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

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

**ON BEHALF OF
FLORIDA POWER CORPORATION**

REDACTED

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

DOCUMENT NUMBER-DATE
01611 FEB 11 02
FPSC-COMMISSION CLERK

1 **Q PLEASE STATE YOUR NAME, BUSINESS AND ADDRESS.**

2 A. My name is Charles J. Cicchetti. My address is Pacific Economics Group
3 LLC (PEG), 201 South Lake Avenue, Suite 401, Pasadena, California
4 91101.

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

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

8 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

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

15 **Q. HOW IS YOUR REBUTTAL TESTIMONY ORGANIZED?**

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

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

22 A. We start with the revenue requirements associated with retail consumers.
23 These retail revenue requirements are conservatively projected to be

1 about $51.055 million per year less than they would have been without
2 this merger. These savings are effectively gross benefits. Retail
3 consumers would expect to find a reduction equal to this amount (mostly
4 in reduced labor expenses) in their underlying cost-of-service and
5 associated revenue requirements.

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

15 The retail consumers would net about 24 percent per year more
16 than they would have, if the merger had not occurred from this annual cost
17 of $41.2 million in two forms. First, FPC would make a guaranteed
18 payment of $5 million per year in reduced retail revenue requirements.
19 This benefit is not dependent upon FPC actually achieving the projected
20 synergies. This is equivalent to a fifteen year guaranteed annual return of
21 12.14% ($5 million from $41.2 million). In addition, the remaining
22 conservative synergy estimates of gross revenue requirement benefits are
23 about $46.06 million (i.e. $51.06 million - $5 million) in projected savings.

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

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

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

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

18 To enhance the likelihood that customers will receive additional
19 benefits from this merger, FPC's regulatory plan includes a progressive
20 earnings sharing mechanism (ESM). Under FPC's progressive ESM,
21 customers, in addition to the guaranteed $5 million retail rate credit, will
22 have the opportunity to receive a greater share of the more easily attained
23 cost reductions and savings. Conversely, FPC will receive a greater share

1 of the more difficult to achieve savings. This progressive ESM will benefit
2 customers in two ways. First, customers will receive the lion's share of the
3 more easily attained, and therefore the most likely to be achieved, cost
4 savings. Second, FPC will have the proper incentive to take extraordinary
5 methods to seek the harder to achieve savings because it will retain a
6 greater share of these savings. Under non-progressive plans, sharing
7 bands lack such effective incentives. However, under FPC's progressive
8 ESM, customer benefits will be maximized.

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

15 **OPC WITNESSES**

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

20 A. No. First, it is important to recognize that, in utility mergers, an acquisition
21 premium is typically thought of as the difference between the purchase
22 price and the depreciated book value, sometimes known as goodwill. In
23 this proceeding, Florida Power Corporation (FPC) is not seeking to

1 recover from customers the $3.4 billion difference in what Progress
2 Energy paid for Florida Progress and its depreciated book value.
3 Second, it is also important to realize that FPC is not seeking to
4 recover from retail customers in Florida the difference between the
5 amount paid to acquire the outstanding shares in for FPC and its then
6 (pre-merger) current market price. As I discussed in my Direct Testimony,
7 FPC is seeking to recover only a portion (30.9%) of the difference
8 between what Progress Energy paid and FPC's then current market price.
9 Third, FPC is seeking to recover only those costs related to this
10 transaction/merger. The significant net cost benefits, with more than one
11 half of the net savings guaranteed, result in extraordinary gains for
12 Florida's retail customers.
13 The specific percentage of the total transaction costs that FPC
14 seeks to recover is based on the estimated percentage of synergy savings
15 that FPC expects to achieve through this merger. The "net synergy"
16 savings to cost recovery (including transition cost recovery) results in
17 significant net consumer benefits in Florida. Thus, it is only a fraction
18 (30.9%) of the difference between what was paid for FPC and its then
19 current market price that FPC is seeking authority to recover through the
20 savings/synergies that FPC projects will be generated by this merger.
21 This amounts to annual cost recovery of about $10 million annually,
22 results in significant net cost benefits for consumers, with more than half

1 of this guaranteed. This results in a positive benefit to cost ratio when
2 comparing annual savings to annual transition plus transaction costs.

3 **Q. WHAT IS THE BENEFIT TO COST RATIO?**

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

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

19 A. No. Ms. Dismukes implies that retail prices will increase if customers are
20 forced to pay what she calls an acquisition premium or acquisition
21 adjustment. In reality, customers' rates will not be increased by the
22 merger and the associated regulatory plan that FPC has proposed. In
23 fact, as I testified to in my Direct Testimony, FPC is providing a

1 guaranteed annual $5 million retail rate credit to customers for 15 years.
2 This guarantees that customers will receive at least $5 million of FPC's
3 estimated share of the synergy savings that arise from this merger,
4 regardless of their being achieved. Under its proposed regulatory plan,
5 FPC will recover its transaction and transition costs from the synergy
6 savings that are generated by the merger and net about $10 million per
7 year in cost reductions for Florida's consumes.

