected**
21 **to bear the cost of severance packages paid to terminated Florida Power**
22 **executives because they are unreasonably high. How do you respond to that?**

1 A. These severance arrangements were a necessary and reasonable cost of doing
2 business and bringing about the merger and therefore should be recovered as part
3 of the costs of bringing about the merger synergies. It is important to recognize
4 that a company like Florida Power cannot operate without high caliber executive
5 officers. These officers had to be given the incentive to manage the Company
6 while pursuing merger opportunities that might prove beneficial to the Company's
7 customers and shareholders even if such a merger might compromise the personal
8 interests of the executives (because, in all likelihood, it would result in their
9 termination). Once an attractive merger opportunity was identified, it was critical
10 to be able to retain these executives throughout the period when the merger was
11 being negotiated and consummated.

12
13 In determining the amount of these severance packages, Florida Power's
14 Compensation Committee obtained the advice of experts in executive
15 compensation and supplemental executive retirement plan ("SERP") matters
16 (including Towers Perrin and MCG Northwest), obtained information concerning
17 SERP and change-in-control programs of a cross-section of publicly held utility
18 companies, reviewed the before- and after-tax costs of both the amended SERP
19 and change-in-control program, and considered the recommendations of Florida
20 Power's chief executive officer regarding the proposed SERP and change-in-
21 control program. Upon completion of this evaluation process, the Committee
22 concluded that the proposed plan and program were reasonable.

23

1 **Q. Witness Deronne argues that Florida Power should not be able to recover the**
2 **severance costs because they were expensed in 2000, and the Company still**
3 **was able to earn a reasonable rate of return, and they have been included in**
4 **surveillance reporting for 2001, without impairing the Company's rate of**
5 **return. Is that correct?**

6 A. No, it is not correct. Although we expensed these costs in 2000 for accounting
7 purposes (as we were required to do under GAAP, absent regulatory authorization
8 of some other treatment), we backed them out of surveillance for that year for
9 purposes of calculating our regulatory ROE. Therefore, it makes no sense to say
10 that the Company earned a reasonable rate of return in 2000, despite booking
11 these expenses. The transition expenses were simply ignored (and thus not
12 charged to customers) in 2000 in calculating our ROE. So of course they had no
13 adverse impact—for that matter, no impact of any kind—on the ROE we reported.
14 In the absence of those expenses, we accelerated the amortization of the Tiger
15 Bay regulatory asset, which provided a direct customer benefit by advancing the
16 date when customers will enjoy an immediate reduction of pass-through expenses
17 now being charged to recover the cost of that asset.

18
19 We temporarily added the transition expenses back into our surveillance
20 report for 2001 as a place holder for the acquisition adjustment that we are
21 seeking in this case. Again, we backed out those expenses for surveillance
22 reporting at the end of 2001, and we are requesting that the Commission approve
23 the acquisition adjustment we have requested to take the place of those expenses.

1 As I described in my Direct Testimony of September 14, 2001, we are proposing
2 that we spread the recovery of these transition costs over a 15-year period,
3 without interest.

4
5 **Q. Witness Deronne further contends that, instead of accelerating the**
6 **amortization of Tiger Bay, the Company should have incurred additional**
7 **expenses to fund the improvements in reliability and service that Florida**
8 **Power is now treating as merger synergies. Do you agree?**

9 A. No, I do not. First, let me repeat that our decision to accelerate the amortization
10 of the Tiger Bay regulatory asset did not benefit our shareholders; rather, it
11 directly benefited our customers. As soon as that regulatory asset is retired, our
12 customers will get immediate rate relief, without any action by the Commission,
13 through a reduction of monies recovered under the fuel and capacity cost recovery
14 clause. In choosing between spending money on infrastructure or “spending”
15 money to accelerate the amortization of Tiger Bay, the Company was exercising a
16 business judgment about which way to benefit our customers, not about whether
17 to benefit our customers. The Company must constantly make judgments about
18 how much is too much when it comes to spending money on infrastructure, and it
19 has made great efforts to stretch the customers’ dollars as far as they can
20 reasonably go.

21
22 The Company has now made a judgment that spending additional dollars
23 to improve reliability and customer service is warranted and appropriate. We are

1 not claiming that spending more money is itself a merger “synergy.” We are
2 stating that the merger is enabling Florida Power to get more bang for its buck in
3 the areas of improving reliability and customer service. It must be recognized
4 that, prior to the merger, Florida Power’s energy delivery system was operating at
5 acceptable levels. The merger provided Florida Power with opportunities to
6 identify best practices in this area and brought CP&L’s focus of top-quartile
7 quality of service to Florida. With the benefit of best practices obtained from
8 CP&L and the integration of various management, financial, and operational
9 functions, the Company is able to take significantly greater strides in these areas
10 in a more cost-effective way.

