BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NOS. 020262-EI, 020263-EI
FLORIDA POWER & LIGHT COMPANY

SEPTEMBER 11, 2002

IN RE: PETITION FOR DETERMINATION OF NEED FOR PROPOSED ELECTRICAL POWER PLANT IN MARTIN COUNTY OF FLORIDA POWER & LIGHT COMPANY

IN RE: PETITION FOR DETERMINATION OF NEED FOR PROPOSED ELECTRICAL POWER PLANT IN MANATEE COUNTY OF FLORIDA POWER & LIGHT COMPANY

REBUTTAL TESTIMONY OF:

WILLIAM E. AVERA

DOCUMENT NUMBER-DATE

09637 SEP 11 8

FPSC-COMMISSION CLERK

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6

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

8 A. William E. Avera, 3907 Red River, Austin, Texas, 78751.

9

10 **Q. Are you the same William E. Avera who previously filed direct testimony**

11 **in this case?**

12 A. Yes, I am.

13

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

15 A. My purpose here is to respond to the testimony submitted by Andrew L.

16 Maurey on behalf of the staff of the Florida Public Service Commission

17 (FPSC or the Commission) and by Kenneth J. Slater on behalf of The Florida

18 Partnership for Affordable Competitive Energy. Both argue that Florida

19 Power & Light Company (FPL or the Company) should ignore the equity

20 penalty in evaluating the most cost-effective alternative for new power

21 supplied.

22

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1 **Q. Does either witness disagree with how the equity penalty was calculated?**

2 A. No. Both witnesses contend that no consideration should be given to the cost
3 of off-balance sheet obligations associated with long-term purchased power
4 contracts. Neither takes issue with the reality of the off-balance sheet
5 obligation or with the way that the resulting costs were quantified by FPL. In
6 fact, Mr. Maurey explicitly accepts FPL's financial assumptions, which
7 include the equity and debt costs as well as the target capital structure used to
8 calculate the equity penalty.

9

10 **Q. What fundamental flaw underlies Mr. Maurey's recommendation to**
11 **ignore the equity penalty?**

12 A. Mr. Maurey's testimony contains a great deal of discussion regarding utility
13 bond ratings and the role of rating agencies in general. Mr. Maurey also
14 opines on the impact of purchased power and other factors on bond ratings for
15 FPL and other utilities. He also embarks on a wide-ranging discussion of
16 FPL's capital structure policies and the wisdom of FPL's current debt/equity
17 ratio. Putting aside any disagreements I might have with Mr. Maurey's
18 opinions on all of these issues, the fundamental flaw is that his discussion is
19 unrelated to the specific question at hand. Namely, do purchased power
20 contracts impose a cost on the utility by effectively increasing debt leverage
21 and, if so, should the incremental costs associated with this increased leverage
22 be accounted for in FPL's economic evaluation of power supply alternatives?

23

1 Indeed, the evidence presented in Mr. Maurey's testimony and on his exhibits
2 confirms that investors regard a portion of capacity payments under purchased
3 power contracts as debt in assessing the utility's financial position. Since the
4 addition of off-balance sheet obligations increases the cost to FPL, then this
5 cost must be considered to make a rational comparison between self-built
6 generation and purchased power. Mr. Maurey does not focus on the simple
7 question of whether purchased power contracts increase the effective cost of
8 financing the utility, all else being equal. Rather, he claims that FPL has
9 "exaggerated" the risks of purchased power and that the Company is not
10 "compelled" to make the equity penalty adjustment.
11
12 Q. **Is it necessary to explore the various risk factors impacting FPL's**
13 **generation and purchased power as well as the wisdom of the Company's**
14 **capital structure policies to evaluate the equity penalty?**
15 A. No. To derive the equity penalty FPL has merely followed the same
16 methodology used by the investment community to evaluate the financial
17 impacts of purchased power commitments. It is only logical that FPL's
18 evaluation of potential purchased power options incorporate the costs
19 associated with the incremental debt leverage that results from such contracts.
20 It is sound economic and financial principles, not FPL's current financial
21 position, that compels the FPSC to include the equity penalty in evaluating the
22 alternative power supply options in this case.
23