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

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

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

1 **TO THE SEBRING ACQUISITION. PLEASE RESPOND TO HER**
2 **CRITICISMS.**
3 A. I never suggested that the Sebring acquisition was comparable to the
4 merger that is the subject of this hearing. My intention was to explain that
5 the Florida Public Service Commission (FPSC) had, in the past, allowed
6 acquisition premiums, by which I mean goodwill (i.e., the difference
7 between the purchase price and depreciated book value), to be included
8 in rate base where it found that extraordinary situations existed. I also
9 explained that the Commission specifically stated that the Sebring case
10 was not intended to be used as precedent. However, I referenced the
11 Sebring case for the proposition that the Commission recognizes that it is
12 important to encourage mergers that yield significant customer benefits.
13 The undisputed facts here demonstrate net annual projected savings of
14 about $10 million per year for 15 years. To this end, if the Commission
15 fails to allow merging companies to recover the costs necessary to
16 achieve these levels of net consumer benefits, similar beneficial mergers
17 are less likely to occur, which will be to customers' detriment in Florida.
18 **Q. AT PAGE 13 OF HER DIRECT TESTIMONY, MS. DISMUKES**
19 **DISCUSSES YOUR REFERENCE TO THE PEOPLES GAS COMPANY**
20 **ACQUISITION BY SOUTHERN GAS COMPANY. PLEASE RESPOND**
21 **TO HER DISCUSSION.**
22 A. Again, I simply cited the People's Gas case for the proposition that the
23 FPSC has allowed an acquisition premium to be included in rate base

1 when it finds that extraordinary conditions exist. In that case, the
2 Commission referenced five criteria as evidence of "extraordinary
3 conditions." These are: (1) increased service quality; (2) lowered
4 operating costs; (3) increased ability to attract capital for needed
5 improvements; (4) lower overall cost of capital; and (5) more professional
6 and experienced managerial, financial, technical and operational
7 resources as factors evidencing extraordinary circumstances. Ms.
8 Dismukes and I do not appear to disagree on what this particular case
9 stands for.

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

17 Also, Ms. Dismukes, at pages 14-16 of her Direct Testimony,
18 discusses the Jacksonville Suburban Utilities Corporation case, where the
19 FPSC allowed the companies to recover an acquisition premium, although
20 "both utilities were relatively healthy and not suffering from quality of
21 service problems." Mr. Dismukes cites a dissenting opinion in that case
22 by Commissioner Julia Johnson, who states that the FPSC's decision
23 marks a "shift in Commission policy." Unlike Ms. Dismukes, I do not go so

1 far as to suggest that the FPSC's policy with respect to acquisition
2 premiums has changed and no longer requires that extraordinary
3 circumstances be shown. To the contrary, I maintain that even though
4 FPC is not asking that the Commission put any part of an acquisition
5 premium in rate base, but is only asking for a regulatory plan that would
6 allow FPC to collect a portion of the transaction costs it has incurred
7 effectively by splitting the savings achieved that are made possible by the
8 merger, this merger still meets the FPSC's criteria for exceptional
9 circumstances, but rate base will not increase and base retail prices will
10 likely be almost $10 million less annually than they would have been.
11 Furthermore, FPC proposes a guaranteed $5 million retail rate credit.

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

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

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

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

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

21 The second factor is an increased ability to attract capital. Ms.
22 Dismukes grudgingly admits that this effect "may be true." She then
23 attempts to temper her admission by arguing that this one fact does not

1 make the merger extraordinary. This is true. However, because all five
2 factors are satisfied by this merger, the merger does meet the FPSC's
3 criteria for being extraordinary.

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

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

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

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

15 A. I do not disagree with Ms. Dismukes that the annual transaction cost is not
16 tax deductible. That is precisely why the annual payment must be grossed
17 up for tax purposes. However, her pejorative statement that FPC is
18 "...asking ratepayers to pay the full amount" does not follow from the tax
19 treatment. The fact is the government takes about 40 cents out of every
20 dollar in net revenue. As I discussed in detail earlier, FPC is seeking a
21 regulatory plan that will enable it to be repaid its share of the transaction
22 costs through savings enabled by the merger. Further, customers are
23 guaranteed at least an annual $5 million retail rate credit and the likelihood

1 of a net cost reduction through synergy after transaction and transition
2 costs are netted against the projected synergies annually. FPC is simply
3 asking to pay for a fraction of the merger's costs from a portion of the
4 projected FPC savings generated by the merger. It is very important to
5 remember that FPC's projected share of the merger will yield significant
6 net cost benefits to consumers, with more than half guaranteed.

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

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

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

20 I understand that CEOs talk about growth strategies. They and
21 their investor analyst audiences give more weight to the inherent strategic
22 and business vision and less to actual growth projections. Recent events

1 in California and at Enron demonstrate that while the vision may be
2 strong, the growth projections are, at best, plans, not guarantees.

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

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

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

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

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

21 It has also been my experience that when a utility is well run and
22 has a clear strategic vision, both customers and shareholders benefit.
23 The shareholder/customer relationship works best when it is based on

1 mutual sharing. In other words, all stakeholders are much better off if
2 neither side benefits at the expense of the other, and both sides benefit
3 from their joint relationship. That is precisely what the FPC regulatory
4 plan seeks to accomplish. Shareholders recover the costs of completing
5 the merger to the extent that synergy savings are sufficient to cover the
6 expense. Furthermore, FPC has strong incentives to beat this spread.
7 Regardless, customers are guaranteed an immediate and recurring $5
8 million retail rate credit for 15 years. Because savings are greater than
9 the amount of the transaction and transition costs, both sides are better
10 off; a classic win-win situation based on "splitting the savings."

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

16 A. It is not clear from Ms. Dismukes' testimony if she disputes or agrees with
17 her own breakdown of the synergies attributable to Progress Energy's
18 nonregulated operations. She is clear in her observation that FPC is
19 getting the smallest share of synergies. However, she does not dispute
20 Mr. Myers' testimony with respect to the way the synergy breakdown and
21 allocation was developed. Further, Ms. Dismukes fails to recall that the
22 percentage of the transaction costs that FPC seeks to recover from these
23 savings is exactly equal to the percentage of synergies it expects to

1 receive. In other words, if FPC is under represented on the savings side,
2 it would similarly be under allocated on the transaction cost side. Ms.
3 Dismukes does speculate that "it is possible that the premium paid for
4 FPC's stock relates to the enhanced potential for profits from future
5 unregulated operations." This is, to some extent, undoubtedly true. And it
6 is also true that these same unregulated enterprises will be assigned the
7 responsibility ****REDACTED**** of the transaction costs.