11
12 **Q. Publix witness Brown argues that your proposed 15-year recovery period is**
13 **too short, and FIPUG witness Gorman contends that this recovery period is**
14 **too long. How do you defend your decision to propose this 15-year period?**

15 A. We selected this period exactly because it does steer a middle course between a
16 longer period that would burden the customers for too great a time and a shorter
17 period that would require recovering an unduly large amount on an annual basis.
18 The Commission approved 15 years for cost recovery of our Sebring merger
19 based on the same analysis. In addition, 15 years represents the average term of
20 the debt that Progress Energy is using to finance the acquisition costs, and it is the
21 period that the Federal Tax Act prescribes for amortizing a premium paid over
22 book to acquire assets.

23

1 **IV. Capital Structure**

2 **CR 3 Adjustment**

3 **Q. OPC witness Deronne contends (at pp. 6-7) of her testimony that the**
4 **Commission's Order approving the CR 3 stipulation does not contemplate**
5 **continuation of the CR 3 equity adjustment after a rate case. Do you agree?**

6 **A.** I agree that the Order does not direct that the adjustment be continued after a rate
7 case, no matter what the outcome of the rate case. Nor does not the Order
8 indicate that the adjustment should be discontinued after a rate case, no matter
9 what the outcome. As Ms. Deronne acknowledges, however, the Order does
10 contemplate that the CR 3 adjustment should be made for purposes of earnings
11 surveillance. What Ms. Deronne overlooks is the fact that the earnings
12 surveillance reporting requirement is an abbreviated form of rate case reporting,
13 requiring the Company to make all the same adjustments and jurisdictional
14 allocations that are required in a rate case, but on a monthly basis.

15
16 Through this reporting requirement, the Commission is able to monitor
17 whether the Company's revenue requirements and Return on Equity are within
18 the authorized rates set in the last formal rate case. Through its Order approving
19 the CR 3 adjustment, the Commission acknowledged that revenue requirements
20 and rates need to be sufficient so as not to harm or distort Florida Power's
21 financial performance in the future. This can be accomplished only through the
22 continuation of the adjustment to common equity and its consideration in the rate-
23 setting process.

1 **Q. FIPUG witness Gorman contends (at pp. 19-22) that the Company’s**
2 **proposed CR 3 equity adjustment should be rejected for the reason that the**
3 **Company’s capital structure includes too much equity. What is your**
4 **response?**

5 A. His conclusion is mistaken. He is able to reach that conclusion only by ignoring
6 Florida Power’s off-balance sheet obligations, namely, power purchase
7 agreements. As the Commission is well aware, Florida Power dutifully entered
8 into numerous power purchase agreements in the early ‘90s to comply with the
9 directives of the Public Utility Regulatory Policies Act (“PURPA”) and this
10 Commission’s implementing rules. These contracts create payment obligations
11 virtually indistinguishable from debt-service obligations under promissory notes.
12 (In fact, entering into such contracts is analogous to building a power plant using
13 only debt financing.) Accordingly, Standard & Poors (a rating agency) imputes
14 additional debt to our balance sheets to account for these power purchase
15 agreements. This is indicative of how investors evaluate the capital structure of
16 the Company in determining the investment risk associated with it. Thus, the
17 existence of these off-balance sheet obligations increase the Company’s cost of
18 capital. The Commission has recognized this fact as recently as its Order
19 approving the Hines 2 project. (PSC Order No. PSC-01-0029-FOF-EI). Florida
20 Power witness Scott Wilson provides a detailed explanation of why Mr. Gorman
21 is mistaken.

22
23

1 V. **Rate Base**

2 **Closed Business Offices**

3 Q. **Ms. Deronne contends (at pp. 21-22) that the Company failed to remove from**
4 **the 2002 test year all the impacts of the 33 business offices that the Company**
5 **has closed, and so she proposes to reduce plant in service by \$13,684,000,**
6 **accumulated depreciation by \$3,147,000, and depreciation by \$419,000. Is**
7 **she correct?**

8 A. Only partly. We accept an adjustment reducing depreciation by \$419,000.
9 Beyond that, however, we do not agree with her recommended adjustments. As
10 of this time, the Company has not finalized the disposition of these offices. Some
11 offices are being converted for other operational purposes (e.g., training) or may
12 have a future use benefit. Accordingly, it is appropriate to carry the plant and
13 accumulated depreciation in rate base.

14
15 VI. **Net Operating Income**

16 A. **Operating Revenues**

17 **Miscellaneous Service Revenues—Account 451.0**

18 Q. **Ms. Deronne proposes (at 22-23) to increase Miscellaneous Service Revenues**
19 **(amounts collected for changing, connecting, and disconnecting service)**
20 **based on her argument that recent actual experience suggests that the**
21 **Company is inappropriately projecting a decline in these revenues. Do you**
22 **agree with this adjustment?**

1 A. No, I do not. The Company makes its projections based on historical trends
2 tempered with any known, probable future changes. This account balance trend
3 over the last five years shows a zero growth rate, with some years having positive
4 growth rates and some having negative growth. The year-end 2001 balance in
5 this account was projected to have a two percent decrease, using the first five
6 months of actuals and the last seven months of budget. As this balance has not
7 had a decline for two consecutive years, the projected year 2002 was held flat
8 with no growth. This is sound forecasting methodology that attempts to
9 normalize the going forward revenue expectations while still incorporating any
10 known probable future changes.