1 **Q. Did Mr. Maurey take issue with the methodology or financial**
2 **assumptions that FPL used to calculate the equity penalty?**
3 A. No. Mr. Maurey had no quarrel with the methodology used to calculate the
4 equity penalty, and after reviewing FPL's financial assumptions, including the
5 capital structure and component costs of debt and equity, Mr. Maurey
6 specifically concluded that *these assumptions are reasonable for purposes of*
7 *this proceeding* (p. 29).
8
9 **Q. Did Mr. Maurey disagree with your testimony that the investment**
10 **community considers the financial impacts of purchased power?**
11 A. No. Mr. Maurey specifically acknowledged (*e.g.*, p. 24) that reliance on
12 purchased power contracts is incorporated in the evaluation of a utility's
13 financial position. Indeed, his Exhibit ALM-1 details rating agency
14 adjustments made to account for purchased power contracts.
15
16 **Q. Do you believe a detailed review of FPL's financial policies or risk factors**
17 **is necessary or appropriate to evaluate the reasonableness of the equity**
18 **penalty adjustment?**
19 A. No. Clearly, a detailed evaluation of a utility's financial policies, including
20 capital structure and other risk factors, is a time consuming and highly
21 contentious process. Such an ambitious undertaking is simply not required or
22 justified by the issues that are properly the subject of this case. Indeed, Mr.
23 Maurey granted that the assumptions used by FPL to calculate the equity

1 penalty were reasonable. As noted in my direct testimony, the equity ratio
2 used to calculate the equity penalty is also consistent with the adjusted capital
3 structure recognized by the Commission in approving the revenue sharing
4 agreements included in Orders PSC-02-0501-AS-EI and PSC-99-0519-AS-EI.
5 These orders provide that, for surveillance reporting purposes, FPL's equity
6 ratio will be monitored on the basis of an "adjusted equity ratio" as
7 established by the Standard & Poor's methodology. The adjusted equity ratio
8 used by the Commission for surveillance reporting purposes is consistent with
9 the target capital structure employed in the economic analysis of the
10 Supplemental RFP, including the equity penalty calculations. Just as
11 importantly, whatever Mr. Maurey's views on FPL's financial policies might
12 be, they do not change the fact that (other things being equal) new purchased
13 power contracts imply an increase in the utility's financial costs solely
14 attributable to such contracts and totally unrelated to the utility's self-build
15 options.
16
17 **Q. Does Mr. Maurey's discussion of past cases at the FPSC (pp. 6-9) support**
18 **his contention that the equity penalty should be disregarded in this**
19 **proceeding?**
20 A. No. Mr. Maurey's review of prior FPSC decisions confirms what I concluded
21 in my direct testimony; namely, that the FPSC has previously recognized that
22 it is reasonable to consider the financial impact that purchased power
23 contracts have on the utility when evaluating supply alternatives. Indeed,

1 while Mr. Maurey quotes extensively from the findings of the hearing officer
2 in Docket No. 910759-EI, he failed to note that the FPSC concluded in Order
3 No. 25805 that:
4
5 Credit rating agencies recognize that, without compensating
6 factors, increased reliance on purchased power obligations may
7 lower coverage ratios. A utility can compensate for the
8 financial consequences of increased purchased power
9 obligations by increasing its equity ratio (reducing its debt
10 leverage), increasing its earnings, or petitioning for modified
11 regulatory treatment that allows the utility an opportunity to
12 earn a return on this capacity.
13
14 Mr. Maurey also attempts to distinguish between past proceedings and the
15 current case based on the relative magnitude of the equity penalty adjustment,
16 and arguing that it *was not subject to careful financial analysis* (p. 10). While
17 I cannot comment on Mr. Maurey's suggestion that the FPSC based its earlier
18 decisions on less than "careful" analyses; the more salient point is that the
19 equity penalty concept has already been debated, understood, and
20 incorporated by the Commission in the evaluation of power supply
21 alternatives (*e.g.,* Order No. PSC-01-0029-FOF-EI (January 5, 2001)). The
22 relative magnitude of the equity penalty, which obviously fluctuates case-by-
23 case and contract-by-contract, has no bearing on the conceptual validity of the

1 adjustment, which the FPSC has previously recognized and adopted.