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

13 A. Ms. Dismukes is simply setting up a convenient straw person to knock
14 down. Her entire discussion of acquisition premium recovery in other
15 jurisdictions is misguided and irrelevant. First, I must point out that I
16 offered Exhibit CJC-2 to show examples of states in which the respective
17 state Commissions had followed a front-end loading transaction cost
18 recovery principle in designing their regulatory plans to share merger
19 savings. As can be seen from reviewing CJC-2, in most of these cases
20 the Commission allowed the merging utility to keep a portion of (i.e.,
21 share) the merger savings to pay for the transaction costs associated with
22 the merger. Thus, most of these regulatory commissions recognized the
23 need to allow merging utilities the opportunity to recover their transaction

1 costs in order to achieve customer benefits. These orders were certainly
2 not offered as examples of the way in which various state commissions
3 treated requests to include an acquisition premium in rate base. Again, I
4 stress that an acquisition premium is sometimes defined as the difference
5 between depreciated net book value and the purchase price (i.e.,
6 goodwill). This is not what FPC is seeking in this proceeding.
7 Consequently, pointing to a series of Commission Orders from other
8 states that mostly did not consider including an acquisition premium in rate
9 base is simply not relevant. I conclude most merging utilities have not
10 requested authority to add such premiums to their rate base on which they
11 would be entitled to shareholder profit. Nevertheless, the regulatory
12 commissions did approve plans in which synergy savings are shared
13 between customers and shareholders in recognition that the latter group
14 needs to recover their merger related costs, and in certain cases, their
15 acquisition premium.

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

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

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

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

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

3 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

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

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

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

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

---

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

1 **Q. AT PAGE 28 OF HER DIRECT TESTIMONY, MS. DISMUKES CLAIMS**
2 **THE PENSYLVANIA PUBLIC UTILITY COMMISSION (PPUC)**
3 **DECISION IN THE GPU/FIRST ENERGY MERGER SUPPORTS HER**
4 **POSITION. DO YOU AGREE WITH HER?**
5 A. Again, I must emphasize two things. First, FPC is not seeking rate base
6 treatment for an acquisition premium. Rather, it is seeking to have the
7 opportunity to recover a part of its transaction costs, to be netted against
8 projected merger savings. Second, the applicants in the GPU/FirstEnergy
9 merger were likewise not seeking rate base treatment for their acquisition
10 premium. That said, this case still does not provide her with support
11 sufficient to even knock down the straw person she set up. While the
12 PPUC did state that an acquisition premium would not be allowed in rate
13 base, it did allow a six year rate cap extension and allowed transition costs
14 to be amortized over that six year period. Thus, the Commission provided
15 for and allowed recovery of the transaction costs and transition costs from
16 merger savings, just like what FPC is requesting in this hearing.
17 **Q. AT PAGES 28-29 OF HER DIRECT TESTIMONY, MS. DISMUKES**
18 **CLAIMS THE NORTH CAROLINA UTILITY COMMISSION (NCUC)**
19 **DECISION IN THE SCANA/PSNC MERGER SUPPORTS HER**
20 **POSITION. DO YOU AGREE WITH HER?**
21 A. Again, this is a case where the applicants were not even seeking to put an
22 acquisition premium into rate base. The NCUC did state that an
23 acquisition premium would not be included in customers' rates (i.e.,

1 included in rate base). However, in that case the NCUC did allow rates to
2 be capped for a total of six years, which would allow the applicants to
3 recover their transaction and transition costs ($495 million) from any
4 merger savings that could be attained. Therefore, this case also supports
5 FPC's proposed regulatory sharing plan. NCUC staff did acknowledge
6 that acquisition premiums have "been allowed in a number of states to the
7 extent that merger savings or other benefits are achieved to offset it."[3]

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

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

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

---

[3] 198 PUR 4th 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.

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

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

20 A. Again, I must stress that FPC is seeking the opportunity to recover its
21 transition costs from the savings that will be enabled through this merger.
22 The customers will not bear directly these costs through rate increases. In

1 fact, the regulatory plan proposed by FPC accomplishes just the opposite,
2 a guaranteed $5 million rate credit.

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

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

19 Ms. Dismukes' assertion that there is no distinction because "rates
20 would increase due to the recovery from ratepayers of these costs" is also
21 not true. If an acquisition premium is put into rate base, without question
22 customers will be the direct source of the recovery of and on the amount
23 put into rate base. However, under FPC's regulatory plan, FPC will

1 recover its allocated share of the transaction and transition costs only to
2 the extent that savings are sufficient. Further, under FPC's proposed
3 regulatory plan, customers will receive significant net benefits, more than
4 half of which are guaranteed with the very real possibility of even greater
5 savings in the future. In my experience, this is a very good regulatory
6 "bet" to make.