11

12 **Other Electric Revenues—Account 456.20**

13 **Q. Ms. Deronne (at pp. 24-25) proposes to adjust Other Electric Revenues by**
14 **\$64,195 (derived primarily from remittance processing revenues for third**
15 **parties and non-FPC bill collection revenues) based on her view that some**
16 **decline in this account is likely but not at the level projected by the**
17 **Company. Is she correct?**

18 A. No, she is not. The revenues recorded in account 456.20 are primarily from
19 remittance processing revenues for third-parties and non-FPC bill collection
20 revenues. There was \$144,372 recorded in this account in 2000 for processing
21 fees—release of easements for third parties and lease of rights-of-way. The
22 Company is not forecasting to collect as much in revenues for these services in
23 2002. In fact, the Company has seen a decline in revenues over the prior year of

1 \$75,000 in 2000, \$185,000 in 1999, and \$1,395,000 in 1998. This continued
2 decline supports the Company's forecast.

3
4 **Fuel Revenue and Expenses**

5 **Q. FIPUG witness Gorman (at pp. 13-14) argues that the Company has**
6 **inappropriately reduced net operating income by removing recoverable fuel**
7 **revenue and expenses from total projected operating expenses, in order to**
8 **cover interest on the Tiger Bay regulatory asset. What is your response?**

9 **A.** Mr. Gorman's premise is flawed. In the Commission's Order approving the
10 Company's purchase of Tiger Bay and the termination of the five power purchase
11 agreements, the Commission authorized the Company to continue to collect
12 revenues from customers through the fuel and capacity clause as though the five
13 power purchase agreements were still in effect. The Commission then directed
14 the Company to apply those revenues to the actual fuel cost of the plant, which is
15 now part of the Company generating fleet, to interest expense based on the
16 balance of the unamortized regulatory asset, and finally to apply any remaining
17 revenues to the amortization of the regulatory asset.

18
19 Against that background, it is evident that our proposed adjustment is
20 correct. First, we removed the total revenue collected through the fuel and
21 capacity cost recovery clauses. Second, we removed the expenses included in Net
22 Operating Income that the revenues have been intended to recover. As
23 demonstrated by MFR—C-3, those components are fuel expense, amortization

1 and depreciation, federal and state income taxes, and taxes other than income
2 taxes. The one component that is not part of Net Operating Income, but that is
3 part of the revenues established by the Commission through the pass-through
4 clauses, is interest. Interest on the Tiger Bay regulatory asset, as well as interest
5 on any over or under recovery, is accounted for after Net Operating Income but
6 before Net Income. Therefore, once the interest expense is taken into
7 consideration, the pass-through clause adjustment is fully reconcilable.

8
9 **Sales Forecast**

10 **Q. Mr. Gorman (at pp. 14-16) contends that the Company should use a**
11 **“normalized” sales forecast for 2002 rather than a forecast that reflects**
12 **actual, depressed economic conditions. Do you agree?**

13 A. No. As Florida Power witness John B. Crisp explains in further detail in his
14 rebuttal testimony, it would not be appropriate or conventional to “normalize”
15 sales forecasts as Mr. Gorman proposes. Most simply put, if we were to
16 “normalize” our forecast for 2002 for the purpose of “better” predicting economic
17 conditions for the years following 2002, we would experience a revenue shortfall
18 in the test year itself. It is important to get rates right for the test year at least.
19 The Commission has the means to monitor future developments through the
20 surveillance reporting mechanism.

1 **B. Operating & Maintenance Expenses**

2 **Storm Damage Expense and Reserve**

3 **Q. Witness Brown (at pp. 29-30) proposes an adjustment to the Company's**
4 **accrual of \$6 million in storm damage expense, suggesting that the accrual**
5 **should be reduced to \$2 million annually. Do you agree?**

6 **A. No, I do not. Ms. Brown asserts that Florida Power's storm damage reserve and**
7 **the annual expense is too high based solely on the Company's storm history.**
8 **What Ms. Brown neglects to discuss is the purpose of this reserve. This reserve**
9 **was established by the Public Service Commission to provide insurance to deal**
10 **with catastrophic losses from acts of nature for which insurers worldwide will not**
11 **write storm coverage. Therefore, the issue is not the average annual T&D**
12 **damages associated historically with non-catastrophic storms, but the potential for**
13 **catastrophic losses.**

14
15 Statistics indicate that seven storms have hit Florida over the past 70-80
16 years that would be considered catastrophic. Each year, new T&D facilities are
17 being built to meet growth in Florida Power's service territory, increasing the
18 total potential costs associated with catastrophic storms.