2

3 **Q. Do you agree with Mr. Maurey's observation that the purpose of adjusted**
4 **financial ratios published by bond rating agencies is not to advise state**
5 **regulators (p. 12)?**

6 A. Yes. The focus of bond rating agencies such as Standard & Poor's (S&P),
7 naturally enough, is to endeavor to provide investors with the best information
8 possible regarding the financial integrity of the companies under their review.
9 To this end, S&P has repeatedly noted that contractual payments under long-
10 term purchased power contracts imply greater financial leverage and reduce a
11 utility's financial flexibility. Because of the significant impact associated with
12 these commitments, S&P incorporates the debt equivalent portion of
13 purchased power contracts in its assessment of a utility's credit strength and
14 reports adjusted ratios that investors consider in assessing their required rates
15 of return.

16

17 The fact that S&P is clearly not in the business of advising state regulators
18 says nothing about the real impact that purchased power has on investors'
19 evaluation of a utility's financial strength or the need to account for this in
20 analyzing alternative power supply options, as FPL has done. In the course of
21 their deliberations, regulators routinely consider and rely on information
22 published by the investment community, including bond ratings, growth
23 projections, and other financial analyses. An example is the excerpt from the

1 FPSC Order No. 25805 I quoted earlier. Obviously, the fact that investment
2 advisory services do not make recommendations to regulators or actively seek
3 to sway the outcome of administrative proceedings does not prevent the FPSC
4 from acknowledging and/or utilizing information and methodologies from
5 sources such as S&P. Mr. Maurey's allegation that FPL has used S&P's
6 methodology *for a purpose it was never intended* (p. 4) could not be further
7 from the truth. As the quote from Order No. PSC-1713-TRG-EG on page 8 of
8 his testimony makes abundantly clear, the FPSC has already weighed in on
9 this very issue by recognizing S&P's approach to measuring the effect that
10 purchased power has on a utility's financial leverage.
11
12 **Q. Are investors' views regarding the quality of regulation in Florida (p. 15-**
13 **16) relevant in determining whether an equity penalty adjustment is**
14 **warranted?**
15 A. No. I acknowledge that investors regard the FPSC as having been generally
16 evenhanded in the regulation of electric utilities in Florida. Also, I do not take
17 issue with Mr. Maurey's description of certain of the mechanisms under
18 which FPL recoups its purchased power costs from ratepayers. While Mr.
19 Maurey's discussion may be informative, however, it has no bearing
20 whatsoever on the reasonableness of FPL's proposed equity penalty. As
21 discussed at length in my direct testimony, the equity penalty is required to
22 recognize the financial leverage, and associated costs, that occur when a
23 utility enters into a contractual agreement for purchased power. This financial

1 obligation, in the form of off-balance sheet liabilities and reduced financial
2 flexibility, arises irrespective of whether regulation in Florida is deemed
3 "supportive." Indeed, Mr. Maurey's exhibits show that the rating agencies
4 make this adjustment irrespective of the particular state jurisdiction.
5 Regulatory quality undoubtedly affects the absolute level of risk faced by
6 FPL's investors, but it does not change the relative impact that adding
7 additional purchased power contracts has on the Company's debt leverage.
8 The equity penalty adjustment incorporated by FPL is a logical and accepted
9 means to reflect the economic cost of this leverage in a balanced comparison
10 of purchased power with self-build options.
11
12 **Q. Please address Mr. Maurey's argument that FPL's corporate credit**
13 **rating is unlikely to be downgraded as a result of entering into new**
14 **contracts for purchased power.**
15 A. Because investors recognize the additional financial leverage that
16 accompanies obligations under purchased power contracts, it has been
17 necessary for FPL to maintain a relatively greater proportion of equity capital
18 in order to support its credit standing. FPL's financial policies have explicitly
19 recognized the leverage implicit in existing purchased power contracts in
20 order to avoid a deterioration in the Company's financial integrity. As a
21 result, it would come as no surprise that some increment of additional
22 purchased power obligations might be accommodated without immediate
23 negative actions on the part of the bond rating agencies. However, every