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

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

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

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

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

1 **$58.7 MILLION THAT IT DOES NOT PLAN TO INCUR. DO YOU**
2 **CONCUR WITH HER CONCLUSION?**
3 A. No. The adjustment to which Ms. Deronne refers is simply designed to
4 net the cost of obtaining the merger savings and benefits against the
5 savings in order to obtain true net synergies. The savings projected, at a
6 minimum, exactly offset this adjustment. If any business saves money, its
7 costs are reduced, period. There is no ignoring the fact that if FPC saves
8 about $50 million, its customers will be better off, even if they pay about
9 $40 million to achieve this saving.
10 **Q. AT PAGE 8 OF HER DIRECT TESTIMONY, MS. DERONNE SUGGESTS**
11 **THAT IN EXHANGE FOR RECOVERING $58.7 MILLION IN COSTS,**
12 **FPC IS GIVING A $5 MILLION RATE CREDIT. HOW DO YOU**
13 **RESPOND TO HER STATEMENT?**
14 A. As I explained above, the $58.7 million adjustment is simply an accounting
15 projection of the projected savings FPC expects to be realized as a result
16 of this merger. The implication that the company will charge customers
17 $58.7 million in rates for costs that will not be incurred in exchange for a
18 $5 million rate credit is an inaccurate portrayal of FPC's regulatory plan.
19 What is true is that the acquisition adjustment will be paid for through the
20 projected savings, and that the net synergy savings that will be identifiable
21 through this adjustment methodology will be shared about equally with the
22 customers. Further, customers are guaranteed the first $5 million in

1 savings through the annual retail rate credit and FPC's proposed incentive
2 regulation to encourage even greater savings for customers.
3 Ms. Deronne attempts to suggest that reducing costs by about $60
4 million per year is a trade-off for FPC's guaranteed annual retail rate credit
5 of $5 million. Both are important aspects of consumer benefits. There is
6 simply no "tradeoff" here and like it or not, the tax collectors will take their
7 bite.

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

11 A. It is beyond dispute that when there are changes in control such as occur
12 during a merger, there will be change in control payments made to
13 executives in the companies whose services are no longer required.
14 There will also be severance packages awarded to other employees
15 whose services are no longer required I have found it to be an almost
16 universal practice for valuable and key executives to have in place change
17 in control provisions in their employment contracts that pay them multiples
18 of their annual salaries if they lose their positions through a merger.
19 Without such provisions, executives would either receive higher current
20 compensation or they would be loath to explore merger opportunities that,
21 despite their impressive net benefits for consumers, might cause these
22 executives to lose their position. Consequently, with such provisions in
23 place, key executives are encouraged to seek out and complete mergers

1 that will benefit both shareholders and customers. Consequently, I
2 disagree with Ms. Deronne that these transition expenses should not be
3 recovered by netting them against the projected gross synergies of this
4 merger. To the contrary, these transition costs are reasonable and
5 necessary costs, without which this merger and other beneficial mergers
6 would likely not occur.

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

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

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

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

1 Progress Energy's merger related debt, which has been financed at about
2 a 7.5 percent interest rate. Again, FPC's regulatory plan seeks only to
3 recover the costs that were required to accomplish this merger, which
4 results in significant net retail customer benefits.

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

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

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

17 A. No. First, I would like to clarify a quote that Ms. Deronne attributed to me.
18 She stated that I said "Importantly, FPC is not proposing an acquisition
19 adjustment be included in base rates…". I actually testified that "FPC is
20 not proposing an acquisition adjustment be included in rate base..."
21 There is a distinction. Ms. Deronne herself testified as to the distinction in
22 what FPC is proposing to do through its regulatory plan and including
23 goodwill or an acquisition premium in rate base, when she acknowledged

1 that the 4.607 pre-tax interest rate applied to the transaction costs are
2 lower than the overall requested rate of return. Rate base treatment
3 would receive the higher FPC cost of capital. In addition, I have explained
4 that FPC proposes a mechanism that will reduce retail rates below what
5 they likely would have been "but for" this merger. Further, the full context
6 of the FPC regulatory plan is significantly different than what would occur
7 with rate base treatment. For example, FPC will recover the transaction
8 costs netted against the gross synergy savings. Net utility savings will
9 then be given to customers through the immediate and guaranteed annual
10 $5 million rate credit and through additional savings for regulatory cost of
11 service and surveillance regulatory purposes, and through the earnings
12 sharing mechanism (ESM) I described in my Direct Testimony.

13 **Q. DOES FPC PROPOSE, AS MS. DERONNE SUGGESTS AT PAGES 16-**
14 **17 OF HER DIRECT TESTIMONY, THAT RETAIL CONSUMERS**
15 **SHOULD PAY FOR THE SAME UTILITY INVESTMENTS MORE THAN**
16 **ONCE?**

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

20 Ms. Deronne either does not understand FPC's proposal or she
21 intentionally mischaracterizes the proposal. Again, Ms. Deronne is
22 confusing FPC's regulatory plan with including goodwill in rate base. FPC
23 does not propose to mark up its rate base and create a new book value

1 equal to the price paid to acquire FPC. Quite the contrary, FPC's
2 regulatory plan will depend on achieving gross synergies to pay (i.e., to
3 net against) the transaction costs associated with this merger. Ms.
4 Deronne's concerns and comments are misguided. FPC's regulatory plan
5 will not, as Ms. Deronne asserts, adversely affect the rates charged to
6 FPC's customers. Ms. Deronne's fears are simply misplaced. This
7 merger will reduce retail prices relative to FPC standing alone.

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

12 A. No. Ms. Deronne's fear comes from misunderstanding FPC's proposed
13 regulatory plan. As I have previously stated, under FPC's regulatory plan,
14 recovery of the transaction and transition costs will be netted against
15 merger savings. Customers will not see a rate increase to cover merger
16 costs. To the contrary, customers are guaranteed an immediate annual
17 $5 million retail rate credit and retail rates will be less than FPC standing
18 alone. Furthermore, as I have also said, if the company is not permitted
19 an opportunity to recover its transaction costs, there will be a chilling effect
20 on future beneficial mergers in Florida, an unhappy circumstance that will
21 deprive consumers in Florida the significant net benefits associated with
22 such mergers.