19
20 It has been well publicized over the past several years that the frequency
21 and intensity of storms affecting the U. S. coastal areas are expected to increase.
22 Dr. William Gray, the most outspoken and well known hurricane forecaster, has
23 written a number of articles regarding the changing weather patterns that will lead
24 to increased storm activity over the next several years. There is every reason to

1 believe that it is only a matter of time before a severe storm hits our service
2 territory. The fact that insurers worldwide will not write storm coverage on T&D
3 lines for U. S. coastal utilities is strong evidence that we are at risk of sustaining
4 huge losses. In fact, based on these considerations, we could reasonably increase
5 our annual accrual.

6
7 We need look no further than the service territory of Florida Power's
8 affiliate, CP&L, for substantiation of the kind of losses catastrophic storms can
9 bring about. The T&D costs associated with storms in CP&L's territory in recent
10 years are as follows:

11	1996	Hurricane Bertha	\$11,000,000
12	1996	Hurricane Fran	\$95,000,000
13	1998	Hurricane Bonnie	\$25,000,000
14	1999	Hurricane Floyd	\$64,000,000

15 In addition SCANA and Duke each suffered T&D losses of approximately
16 \$60 million from Hurricane Hugo in 1989 and, from information in our files, it
17 appears that the estimated total T&D damage suffered by FP&L from Hurricane
18 Andrew in 1993 was \$270,000,000.

19
20 **Q. Ms. Brown (at pp. 30-31) contends that, should the Commission allow**
21 **Florida Power to continue accruing \$6 million a year for storm damages, the**
22 **Company's recommended rate base offset should be adjusted. Do you agree?**

1 A. No, I do not. When budgeting for this type of cost, the Company makes a
2 conservative assumption that it will be subject to storm damage and therefore
3 would need to draw upon funds from the reserve.

4
5 **Power Marketing Expenses**

6 **Q. Ms. Brown (at pp. 31-33) proposes to allocate to Florida Power's**
7 **shareholders 20 percent of the increase in 2002 in power marketing expenses**
8 **over the three-year average from 1999-2001 (the increase being \$2.385**
9 **million), allocating the balance of test year power marketing expenses to both**
10 **the wholesale and retail jurisdictions. Is this an appropriate adjustment?**

11 A. No, it is not. The 2002 projected \$4.9 million in power marketing services
12 expense includes natural gas and residual oil trading and supply service, power
13 trading, trading support services and Energy Ventures management. The \$4.9
14 million was determined by reclassifying portions of Fuel Supply expenses (FERC
15 Accounts 501 and 547) into power marketing services (FERC Account 912).
16 Furthermore, historical actuals with an escalation factor determined the 2002
17 projections. The increase between 2000 actuals and the 2002 projected expenses
18 is due to the accounting reclassification and enhanced Information Technology
19 systems and business management procedures. This area is heavily dependent on
20 technology, and technology is expensive, but these increased costs should be
21 balanced against the immediate benefits that customers gain through the fuel
22 adjustment clause in lower fuel costs and higher margins on non-separated
23 wholesale sales. See table below:

1

Contributions Made by Power Marketing

Year	Savings From Purchases	Savings From Sales	Total Savings
1994	\$ 6,686,693	\$ 1,917,723	\$ 8,604,416
1995	3,930,277	3,299,416	7,229,693
1996	12,739,582	1,701,131	14,440,713
1997	9,215,965	4,094,564	13,310,529
1998	5,729,529	12,788,820	18,518,349
1999	2,120,470	13,947,695	16,068,165
2000	11,867,570	8,939,096	20,806,666
2001	4,027,490	10,283,714	14,311,204
	<u>\$ 56,317,576</u>	<u>\$ 56,972,159</u>	<u>\$ 113,289,735</u>

2

3

4 **Q. Ms. Brown points out (at p. 31) that Florida Power did not allocate any**
5 **power marketing expenses to the wholesale side. What is your response?**

6 A. We agree that power marketing expenses should have been allocated between the
7 retail and wholesale jurisdictions. This omission was an oversight that we agree
8 to correct. Nonetheless, given the proportionately small amount of wholesale
9 business, the impact of this correction on retail customers will be minimal.

10

11 We disagree with Ms. Brown to the extent that she argues that the
12 Company is attempting to recover all of its power marketing costs from retail
13 customers. Between rate cases, shareholders carry the risk of annual changes in
14 power marketing expenses, while our customers will always benefit from the
15 margins on non-separated wholesale sales regardless of the changes in the costs of
16 achieving those savings. Under the Commission's rules, 80 percent of the margin

1 created from increased sales flows annually to retail customers through the fuel
2 adjustment clause, and fuel rates are set by including a reduction for estimated
3 benefits from this sales activity.