1 additional purchased power obligation increases the Company's leverage. It
2 cannot reasonably be maintained that it is only the last contract before a
3 downgrade that adversely affected the Company's financial integrity. Indeed,
4 it is entirely conceivable that investors' required rates of return could still rise,
5 even without a downgrade.
6
7 In any event, neither FPL nor I have ever claimed that it is necessary to
8 incorporate the equity penalty in order to avoid a downgrade in FPL's existing
9 bond ratings. Rather, as I made clear in my direct testimony, in order to
10 conduct a meaningful economic evaluation of power supply alternatives, it is
11 necessary to recognize quantifiable differences between individual proposals.
12 The incremental costs that are associated with additional financial leverage
13 arising from purchased power contracts are one such difference that has been
14 recognized by the investment community and the FPSC. Similarly, Mr.
15 Maurey also described the impact of purchased power on the utility's financial
16 position as an *incremental risk* (p. 24). Failing to incorporate the associated
17 costs will result in a distorted comparison that would effectively subsidize
18 developers of projects being compared to FPL's self-build options. Clearly,
19 given the current financial condition in which many of the independent power
20 producers find themselves, they would be most anxious for the FPSC to
21 approve such a subsidy. That aside, while one additional purchased power
22 contract may not necessarily lead to an immediate downgrade of the
23 Company's debt, this is only because FPL has maintained (and the

1 Commission has recognized) financial policies that reflect the realities of
2 purchased power contracts. There is simply no basis to ignore those financial
3 realities and costs in evaluating the options available to meet FPL's current
4 needs, irrespective of whether the additional imputed debt actually results in a
5 downgrading of FPL by the bond rating agencies.
6
7 **Q. Does any subsequent decline in FPL's existing purchased power**
8 **commitments negate the need to consider the equity penalty in this case?**
9 A. No. FPL's off-balance sheet obligations for purchased power may decline at
10 some point in the future, but this does not alter the fact that, all other things
11 equal, additional purchased power contracts impose incremental financial
12 costs not associated with FPL's self-build options. The debt equivalent
13 associated with purchased power alternatives submitted in response to the
14 Supplemental RFP imply financial costs that would be ignored if Mr.
15 Maurey's recommendation were to be adopted. The subsequent reduction in
16 commitments under existing purchased power contracts may ultimately lead
17 to a change in FPL's actual capital structure going forward; however, the
18 impact of those reductions would occur irrespective of whether FPL builds or
19 buys in this instance. Therefore, the analysis of the impact of purchased
20 power in FPL's Supplemental RFP is properly done on an incremental basis.
21
22 **Q. Please comment of the relevance of the regression analysis described on**
23 **pages 20-21 of Mr. Maurey's testimony.**

1 A. As a former teacher of business statistics, I have a natural urge to critique the
2 study on technical grounds. But to do so would be an unnecessary diversion
3 because the study simply does not address the salient issue of whether the cost
4 of off-balance sheet obligations should be recognized in making a rational
5 choice between utility-built plants and purchased power contracts. Setting
6 aside a number of serious methodological flaws and shortcomings that
7 compromise the statistical results, including the very limited sample size (7
8 holding companies) and the staleness of the data (FPL's bond rating is no
9 longer AA-), this exercise and the conclusions Mr. Maurey draws from it say
10 nothing about the validity of the equity penalty adjustment.
11
12 As noted earlier, the additional leverage and financing costs associated with
13 purchased power arise irrespective of bond ratings or changes in credit
14 standing. These financial obligations, in the form of off-balance sheet
15 liabilities, have been recognized by the investment community and the FPSC.
16 Even ignoring the flaws in the analysis presented by Mr. Maurey, the degree
17 of statistical association between purchased power and bond ratings has no
18 bearing on the additional costs of financial leverage that accompany
19 incremental purchased power contracts and the off-balance sheet obligations
20 they represent. Indeed, the only significance of the regression analysis for this
21 case is that the utility-specific equity ratio used in the study was adjusted for
22 these obligations – confirming that Mr. Maurey regards these adjustments for
23 purchased power contracts as an objective benchmark for their financial

1 impact.