1 **Q. AT PAGE 18 OF HER DIRECT TESTIMONY, MS. DERONNE ASSERTS**
2 **THAT THE FPSC HAS ALLOWED AN ACQUSITION PREMIUM IN**
3 **ONLY RARE CASES, MOST OFTEN WHEN THE ACQUIRED UTILITY**
4 **IS A TROUBLED UTILITY. PLEASE COMMENT ON HER TESTIMONY.**
5 A. To a large extent, I agree with her that the FPSC typically does not allow
6 an acquiring utility to include an acquisition premium in rate base.
7 However, I also explained above that Ms. Dismukes cited one recent
8 FPSC decision where the dissenting Commissioner suggested that this
9 policy was being changed by the Commission's Order in that case.
10 Regardless, the issue in simply not relevant here because FPC does not
11 propose to include an acquisition premium in rate base. And, as I have
12 testified to at length both in my Direct Testimony and here, this merger
13 meets the FPSC criteria for an extraordinary merger, justifying allowing an
14 acquisition premium is rate base. However, as I have stated, FPC is not
15 asking for such regulatory treatment. It is simply asking for approval of a
16 regulatory plan that would share the projected synergies by netting its
17 transaction and transition costs against gross merger savings, while
18 guaranteeing an annual $5 million retail rate credit, and providing the
19 opportunity for additional retail rate relief and greater future savings.
20 **Q. AT PAGE 19 OF HER DIRECT TESTIMONY, MS. DERONNE**
21 **SUGGESTS THAT YOU CONTRADICT YOURSELF BY SAYING THAT**
22 **THE MERGER SAVINGS ESTIMATED HERE ARE WITHIN THE NORM**
23 **OF OTHER MERGERS, YET THAT THE MERGER OFFERS**

1 **EXTRAORDINARY BENEFITS TO CUSTOMERS. PLEASE RESPOND**
2 **TO HER CRITICISM.**
3 A. As did Ms. Dismukes before her, Ms. Deronne is mixing two distinct
4 concepts. It is true that the relative merger savings estimated for this
5 merger fall within the norm of merger savings estimated in other mergers.
6 This is a good thing. It means that the company has used reasonable
7 assumptions in estimating merger savings, not purposely under or over-
8 estimating potential savings. Further, whether within the expected range
9 or not, annual savings of $175 million are certainly extraordinary by any
10 measure. The same conclusion is applicable for FPC's apportionment,
11 which also exceeds its associated cost recovery.
12 The key point that both Ms. Deronne and Ms. Dismukes have missed
13 is that there are also nonquantifiable benefits for consumers, such as
14 increased service levels and increased choices in services that will
15 emerge from this merger. These benefits would increase the savings to
16 cost ratio that I discussed earlier in this Rebuttal Testimony. These, in
17 addition to the five factors that qualify this merger as extraordinary under
18 FPSC guidelines, mean that this is, indeed, an extraordinary merger.
19 **PUBLIX WITNESSES**
20 **Q. AT PAGES 4-5 OF HER DIRECT TESTIMONY, MS. BROWN**
21 **CHARACTERIZES YOUR AMORTIZATION OF TRANSACTION COSTS**
22 **AS EFFECTIVELY A RATE BASE RECOVERY MECHANISM. DO YOU**
23 **AGREE WITH HER?**

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

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

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

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

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

21 A. No. As I explained in my Direct Testimony and earlier in my Rebuttal
22 Testimony, FPC has included the $58.7 million to represent the projected
23 synergy savings that will be achieved in Florida through this merger. In

1 this way, FPC will net the transaction costs against the projected synergy
2 savings. Customers' rates will not increase as a result of this
3 methodology because the increased cost is more than offset by the
4 savings. Ms. Brown is not correct in her allegation that customers' rates
5 will increase under FPC's proposal as a result of this merger. As I stated
6 earlier, FPC customers will enjoy an immediate and guaranteed $5 million
7 annual rate credit under the regulatory plan proposed by FPC.
8 Additionally, the accounting and incentives provided under the regulatory
9 plan will mean and encourage FPC to gain even greater synergy savings,
10 which will provide even more rate reduction savings to the customers. Ms.
11 Brown seems to ignore the fact that this proceeding is a "rate case" and
12 other cost of service changes that would have occurred without this
13 merger are also "in play" in this proceeding.

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

18 A. As I explained earlier in this Rebuttal Testimony, one purpose of FPC's
19 regulatory plan is to provide the company with the opportunity to recover
20 the costs it expended in completing the merger. The transaction costs are
21 a portion of those costs. Those transaction costs were borrowed.
22 Therefore, interest expense accrues on the borrowed funds. By allowing
23 FPC to recover 7.5% interest on the transaction costs (Progress Energy's

1 actual cost of the money), the company will be provided the opportunity to
2 recover the amount it actually expended to bring about the merger's
3 successful completion. And, as pointed out by OPC witnesses, the
4 interest charge is actually lower than FPC's requested cost of capital.
5 Regardless, these cost estimates are used to net against projected
6 synergy savings and not to increase rate base.

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

12 A. The basis for Ms. Brown's disbelief seems to stem from the fact that
13 Progress Energy should have petitioned the Commission prior to the
14 merger to assure that the costs would be recoverable. There is, however,
15 a flaw in her logic. If the Commission chooses to disallow the transaction
16 and transition costs reasonably incurred in this merger, it will establish a
17 chilling precedent for all other utilities that are or may be considering
18 future mergers with Florida utilities. Such an inhospitable regulatory
19 climate would cause other utilities to think twice about merging with a
20 Florida utility. Petitioning the Commission formally prior to completing this
21 merger would have injected an unnecessary procedural step that could
22 have increased transaction costs. Such action was not required.
23 However, this in no way diminishes my opinion that disallowing transaction

1 and transition costs in this case will have a chilling effect on future
2 mergers, to the detriment of customers in Florida who would be denied the
3 type of net benefits found in this merger in any future mergers in Florida.