4
5 **Q. Ms. Deronne (at pp. at 39-40) recommends that projected 2002 test year**
6 **expenses associated with Power Marketing Services (Account 912.70) be**
7 **reduced by \$2,316,000 to reflect the actual historic test year amount of**
8 **\$2,581,000. Do you agree?**

9 A. No, I do not, for the reasons I have just given.

10
11 **General Advertising Expense**

12 **Q. Ms. Deronne (at pp. 41-44) recommends that expenses in Account 930.13—**
13 **Other General Advertising be reduced by \$4,693,000 from the Company's**
14 **projection to reflect a four-year average level for this account of \$456,000**
15 **based on her concern that the proposed increased in this category will be**
16 **spent on imaging. What is your response?**

17 A. Ms. Deronne is mistaken, and her recommendation should be rejected. She relies
18 on discovery that is inclusive of both recoverable advertising and non-recoverable
19 imaging to contend that the Company is proposing to use its budgeted advertising
20 expenses for non-recoverable imaging. What she overlooks is the fact that the
21 imaging activities the Company included in its overall advertising plan have
22 already been recognized and adjusted out of the rate case in the amount of \$4,
23 007,000. The remaining plan objectives (reflected in goals two and three of the

1 three she mentions) are not related to building the Company's image as explained
2 below:

3
4 • BEGIN CONFIDENTIAL. The Company's second stated goal is to "develop
5 new external messages for 2002 focusing on the key attributes of trust,
6 reliability, safety, conservation and the environment to begin running in May
7 2002." This goal is to run advertising that provides Florida Power customers
8 with useful tips on how to use energy more safely and efficiently. These tips
9 should motivate customers to change the way they use power, no matter who
10 provides it. We believe that this type of advertising is the kind that the
11 Commission would want the IOUs in the state of Florida to emphasize in
12 order to create more energy-wise customers.

13
14 • Our third stated goal is to "integrate communications to ensure synergy of
15 messages for consistency and impact." This means that we will plan our
16 communication efforts so that our appeals to the public through various media
17 and at various times about safety, efficiency, and conservation will be
18 coordinated to drive home our message consistently and effectively. This goal
19 also reflects the fact that our merger will enable us to take advantage of
20 efficiencies in advertising developed both for Progress Energy's Florida-based
21 and Carolina-based electric utilities. Many advertising campaigns are used by
22 both CP&L and Florida Power, so development costs are shared. This creates
23 synergy and efficiency for Florida Power who would have otherwise borne the
24 entire cost of these projects. END CONFIDENTIAL.

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Further, Ms. Deronne's analysis ignores the fact that Florida Power's advertising program was not as aggressive prior to the merger as it is today. As a result of the merger, we have learned from CP&L's positive experience in this area that we can achieve significant benefits from better informed customers. Our 2002 media campaign reflects a wide-ranging effort to reach all Florida Power customers with key messages of conservation, safety, storm preparedness, and customer service. Today, we are committed to reaching as many of our customers as possible with these important messages. Whereas much of our media efforts in the past were limited to certain major markets, we are now placing advertising to reach customers in all parts of our service territory. Our goal is to educate not only Florida Power's customers in major metropolitan areas about conservation and safety, but to reach equally important customers who live in smaller towns as well.

Finally, Ms. Deronne ignores the increasing costs of advertising. Advertising expenditures have increased much faster than the general rate of inflation. Since 1997, television advertising costs have risen 24 percent, newspaper advertising costs are up 26 percent, and radio advertising costs have increased 51 percent. Advertising production expenses have risen as well. Specifically, costs for creative time (including design and writing) are up 50 percent, photography costs have increased 50 percent, and printing costs are up 25 percent.

1

2

Last Core Nuclear Fuel and End-of-Life Materials and Supplies

3

Q. Ms. Brown proposes (at pp. 33-36) that the Company should not amortize last core nuclear fuel expenses at this time based on her assumption that the Company will obtain extension of the operating license for CR 3. Is she right?

4

5

6

7

A. No, she is not. There is no evidence in this proceeding, and none exists, to indicate that Florida Power has received approval from the Nuclear Regulatory Commission for a license extension, nor that Florida Power has completed any analysis that would indicate that a license extension is even cost effective. Ms. Brown is attempting to introduce unsubstantiated expectations of future events into the test year.

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Q. Ms. Brown (at pp. 37-38) challenges the Company's amortization of Nuclear End-of-Life Materials and Supplies expenses. What is your response?

21

22

A. This is no longer an issue, given Commission Order No. PSC-02-0055-PAA-EI, which establishes the annual accrual amount for end-of-life nuclear materials and

23

1 supplies. The Company agrees to update its filing to reflect the Commission's
2 Order.