2

3 **Q. Does the comparison described on pages 24-25 of Mr. Maurey's**
4 **testimony accurately portray the impact of purchased power on utility**
5 **financial policies?**

6 A. No. Mr. Maurey attempts to correlate the equity ratios presented in Exhibit
7 ALM-1 with fuel mix data shown on Exhibit ALM-5, arguing that 10 of the
8 companies actually have a greater reliance on purchased power than FPL
9 while maintaining lower debt ratios. Based on this observation, he concludes
10 that FPL already has a sufficient equity cushion to compensate for purchased
11 power risks. However, Mr. Maurey's analysis ignores the purchased power
12 commitments that give rise to the financial obligations considered by FPL's
13 equity penalty adjustment.

14

15 As noted on Exhibit ALM-5, Mr. Maurey obtained his data regarding fuel mix
16 from The Value Line Investment Survey (Value Line). While Value Line
17 regularly reports statistics concerning the relative share of the utility's total
18 energy requirements met by purchased power, the investment advisory service
19 makes no distinction between the many alternative forms of power purchases.
20 Apart from long-term contracts, utilities also obtain power through short-term
21 agreements, purchases on the wholesale spot market, arrangements for
22 seasonal exchanges, economy energy purchases, as well as other sources. As
23 S&P has clearly recognized, the implications for a utility's financial leverage

1 vary significantly depending on the nature of the power purchase agreement
2 and the degree of firmness associated with any underlying payment
3 obligations. Obviously, while power purchased on the wholesale spot markets
4 would be reflected in a utility's resource mix, it has no fixed payment
5 requirements and, therefore, no debt characteristics. As a result, it would not
6 give rise to the off-balance sheet liabilities that FPL must account for in
7 determining its financial policies.
8
9 In addition, there are other significant differences between FPL and the
10 utilities referenced by Mr. Maurey that illustrate the fallacy of his overly
11 simplistic comparison. As Mr. Maurey noted, for example, NSTAR and
12 DQE, Inc. have both sold all of their generating assets. The fact that these
13 firms no longer participate in the power generation segment of the electric
14 utility industry implies a different set of operating risks than that faced by an
15 integrated utility such as FPL. Thus, while there may be logical reasons for
16 the distinctions in financial policies observed by Mr. Maurey, they are
17 unrelated to the debt equivalent portion of firm purchased power contracts that
18 is the basis for FPL's equity penalty adjustment.
19
20 **Q. Is there a more meaningful comparison that illustrates the flaw in Mr.**
21 **Maurey's logic?**
22 A. Yes. In order to capture the financial impacts of power purchase contracts,
23 such as those at issue in this case, a more meaningful benchmark is with the

1 off-balance sheet liability for each utility, as calculated by S&P. While FPL's
2 capital structure is more conservative than those of the firms singled out by
3 Mr. Maurey, a review of his Exhibit ALM-1 reveals that the Company's off-
4 balance sheet liabilities attributable to purchased power contracts also far
5 exceed those attributable to these other utilities. Indeed, the $1.2 billion in
6 off-balance sheet debt equivalents reported by Mr. Maurey for FPL is the
7 highest of all 43 companies contained on Exhibit ALM-1 and exceeds the
8 average for Mr. Maurey's 10-company group by over 3 times. While this
9 comparison does not account for other factors influencing a utility's choice of
10 capital structure (e.g., exposure to nuclear generation or service area
11 characteristics), it is consistent with FPL's decision to incorporate the equity
12 penalty in its economic evaluations of power supply options.
13
14 **Q. Do you believe the Wall Street Journal article referenced in your direct**
15 **testimony (p. 14, ln. 3-7) is "off point" in this case, as Mr. Maurey alleges**
16 **(pp. 25-26)?**
17 A. No. There is little debate that recent events in the power industry, including
18 the debacle in California and the collapse of Enron have focused investors'
19 attention sharply on the finances of all industry participants, including
20 integrated electric utilities such as FPL. As S&P observed in an April 15,
21 2002 publication entitled "Credit Policy Update: Factoring Off-Balance-Sheet
22 Financing Into the Ratings Process":
23