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

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

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

1 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.

9 **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?**

14 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.

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

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

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

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

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

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

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

1 it is bad for consumers if the merger is accretive. This is wrong. Just the
2 opposite is true.

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

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

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

20 A. Ms. Brown mostly has it right. One reason for this merger is to allow the
21 companies to position themselves to be a strong regional player in an
22 increasingly competitive market. Part of this will occur through wholesale
23 power marketing functions conducted by non-regulated Progress Energy

1 subsidiaries. As recognized by Ms. Brown, FPC will also be able to make
2 wholesale market sales. This practice will generate an estimated $1
3 million in retail customer value and lower retail prices. However, the
4 unregulated power marketing activities of other Progress Energy
5 companies are beyond the FPSC's jurisdiction and have nothing to do with
6 FPC's proposed regulatory plan. That plan does not seek to recover
7 anything other than FPC's allocated share of the transaction and transition
8 costs. Ms. Brown would have the FPSC look to benefits that accrue to
9 non-regulated portions of Progress Energy to offset the FPC share
10 transactions and transition costs. However, she fails to note that these
11 same non-regulated businesses (and CPL) have already been assigned
12 responsibility for almost 70 percent of the transaction costs associated
13 with the merger. Ms. Brown's proposal to consider the merger benefits
14 associated with these other companies overlooks this fact.

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

21 A. I agree that there are many factors that make this a good merger, one that
22 will benefit customers and shareholders alike. I am glad to see that Ms.
23 Brown apparently recognizes the benefits to customers. However, given

1 the state of deregulation in the industry, I think that it is very uncertain
2 when, or even if, deregulation will actually occur at the retail level.
3 Certainly, the California experience has put a damper on retail
4 deregulation initiatives across the country. Furthermore, deregulation is
5 not a precise concept. Most now realize that the "devil is in the details" of
6 any deregulation transition plan.

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

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

21 **Q. AT PAGES 13-14 OF HER DIRECT TESTIMONY, MS. BROWN**
22 **ARGUES THAT THE ALLOCATION OF MERGER SYNERGIES**
23 **SHOULD REFLECT ******** *REDACTED* ********

1 *********** *REDACTED* ********* **ACCRUE TO SHAREHOLDERS.**
2 **DO YOU CONCUR WITH HER STATEMENT?**
3 A. No. First, ****** *REDACTED* ****** that Ms. Brown asserts accrues to
4 shareholders reflect the fact that income taxes capture 38.575% of gross
5 synergy. Second, these after-tax cost saving synergies are being used to
6 pay the transaction and transition costs associated with the merger.
7 These are costs that have been incurred. The key to understanding
8 FPC's proposed regulatory plan is to focus on the net synergy savings,
9 those savings that remain after paying all the costs necessary to secure
10 the savings. FPC's customers are guaranteed an annual $5 million rate
11 credit, and have additional opportunities to receive even greater savings
12 under the ESM that I recommended in my Direct Testimony.
13 **Q. AT PAGE 14 OF HER DIRECT TESTIMONY, MS. BROWN ALSO**
14 **SUGGESTS THAT** ******** *REDACTED* ******** **ARE**
15 **SUPPORTED BY THE PRODUCTION FUNCTION AND THAT**
16 **ADDITIONAL TRANSACTION AND TRANSITION COSTS SHOULD BE**
17 **ALLOCATED TO THE SHAREHOLDERS TO RECOGNIZE THIS**
18 **SUPPORT. SHE FURTHER ASSERTS THAT SHARED SERVICES**
19 **SUPPORTS THE PRODUCTION FUNCTION, MEANING THAT**
20 **ADDITIONAL TRANSACTION AND TRANSITION COSTS SHOULD BE**
21 **ASSIGNED TO THIS FUNCTION. PLEASE COMMENT.**
22 A. I disagree with Ms. Brown. FPC personnel have gone to great lengths to
23 fairly allocate the synergies to the business units where the savings will

1 occur. I am satisfied that this has been done accurately and appropriately.
2 Consequently, the allocation of transaction and transition costs that follow
3 from the synergy allocation is reasonable. No further adjustments are
4 warranted.

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

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

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

19 A. No. As I stated above, I find that the way in which FPC allocated
20 synergies and transaction and transition costs to be appropriate. Ms.
21 Brown's approach would assign 30% of the transaction and transition
22 costs to the unregulated businesses and then allocate the remainder
23 between FPC and CPL based on the each utility's respective share of the

1 synergy savings. I fail to see the logic in assigning transaction costs to
2 unregulated business units based on a financial value of respective worth
3 and then assigning cost responsibility to regulated units based on the their
4 respective shares of synergy savings. FPC's approach is both symmetric
5 and logical. Consequently, I see no reason to change FPC's proposed
6 regulatory plan based on one financial analyst's breakdown developed in
7 a different context.

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

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

17 Ms. Brown's second adjustment is related to her allocation between
18 regulated and unregulated businesses that I discussed above. Although
19 she never explains how she determined this percentage, Ms. Brown would
20 assign 30% of the transaction cost to the unregulated businesses and
21 then, using the savings breakdown supplied by FPC, allocate 30.9% of the
22 remaining 70% to FPC. This is not reasonable because the 30.9% is
23 based on an allocation that includes a projection for unregulated

