BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NOS. 050045-EI AND 050188-EI
FLORIDA POWER & LIGHT COMPANY

JULY 28, 2005

IN RE: PETITION FOR RATE INCREASE BY FLORIDA POWER & LIGHT COMPANY
AND
IN RE: 2005 COMPREHENSIVE DEPRECIATION STUDY BY FLORIDA POWER & LIGHT COMPANY

REBUTTAL TESTIMONY OF:

MORAY P. DEWHURST

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6

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

8 A. My name is Moray P. Dewhurst. My business address is 700 Universe

9 Boulevard, Juno Beach, Florida 33408-0420.

10 **Q. Did you previously submit direct testimony in this proceeding?**

11 A. Yes.

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

13 A. I will rebut assertions made by various witnesses on behalf of the Florida

14 Office of Public Counsel (OPC), Federal Executive Agencies (FEA), AARP,

15 Commercial Group, Florida Retail Federation (FRF) and the South Florida

16 Hospital and Healthcare Association (SFHHA). My rebuttal testimony will

17 focus on Florida Power & Light's (FPL or Company) appropriate ROE, the

18 Company's request for a 50 basis point performance incentive, the

19 appropriateness of FPL's capital structure, the Company's request for an

20 additional base rate increase for Turkey Point 5, the Company's request for an

21 increase in the storm accrual, and the need for the Company to maintain D&O

22 insurance.

23

1 **RETURN ON EQUITY**

2 **Q. Do you agree with the return on equity recommendations made by Dr.**
3 **Woolridge, Mr. Baudino or Mr. Kahal?**

4 A. No. I will defer discussion of the analytical flaws in their respective
5 approaches to Dr. Avera. My rebuttal testimony discusses the reasonableness
6 of the overall level of return on equity recommended by these witnesses and
7 the general impact on the Company's financial strength, were the Commission
8 to adopt any of their recommendations.

9 **Q. What do you think the Commission's objectives should be in establishing**
10 **the Company's authorized return on equity?**

11 A. The return on equity should be set at a level that, if achieved by the Company,
12 will induce the level of investment needed to provide reliable electric service
13 and accommodate system growth at the lowest reasonable cost and fairly
14 compensate equity holders for the utilization of their capital.

15 **Q. In your opinion, if the Commission were to adopt the return on equity**
16 **recommendations presented by Dr. Woolridge, Mr. Baudino or Mr.**
17 **Kahal, would those objectives be met?**

18 A. No. The Company must compete for investor capital by offering a reasonable
19 return that is at least as large as the returns available on investments with
20 similar risk profiles. The proposed allowed returns on equity suggested by Dr.
21 Woolridge, Mr. Baudino and Mr. Kahal would be substantially below the
22 returns available to investors on comparable investments and insufficient to
23 maintain access to capital markets at reasonable prices. Both Dr. Woolridge's

1 recommendation for an 8.8% return on equity and Mr. Baudino's
2 recommendation for an 8.7% return on equity would result in the Company
3 receiving the lowest authorized return out of the 700+ major electric, gas or
4 telecommunications proceedings since at least 1990 (the most recent date
5 summarized case data are available for comparison). Even Mr. Kahal's 9.5%
6 recommended mid-point allowed return on equity is below the authorized
7 return on equity for every major electric, gas, and telecommunications
8 proceeding since 1990 except for one base rate proceeding for Jersey Power &
9 Light (Final Order for Docket No. ER02080506, issued May 17, 2004) in
10 which its regulator provided for a 9.5% return on equity. However,
11 significantly, that return involved only the distribution assets of Jersey Power
12 & Light, and reflected a 25 basis point penalty as a "regulatory incentive
13 mechanism" until such time as "the Company provides sufficient evidence to
14 the Board that they have made the necessary improvements required to
15 maintain system reliability". It is quite clear, therefore, that the intervenors'
16 ROE recommendations would not represent a fair and reasonable return
17 opportunity for investors.