3

4 **Q. Ms. Deronne (at p. 46) points out that the Company has indicated in**
5 **discovery responses that the amount is included for Nuclear Materials and**
6 **Supply Inventory in Schedule C-1 (\$1,667,000) is incorrect and should be**
7 **\$1,467,000. Is that right?**

8 A. Pursuant to the Commission's Order, the annual accrual has been established at
9 \$1,500,000 on a retail basis.

10

11 **Nuclear Decommissioning Expense**

12 **Q. Ms. Deronne (at p. 51) suggests that the amount Florida Power has included**
13 **in its filing for nuclear decommissioning expenses should be reduced by**
14 **\$2,250,000 to reflect the current status of Docket No. 001835-EI. Do you**
15 **agree?**

16 A. No, I do not. The correct adjustment to the test year data is a reduction of
17 \$982,000 on a retail basis. This would be consistent with the Commission's
18 Order.

19

20 **Nuclear Energy Institute Dues—Lobbying**

21 **Q. Ms. Deronne (at p. 50) recommends that the amount of Nuclear Energy Dues**
22 **associated with lobbying efforts, 20 percent of the total (or \$25,600) be**
23 **removed from the 2002 test year. Do you agree with this recommendation?**

1 A. Yes. We accept this adjustment.

2

3 **Transmission Expenses**

4 **Q. At pp. 38-40, Ms. Brown suggests that the Company's proposed**
5 **transmission expenses should either be capitalized as a component of**
6 **associated capital costs or amortized over a 10-year period. Do you agree?**

7 A. No. As explained in greater detail in the rebuttal testimony of Florida Power
8 witness Sarah Rogers, the Company's proposed transmission expenses reflect the
9 Company's commitment to increase reliability to top-quartile performance and
10 are indicative of ongoing, reliability expenditures that we will incur in the future.
11 There is no more basis to capitalize these ongoing, O&M expenses than any
12 others.

13

14 **Tiger Bay Accelerated Amortization**

15 **Q. Ms. Brown (at p. 42), Ms. Deronne (at pp. 50-51), and Mr. Gorman (at pp.**
16 **16-17) state that the Company should not include the proposed \$9 million**
17 **accelerated amortization of the Tiger Bay regulatory asset in the test year**
18 **revenue requirements. Do you agree?**

19 A. No. In the course of completing the Company's MFRs, we included an amount in
20 accordance with Commission Order No. PSC-7-0652-S-EQ, which "provides FPC
21 the discretionary ability to contribute dollar amounts from its earnings to
22 accelerate the amortization of the Tiger Bay Regulatory Asset," which we

1 anticipated to be \$9 million. The Tiger Bay regulatory asset is now expected to
2 be fully amortized in 2003.

3
4 **Property Tax Expense**

5 **Q. Ms. Derrone (at pp. 51-54) contends that the Company's estimated 4.5**
6 **percent increase in property tax expense for 2001 is too high and that the**
7 **estimated increase for 2002 is likewise too high; so she recommends that the**
8 **projected 2001 property tax expense be reduced by \$3.6 million and that a**
9 **growth factor of 3.51 percent be used to determine taxes for 2002. Do you**
10 **agree?**

11 **A. No, I do not agree. Florida Power's estimate for 2001 was only 2.67 percent off**
12 **from actual taxes paid. Accordingly, her proposed adjustment to 2001 taxes is**
13 **misconceived and not supported by the facts. Ms. Derrone's projections for**
14 **future tax increases are likewise too conservative and do not take into account the**
15 **very real economic pressures that exist today.**

16
17 Most of us would agree that up, until last year, the economy for both the
18 nation and the state has been strong. Accordingly, property values for
19 homeowners and other taxpayers have generally increased significantly as
20 businesses added new equipment, and house values have risen. This has created a
21 situation where local governments did not feel the need to raise mileage rates; in
22 fact, they decreased these rates. This trend cannot continue, however, in light of
23 the recession the state is experiencing and the pressures on taxing authorities to

1 maintain revenue streams necessary to keep local governments functioning. Our
2 projections take into account the current economic situation and are based on
3 reasonable expectations of what the test year will bring.

4
5 *Rate Case Expenses*

6 **Q. Ms. Brown argues (at pp. 43-44) that the Company should be allowed to**
7 **exclude rate case expenses from 2001 only to the extent such amounts are**
8 **applied to the Tiger Bay amortization (and otherwise be required to absorb**
9 **2001 rate case expenses) and amortize remaining expenses over a four-year**
10 **period, given the time that appears to expire between rate cases. Do you**
11 **agree?**

12 **A.** No, I do not. The Commission's practice is that rate case expenses are deferred to
13 the balance sheet until the Commission's decision on what amortization period
14 should be applied.

15
16 With regard to the recovery period, the Florida Public Service
17 Commission authorized a two-year amortization in the past in the two rate cases
18 prior to the 1992 case, and a two-year period is eminently reasonable in this case.
19 Certainly, if the Commission does not see fit to approve our request for a step
20 increase effective November 2003 to recover the revenue requirements of Hines
21 2, we will be back before the Commission in another rate proceeding within two
22 years, and the intervenor arguments for a longer amortization fall by the wayside.