1 synergies. Therefore, Ms. Brown is double counting or double allocating
2 the non-regulatory percentage.
3 Ms. Brown's two-step process reduces the allocated portion of
4 transaction and transition costs to FPC to about $200 million from the
5 $285 million that FPC derived by simply applying the 30.9% allocation
6 factor based on synergy shares to the $924 million transaction price. As I
7 stated above, there is no logical reason to "double" the non-regulated
8 piece using Ms. Brown's tortured two-step process. I find it more
9 equitable to assign cost responsibility based on savings.
10 Ms. Brown's third adjustment is to amortize the transactions costs
11 over 40 years rather than the 15 years I suggested. While 40 years might
12 be an appropriate depreciation schedule for a base-load power plant, I find
13 that it is too long for recovering transaction costs associated with a
14 merger.
15 **Q. AT PAGES 18-19 OF HIS DIRECT TESTIMONY, MR. KURY**
16 **CRITICIZED YOUR ESM PLAN. PLEASE RESPOND TO HIS**
17 **CRITICISM.**
18 A. Mr. Kury's criticism seems to be centered on his concern that the
19 company's return on equity "may increase for many reasons, many out of
20 its control." He seems mostly concerned with the earnings bands that are
21 featured in my ESM because they "assign a majority of the benefits of an
22 increased return on equity to the Company." I fear that Mr. Kury
23 misunderstands my ESM proposal. The bands contained within my ESM

1 mark it as a progressive ESM, where customers gain the greater share of
2 excess earnings when the easier to achieve savings are realized. The
3 company receives a progressively greater share of the harder to achieve
4 savings, encouraging the company to go the extra mile to maximize
5 savings. Further, the ESM that I designed insures that customers enjoy a
6 larger portion of the most easily attained savings now and, to the extent
7 the company can exceed projections, allows consumers to enjoy
8 additional current and higher future retail rate reductions than they would
9 otherwise. Mr. Kury does not explain how he thinks a more traditional
10 ESM would eliminate the "problems" he perceives or would offer
11 customers any greater benefits.

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

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

19 **Q. WHAT DOES MR. KURY RECOMMEND?**

20 A. Mr. Kury, at page 19 of his Direct Testimony, recommends that earnings
21 over the allowed ROE be shared equally between customers and
22 shareholders. This is effectively the same sharing that FPC proposes for
23 its net synergy sharing between customers (in the form of projected cost

1 of service reductions) and shareholders (in the form of transaction and
2 transition cost recovery). Mr. Kury further recommends that the
3 company's portion of the shared earnings be used to accelerate recovery
4 of the Transition and Transaction Costs associated with the merger. As I
5 discussed at length in my Direct Testimony, a progressive ESM offers
6 greater incentives to the company to exceed projections. Thus, the FPC
7 proposal provides customers with greater opportunities for future retail
8 rate reductions than does the more simplistic ESM offered by Mr. Kury.
9 Furthermore, FPC's plan reflects the specific tax treatment of the retail
10 sharing of synergy and merger cost recovery.
11 Further, I disagree with his suggestion that earnings under the ESM be
12 earmarked for any particular purpose. To do so would provide a
13 disincentive for the company. This is the antithesis of how a well designed
14 ESM would work. I find Mr. Kury's recommendations to be unreasonable
15 and unnecessary.
16
17 **FIPUG WITNESSES**
18 **Q. AT PAGE 5 OF HIS DIRECT TESTIMONY, MR. GORMAN**
19 **RECOMMENDS THAT THE TRANSACTION COSTS BE DISALLOWED.**
20 **DO YOU AGREE WITH HIM?**
21 A. No. Mr. Gorman asserts that the transaction costs should not be allowed
22 for the following reasons, all of which have no merit: (1) FPC has not
23 proved that the savings could not have been achieved without the merger;

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

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

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

19 Third, Mr. Gorman's assertion that Progress Energy was able to
20 attain a reasonable rate of return without recovering the costs associated
21 with the merger's completion is just plain wrong. Although it is true that
22 FPC booked the transition costs in 2000, these costs were backed out of
23 the surveillance report and were not charged to customers. Thus, these

1 transition costs are not reflected in year 2000 and are not relevant to
2 FPC's rate of return for that year. These transition costs were put back in
3 the 2001 Surveillance Report as a placeholder until the FPSC rules on
4 FPC's regulatory plan. These facts demonstrate that Mr. Gorman's
5 assertions are wrong. Further, as I explained earlier, if the FPSC denies
6 transactions and transition cost recovery in this case, it will likely have a
7 chilling effect on future mergers. This will deprive Florida consumers the
8 benefits that those future mergers might generate.
9 Mr. Gorman's fourth point is equally misguided. He asserts that
10 shareholders keep 91.5% of the estimated savings. He also ignores
11 various income tax effects. Most importantly, he overlooks the costs that
12 were paid by shareholders to bring about the merger that facilitated
13 synergy savings. Without this cost expenditure, there would have been no
14 savings to share with customers. Mr. Gorman wants to avoid discussing
15 the net savings, which are the relevant savings to discuss. Had he done
16 so, he would be forced to realize that customers are guaranteed an annual
17 $5 million rate credit. Shareholders are guaranteed nothing.
18 Q. **HAS MR. GORMAN CORRECTLY CHARACTERIZED YOUR**
19 **TESTIMONY WHEN HE ASSERTS THAT YOU STATE THAT COST**
20 **RECOVERY NORMALLY OCCURS OVER 3 TO 7 YEARS?**
21 A. No. Mr. Gorman fails to recognize the important difference between
22 FPC's proposed regulatory plan and the many other merger regulatory
23 plans. Other merger plans often give shareholders effectively all the early

1 synergy benefits. This is called front-loading. In contrast, FPC proposes
2 to share benefits with retail consumers from the very outset, as I have
3 already explained. Therefore, the recovery here is somewhat longer than
4 other recovery plans, but by no measure is this unique or unreasonable.