18 Q. **What would be the likely consequences for FPL's financial position if the**
19 **intervenors' ROE recommendations were adopted?**

20 A. There would be several significant and adverse consequences to FPL's
21 financial position, which would hurt customers' interests. The most
22 immediate effect would be a significant reduction in operating cash flow and
23 free cash flow. The three percentage point difference between FPL's

1 recommended ROE (excluding the 50 basis point performance incentive) and
2 the recommendations of Dr. Woolridge and Mr. Baudino translates to nearly a
3 $200 million reduction in annual cash flow. For reference, this is more than
4 10% of projected 2006 operating cash flow for the entire business. This
5 would increase the dependence of the business on access to external funding
6 and would obviously exacerbate the challenge of meeting capital expenditure
7 requirements.
8
9 A second effect would likely be dramatically reduced investor confidence in
10 the Florida regulatory environment. Such a dramatic shift between a
11 regulatory framework that promoted efficiency in operations and provided
12 some measure of regulatory certainty to one that took a company that was
13 operationally among the very best in the industry, and "rewarded it" by giving
14 it the lowest return on equity awarded among any major utility since 1990
15 would seriously reduce investor confidence in the Florida regulatory
16 environment and increase investor perceptions of regulatory risk with respect
17 to other issues. Clearly, this would serve to *increase* the future cost of capital.
18
19 Third, FPL's credit standing would be weakened and credit ratings would
20 likely be lowered. Credit spreads would widen, resulting in immediate losses
21 to debtholders and decreased access to new capital, as well as increases in
22 interest costs. Short-term credit capacity would be substantially decreased,
23 significantly limiting the Company's ability to support the fuel hedging

program it manages for the customer's benefit, reducing flexibility in the event of unexpected shocks, and raising costs.

Fourth, there would be an immediate loss in equity value as well as confidence, a related consequence of which would likely be pressure for an increase in dividends, because the shareholder trade-off between current return (dividend) and future return (capital gain) necessarily would be shifted towards the former. Of course, any increase in dividends needed to maintain equity investor confidence would obviously further exacerbate the cash flow shortfall.

Ultimately, all these effects would be very detrimental to long-run operating performance, undermining FPL's efforts to support its extensive capital building program while maintaining or improving reliability and customer service. The result would not be in customers' long-run interests.

Q. Intervenors, as part of ROE testimony, have cited FPL's strong financial position as reason why FPL has lower risk and should have a lower ROE. Do you agree with this characterization?

A. No. These assertions are circular in that a lower ROE would weaken the Company's financial position, thus undermining the very basis of such contentions. A strong financial position should be viewed as an asset rather than a liability. A strong financial position allows the Company to maintain the flexibility to raise capital when needed to meet our service obligations.

1 This position also provides security that provides the ability to absorb
2 unexpected financial shocks. While our current financial position is strong,
3 this is not a given. Adequate allowed return on equity and an appropriate
4 equity ratio underpin our financial strength. Weakening in any of these areas
5 would clearly be perceived by investors as a decline in our overall financial
6 strength. A decline in financial strength introduces greater risk. In turn,
7 investors will require a greater return on their invested dollar.
8
9 **ROE PERFORMANCE INCENTIVE**
10 Q. **Mr. Larkin and Ms. Brown assert that FPL's requested ROE**
11 **performance incentive is based solely on past performance and, therefore,**
12 **should be rejected. Do you agree with their assertions?**
13 A. No, I do not. FPL is not requesting a performance incentive based solely on
14 past performance, although we certainly agree that past performance is one
15 factor that the PSC can look to as an indicator of whether or not an incentive
16 award may be justified. FPL's request is based in large part on its ***current***
17 operating and performance statistics. As described in the direct testimonies of
18 others in this case, the Company is ***currently*** operating at levels significantly
19 above its industry peer group in the areas of reliable service, customer service
20 and overall cost, providing customers with past, present, and future benefits.
21 Nevertheless, such achievements are not accomplished overnight; they reflect
22 a steady record of improvement over many years. To that end, therefore, past
23 performance cannot simply be ignored. A performance incentive that shifts