23

1 **Q. Ms. Deronne contends (at pp. 46-49) that the Company's rate case expenses**
2 **are unreasonably higher than expenses for Florida Power's 1992 rate case;**
3 **that the Company should have retained cheaper consultants; and that**
4 **consultant fees should be split 50/50 between the Company's customers and**
5 **shareholders. Do you agree?**

6 A. No, our rate case expenses are reasonable. The difference between 1992 costs
7 and current costs is explained not only by the simple passage of time and the
8 escalation of costs outside our control, but also by the fact that we handled more
9 of the responsibilities of the case in-house in 1992 than today. To reduce costs,
10 we have out-sourced legal and professional consulting activities that we used to
11 perform in-house, avoiding the need to maintain this infrastructure in between rate
12 cases or other significant projects. We use outside consulting services with
13 sufficient frequency that we have become highly familiar with the quality and
14 costs of different consultants, and we believe that we have identified and retained
15 consultants in this case who are well-suited to provide high quality, cost-effective
16 service, ultimately to the benefit of our customers.

17
18 **Q. Based on customer testimony given at the Winter Park service hearings**
19 **(alluding to the Company's franchise litigation with that municipality),**
20 **certain of the parties question whether legal fees incurred by the Company to**
21 **negotiate and litigate its franchise disputes with Winter Park (or other**
22 **municipalities) should be recoverable from all ratepayers, just those who live**
23 **in the affected municipality, or not at all. What is your response?**

1 A. These fees are being prudently incurred for the benefit of all of our ratepayers,
2 and they should be fully recoverable in the manner of other O&M expenses.
3 These disputes concern efforts by certain municipalities to terminate Florida
4 Power's right to serve customers in the affected areas and to acquire certain of the
5 Company's facilities used to serve those customers. Even on the face of this, it is
6 apparent that these municipalities are asserting a drastic claim that could, if
7 successful, significantly diminish the Company's customer base. If they were to
8 prevail, the result would be that the Company's fixed overhead costs would have
9 to be borne by a smaller customer base, putting upward pressure on the rates paid
10 by our remaining customers. That being the case, the Company has an obligation
11 to take reasonable steps to defend against these claims, for the benefit of its
12 customers as a whole. At the same time, as discussed more fully in the rebuttal
13 testimony of Company witnesses Sipes, Rogers, and Barnwell, the Company is
14 going to great lengths to ameliorate any underlying customer-service concerns
15 that may be driving this litigation.

16
17 We are also litigating issues concerning whether municipalities can
18 unilaterally impose fees amounting to a tax on the utility (and its customers) after
19 a franchise has expired or in the absence of an effective franchise agreement, and
20 we are negotiating new agreements with various municipalities that will avoid the
21 need for litigation, thus removing the risks to customers that I have described and
22 avoiding litigation expense.

23

1 The Company has retained highly experienced, able outside counsel to
2 handle these matters on the Company's behalf. Florida Power does not enter any
3 litigation lightly. The Company litigates only when it has strong grounds to do
4 so, when it has reasonable positions available, and when it can be assured that it
5 will be represented on a cost-effective basis. We have every assurance, based on
6 our experience, that counsel handling these franchise matters are well-qualified to
7 do so and are doing so on a cost-effective, ethical basis, asserting good faith
8 positions that enjoy a reasonable prospect of success.

9
10 Over the years, a Company of the size and complexity of Florida Power
11 will inevitably become involved in some kind of significant litigation every year.
12 Regrettably, this is a recurring cost of doing business. When the franchise
13 litigation is over, we will undoubtedly face future challenges. We make every
14 effort to manage, control, and contain these costs through the oversight of skilled,
15 highly professional in-house counsel working with responsible business managers
16 and through the use, when necessary, of qualified and ethical outside counsel.

17
18 Accordingly, the concerns expressed about the franchise litigation and
19 negotiation efforts are unmerited and should not be confused with a difference of
20 opinion about the merits of any party's position, which is the job of the courts to
21 resolve.

22
23

1 VII. Hines 2 Adjustment

2 Q. Ms. Deronne (at pp. 57-58) and Mr. Gorman (at pp. 16-18) argue that the
3 Commission should not provide for a subsequent year increase in revenue
4 requirements to account for the addition of Hines 2 in November 2003 to
5 Florida Power's generation fleet because we have no assurance that there
6 will not be offsetting increases in revenues or decreases in expenses. What is
7 your response?

8 A. As a projected test year, 2002 is reasonably indicative of what future rate base,
9 revenues, and expenses will be with one glaring exception: the Hines 2 power
10 plant. We are asking the Commission to approve a subsequent year adjustment
11 permitting the Company to recover the costs associated with Hines 2 because we
12 have every reason to believe that these costs will stand out in 2003 from the
13 otherwise representative revenues and expenses projected for the test year.