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

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

15 However, in my experience, in most mergers (and this merger is
16 not an exception), labor savings comprise the dominant portion of merger
17 savings. In my experience, these labor savings are generally achieved
18 and often surpassed. Here, the labor savings have already been achieved
19 and the test year budget reflects these projected savings. Further, the
20 point of my analysis was to assess whether the companies' projections
21 were reasonable given what other mergers had estimated. As I testified in
22 my Direct Testimony, I found that the estimated synergy savings in this
23 merger were comparable to the estimates presented in other mergers that

1 had taken place. Furthermore, FPC has strong incentives to exceed its
2 estimates of synergy.

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

7 A. No. I do not. Mr. Gorman fails to explain how the 15 year recovery period
8 creates risk for customers. In fact, FPC's proposed regulatory plan is
9 virtually risk free for customers, who are guaranteed an annual $5 million
10 rate credit and provided the opportunity for even greater cost reductions
11 through my proposed ESM. Mr. Gorman seems to also think that the 15
12 year recovery period is above the norm typically allowed in mergers, thus
13 indicating the cost is excessive relative to the savings. Again, Mr. Gorman
14 offers no support for his bald allegations. In fact, as explained earlier, the
15 merger savings will be <u>greater than</u> the amount of the costs expended to
16 achieve the savings. Any rational person would spend $1 to get back
17 more than a dollar (i.e., net savings). (This is like helping a stranger who
18 needs to feed a parking meter, but only has a dollar. The stranger
19 exchanges his dollar bill for the three quarters in your pocket, which puts
20 $1 in your pocket for the 75 cents you spent). And as I showed in my
21 Direct Testimony, the estimated savings are within the range that would
22 be expected for a merger with the Progress Energy characteristics. The
23 fifteen year period I chose is consistent with the 15 year recovery period

1 set forth in the 1993 Federal Tax Act. It is also interesting that Publix
2 Witness Ms. Brown does not share Mr. Gorman's fear that extending the
3 recovery period increases customer risk because she favors increasing
4 the recovery period from 15 years to 20 and 40 years for transition costs
5 and transaction costs, respectively. Mr. Gorman must be shaking in his
6 boots if he has read Ms. Brown's recommendations.

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

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

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

1 **COMPENSATED FOR ITS INVESTMENT IN FLORIDA PROGRESS**
2 **WITHOUT RECOVERING THE TRANSACTION AND TRANSITION**
3 **COSTS IT HAS INCURRED. PLEASE RESPOND TO HIS ASSERTION.**
4 A. Mr. Gorman's assertion are purely speculative. To be sure, I fully expect
5 that the merger will reduce the business and financial risk in the combined
6 companies. A larger entity also finds it easier to attract capital. However,
7 I do not concur with Mr. Gorman's assertion that this will necessarily result
8 in an increase in Progress Energy's stock price, thus fully compensating
9 Progress Energy without the need to allow it an opportunity to recover the
10 costs it expended to complete the merger, which will ultimately benefit
11 consumers. Value and share prices depend largely on cash flow. Mr.
12 Gorman ignores this simple fact. As I said before, if the FPSC denies
13 FPC the opportunity to recover transaction and transition costs, there will
14 be a chilling effect that might very well cause merger activity in Florida to
15 cease, to the detriment of consumers who will be denied the benefits of
16 these future mergers. This chilling precedent will not be overcome by
17 asserting that if the merged company is successful in reducing its
18 business and financial risk, its stock price will go up. Such reasoning is
19 the ultimate Pollyanna view of corporate finance.
20 **Q. AT PAGE 40 OF HIS DIRECT TESTIMONY, MR. GORMAN ARGUES**
21 **THAT AN ESM IS NOT APPROPRIATE UNLESS THAT COMPANY**
22 **CAN FIRST PROVE THAT THE SAVINGS CAN BE ACHIEVED ONLY**
23 **THROUGH THE MERGER. DO YOU AGREE WITH MR. GORMAN?**

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

15 **Q. DOES MR. GORMAN SUGGEST AN ALTERNATE SHARING**
16 **MECHANISM?**

17 A. Yes. He suggests, at page 41 of his Direct Testimony, that the revenue
18 sharing mechanism approved for Florida Power & Light in Docket No.
19 990067-EI might be a suitable ESM.[5] In that case, the FPSC established
20 a cost of equity range of 10-12 percent. Revenues above the range
21 needed to achieve a 12 percent ROE are shared between customers and
22 shareholders. Two sharing bands were established by the FPSC for retail
23 rate base revenues. Revenues within the first band are to be shared, with

1 1/3 going to shareholders and 2/3 going to customers. Excess earnings
2 above this first band are all refunded to customers.
3 I explained in detail in my Direct Testimony why FPC's progressive
4 ESM provides better incentives than does the ESM approach favored by
5 Mr. Gorman. FPC's proposal provides customers with a greater portion of
6 the low hanging fruit, the easiest to achieve cost savings. FPC's ESM
7 plan provides FPC with a greater share of the hardest to attain savings
8 and cost reductions. This greater reward will encourage FPC to go the
9 extra mile to try to exceed its savings and cost reduction projections.
10 Under an ESM, like the one in place for Florida Power & Light, if FPC was
11 to achieve extraordinary success in achieving cost savings that exceeded
12 its projections, it would receive nothing in return for its efforts. In contrast,
13 FPC's progressive ESM provides customers with the largest share of the
14 most easily achieved savings. If the company can achieve even greater
15 savings through its extraordinary efforts, it will be rewarded with a higher
16 share of these harder to achieve savings. This provides the company with
17 an incentive to try to beat its projections. Therefore, I think a progressive
18 ESM like the one FPC has proposed provides the company with the right
19 incentive to achieve as much as it can. Maximizing savings will also
20 maximize customer benefits. Therefore, I recommend that the FPSC
21 approve FPC's proposed progressive ESM.
22 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**
23 A. Yes.

---

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