1 Standard & Poor's long-standing practice has been to factor
2 off-balance-sheet financings into the assessment of a
3 company's financial profile and creditworthiness, and it has
4 specific criteria dealing with various types of these activities.
5 Recently, such financings, their disclosure, and their
6 impact on an issuer's credit quality have attracted wider interest
7 and have become the subject of intense scrutiny by Congress,
8 the SEC, the FASB, and the press.
9
10 Mr. Maurey is correct that investors concerns are heightened for firms in the
11 energy merchant industry. Indeed, this is consistent with the testimony of Mr.
12 Moray Dewhurst, who discusses the current state of the merchant generation
13 market and explains the importance of financial viability as a non-price factor
14 in evaluating power supply alternatives.
15
16 Q. **Has FPL based the equity penalty on a presumption that purchasing**
17 **power is risky and building new capacity is not, as Mr. Maurey suggests**
18 **(p. 27)?**
19 A. No. I am not aware of a single statement in my testimony, or in the testimony
20 of FPL's other witnesses that would support Mr. Maurey's allegation. Clearly,
21 adding capacity – whether in the form of self-build capacity additions or
22 through purchased power contracts – implies a degree of risk to the utility.
23 The equity penalty does not suppose that the self-build option is risk-free;

1 rather, its only purpose is to capture the incremental costs associated with the
2 financial realities of purchased power so that meaningful economic
3 comparisons can be made between supply alternatives. Similarly, Mr.
4 Maurey's assertion that FPL *has completely ignored other factors* (p. 20) in its
5 economic comparison of the self-build versus buy options is also incorrect.
6 FPL used the same 55% incremental equity ratio in analyzing its self-build
7 options that it used to evaluate the purchase power options, including the
8 equity penalty calculation. In addition, risks associated with obtaining
9 capacity and operating and maintaining the utility system are incorporated into
10 the discount rate, which is based upon the Company's weighted average cost
11 of capital, used by FPL in its economic comparisons. While there are a
12 panoply of considerations that impact investors' required rate of return and, in
13 turn, the discount rate – including risks related to procuring power supplies –
14 this provides no basis for ignoring the incremental costs that additional
15 purchased power contracts impose on the utility. Indeed, the fact that the
16 investment community has focused its attention on understanding and
17 quantifying the financial risks inherent with purchased power commitments
18 only serves to emphasize the importance of incorporating the equity penalty in
19 FPL's economic analyses.
20
21 **Q. Is there an alternative to the equity penalty approach that can be used to**
22 **make an "apples to apples" comparison of the cost of utility-built**
23 **generation and long-term power purchase contracts?**

1 A. Yes. An alternative would be to calculate the revenue requirements of the
2 utility-built option based on a capital structure with the same incremental cost
3 impact on the utility as adding off-balance sheet financing from a long-term
4 power purchase. Properly done, this approach would have results identical to
5 the equity penalty calculation in allowing a comparison of costs net of
6 financing. This form of comparison is often used in the unregulated world.
7 For example, I am a part owner of a print shop in Austin. We usually have the
8 option of leasing or buying major equipment like printing presses. If we lease
9 the equipment, banks consider the off-balance sheet obligation in determining
10 how much our business can borrow given our level of equity. In comparing
11 the cost of a lease with the purchase alternative, we usually assume that the
12 purchase would be financed mostly with debt so that the effect on our
13 borrowing capacity is the same. We could just as validly assume an equity
14 penalty associated with the lease. This adjustment is necessary so that the
15 financing decision and the investment decision are considered separately.
16 When the print shop enters a lease commitment for equipment, it is investing
17 in new capacity <u>and</u> increasing its leverage. The financing change (more
18 leverage) and investment (new equipment) are considered by comparing the
19 same investment decision (purchase equipment) with a similar financing
20 effect (mostly debt financing). If FPL enters a long-term firm commitment
21 for generation, that also represents an investment in new capacity and a
22 financial impact through increased leverage. The equity penalty essentially
23 reverses out the financial impact so that the pure investment decision can be

1 compared.