14
15 We are able to recognize the costs of Hines 2 at this time because they are
16 both known and measurable, as demonstrated in my pre-filed Direct Testimony of
17 November 15, 2001. Further, contrary to what Mr. Gorman implies (at p. 17),
18 there is precedent to support our request. In Order No. 15451 (December 13,
19 1985), in Docket Nos. 850050-EI and 850246-EI, the Commission approved a
20 subsequent year adjustment for TECO's power plant, Big Bend 4, which went
21 into service after the conclusion of the test year. The Commission specifically
22 adjusted 1984 test-year expenses to take into account projected 1985 and 1986

1 expenditures necessary to complete the plant (without treating the costs as
2 construction work in progress).

3
4 **VIII. Conclusion**

5 **Q. Please provide an overview of what you have told us.**

6 A. With the exception of the very few corrections that I have noted in my testimony,
7 and that the Company has noted elsewhere, we stand by the submissions we have
8 made to date. Overall, I am pleased to say that the Company is well run, that we
9 will continue to operate in a fiscally conservative manner, and that the budget we
10 are proposing is both reasonable and necessary not only to enable the Company to
11 continue to serve its customers safely and reliably, while improving the quality of
12 our service and meeting the increasing expectations of our customers in the new
13 millennium.

14
15 Our recent merger has positioned the Company to address this challenge.
16 As a result of the merger, Florida Power is a stronger company and is better able
17 to hold the line on costs, pass along net savings to customers, and increase the
18 reliability and quality of its service. In fairness, we ask that the Commission
19 recognize that the Company has not been able to slash O&M costs dramatically
20 without incurring other attendant costs. There is no such thing as a free lunch. As
21 I have described, however, even after our transaction and transition costs are
22 netted against expected synergies, we are pleased to be able to assure our

1 customers of an immediate rate credit of \$5 million and to continue to provide
2 that credit each year for fifteen years.

3

4 **Q. Does this conclude your testimony?**

5 **A. Yes, it does.**

Docket No. 000824-EI
 Exhibit MAM- 8
 Witness: Mark A. Myers

(Thousands)

	Variance	2002 BUDGET	1998 ACTUALS
Total Admin & General	\$(44,255)	\$46,453	\$ 90,708
<u>Adjustments recommended by Ms. Brown</u>			
92200 Adm Exp Transferred-Cr	15,678	15,678	-
Employee Pensions & Benefits	29,887	49,021	19,134
Witness Adjusted Total Admin & General	1,310	111,152	109,842
<u>Corrections to adjustments recommended by Ms. Brown</u>			
92200 Adm Exp Transferred-Cr (should not have been removed)	(15,678)	(15,678)	
Company Adjusted Total Admin & General	\$(14,368)	\$95,474	\$109,842

FLORIDA POWER CORPORATION

Analysis of Operations and Maintenance to Demonstrate that the Budget does include the Synergies

Docket No. 000824-EI
 Exhibit MAM-9
 Witness: Mark A. Myers

Base Recoverable O&M - System Per Book

Actuals / Forecast

	1998	1999	2000	2001	2002	2002 vs. 1998
Total O&M	\$ 471.5	\$ 465.9	\$ 527.5	\$ 433.0	\$ 474.3	\$ 2.8

Adjustment

Base Recoverable Fuel	\$ (4.2)	\$ (3.6)	\$ (5.4)	\$ (7.6)	\$ (8.4)	\$ (4.2)
Remove impact of Inflation (CPI-U, '98 base yr)		\$ (10.4)	\$ (26.7)	\$ (41.2)	\$ (54.5)	(54.5)
Pension Credit - 100%	\$ 27.0	\$ 36.0	\$ 55.0	\$ 57.7	\$ 54.5	27.5
Y2K expenditures		(9.2)				-
Hines 1	(0.6)	(4.6)	(8.9)	(8.8)	(10.7)	(10.1)
Tiger Bay	(7.8)	(4.6)	(5.4)	(5.3)	(7.3)	0.5
Intercession City 12-14			(0.1)	(1.3)	(1.5)	(1.5)
Accr Bus. Comb. Cost			(94.2)			-
CR3 Extended Outage	(5.0)					5.0
Energy Delivery Reliability Projects					(16.7)	(16.7)
Increase in General Advertising					(5.0)	(5.0)
Sub-total						\$ (59.0)
Total Adjusted O&M	\$ 480.9	\$ 469.5	\$ 441.8	\$ 426.5	\$ 424.7	\$ (56.2)
					Total Synergies	\$ (58.7)
					Variance	2.54

Annual Change	\$ (11.4)	\$ (27.7)	\$ (15.3)	\$ (1.8)
	-2%	-6%	-3%	0%

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