2

3 **Q. Why not adjust for the financing effect by adjusting the discount rates**

4 **used to compare the self-build and long-term contract options?**

5 A. In the regulatory arena, the common practice is to evaluate investments using

6 the utility's target capital structure, as FPL has done here. This approach is

7 well established because it ties into regulatory policies for determining fair

8 rates of return. Moreover, an objective benchmark for estimating the equity

9 penalty is available from bond rating agencies that have developed

10 adjustments independent of regulatory proceedings. As discussed earlier, the

11 FPSC has adopted the equity penalty approach in the past, and the

12 methodology used to calculate the equity penalty in this case is completely

13 consistent with that precedent.

14

15 **Q. Is it always necessary to make an equity penalty adjustment when**

16 **comparing firm power alternatives?**

17 A. No. It is only necessary when the alternatives being considered differ

18 materially in their impact on effective financial leverage and the financing

19 costs that result. If, for example, all of the alternatives involve the same

20 degree of off-balance sheet obligations, the equity penalty adjustment is not

21 necessary to make an "apples to apples" comparison. Hence, it does not

22 surprise me that FPL affiliate companies might report no experience with the

23 equity penalty concept, as Mr. Maurey notes (p. 12). This certainly might be

1 expected if those companies are participating in markets where the load
2 serving entity has divested all of its generation and therefore must take power
3 exclusively from outside proposals.
4 If, on the other hand, as is the case here, entering a purchased power contract
5 is being compared to a self-build option financed at the utility's target capital
6 structure, then the extra financial costs associated with the incremental off-
7 balance sheet obligations must be considered to make a fair and rational
8 comparison. To do otherwise would have the effect of artificially lowering
9 the true cost of the purchase alternatives. The FPSC practice of equilibrating
10 the financial impact of alternatives is a sound regulatory policy that should be
11 used by all jurisdictions making similar comparisons between utility-built
12 plants and purchase power commitment options with material off-balance
13 sheet obligations inherent in their structure.
14
15 **Q. Why does Mr. Slater reject the equity penalty concept?**
16 A. He claims that there is no reason to recognize only the financial risk of long-
17 term purchase power contracts to the exclusion of other risks associated with
18 FPL's self-build options (p. 7). He also suggests that FPL has a small and
19 decreasing reliance on purchased power (p. 8).
20
21 **Q. Does the equity penalty imply that only one of a "multitude of risks" is**
22 **being considered, as claimed by Mr. Slater?**
23 A. No. The equity penalty is not designed to consider the impact of some future

1 potential risk; rather, its purpose is to capture the known cost of increased
2 financial leverage due to off-balance sheet obligations. If this cost were
3 ignored, the result would be an inaccurate comparison of utility-built
4 generation with other options.
5
6 **Q. Is the need for the equity penalty adjustment a function of the amount**
7 **and trend of FPL's purchased power?**
8 A. No. As discussed earlier relative to Mr. Maurey, the equity penalty is related
9 not to existing purchased power agreements per se, but to the increased
10 financial leverage and resulting cost associated with incremental off-balance
11 sheet obligations. Without the equity penalty, the incremental cost of the
12 additional off-balance sheet liability associated with new purchased power
13 contracts would be ignored, undermining the objective of making an accurate
14 economic comparison of alternatives, and effectively subsidizing the
15 proposals of independent power producers. As to the expiration of existing
16 purchased power obligations, any resulting changes in the capital structure of
17 FPL would occur irrespective of whether FPL builds or buys in this instance.
18 Therefore, the analysis of the impact of purchased power in FPL's
19 Supplemental RFP is properly focused on this particular buy or build decision.
20
21 **Q. Does this conclude your rebuttal testimony in this case?**
22 A. Yes, it does.