1 the allowed ROE range up 50 basis points would serve as a positive incentive
2 for the Company to continue its excellent performance as well as an important
3 signal to other companies as to the importance of and the Commission's
4 willingness to recognize performance and service achievements in
5 establishing a utility's rates.
6
7 Clearly, both past and present performance is directly relevant in establishing
8 a reasonable rate of return. A system that does not distinguish between
9 superior and mediocre performance, over time will not tend to promote
10 superior performance. Conversely, a system that recognizes superior
11 performance will tend to improve performance and lower cost over the long-
12 term.

13 Q. **Do you agree with Mr. Larkin's and Mr. Kollen's contention that the**
14 **performance incentive is, in the words of Mr. Kollen, "the quintessence of**
15 **improper retroactive ratemaking" and as Mr. Larkin states that the**
16 **Commission, "cannot look to past performance and use that performance**
17 **to enhance or increase future rates"?**

18 A. No. Mr. Larkin and Mr. Kollen appear to be suggesting that the Commission,
19 as a matter of law, cannot approve FPL's requested ROE performance
20 incentive. Regardless of what Mr. Kollen means by "retroactive ratemaking"
21 and Mr. Larkin's frame of reference, my understanding is that the
22 Commission has broad ratemaking authority granted by the legislature in
23 setting just and reasonable rates, including the authority to adjust a company's

1 ROE in recognition of good performance. The Commission has used this
2 authority on several separate occasions. In Order No. PSC-02-0787-FOF-EI,
3 Docket 010949-EI, the Commission provided a 25 basis point ROE incentive
4 to Gulf Power stating:

5 "We find that Gulf's past performance has been superior and we
6 expect that level of performance to continue into the future. In recognition of
7 this, we find that Gulf deserves to have 25 basis points added to the mid-point
8 ROE of 11.75%. Thus, a 12% ROE shall be used for all regulatory purposes,
9 including, for example, implementing the cost recovery clauses and
10 allowances for funds used during construction."

11

12 In addition to providing a reward for good performance, the Commission has
13 also used its authority to impose an ROE penalty for poor performance. In
14 Order No. 23573, Docket 891345-EI, the Commission imposed a two year 50
15 basis point penalty on Gulf's ROE as a result of criminal and unethical
16 conduct of one of its Vice Presidents. In Order Nos. 10557-EI and 9628-EI
17 the Commission granted a 10 basis point adjustment to Gulf Power to reward
18 Gulf's innovative efforts in the area of energy conservation and to send a
19 message to other utilities to promote conservation.

20 **Q. Have Commissions in other jurisdictions employed similar performance**
21 **incentive plans?**

22 A. Yes. FPL's request for a ROE performance incentive is not predicated on
23 actions in other jurisdictions, but rather on this Commission's authority under

1 Florida law. Nevertheless, while we have not attempted to conduct a
2 comprehensive search of ROE-based incentive plans in other jurisdictions, we
3 have identified other instances in which retail regulators have provided
4 recognition of good performance in the form of ROE adjustments such as FPL
5 has requested in this proceeding. These instances include:

6 West Penn Power Co: Docket No. R00942986
7 *Pa. Public Utility Commission: Order Issued Dec. 15, 1994*
8
9 The commission decided to add .25% to the company's allowed ROE
10 "to compensate the company for its management performance,"
11 recognizing that the company "has promoted and accomplished cost
12 efficiencies in several operations aspects."
13
14 US West Communications, Inc: Docket No. RPU-93-9
15 *Iowa Utilities Board: Order Issued June 17, 1994*
16
17 Despite the ultimate finding which required a revenue decrease, the
18 Iowa Utilities Board awarded the company a "management efficiency
19 award of 75 basis points added to the return on equity." It claimed that
20 the award was based upon performance related to the company's
21 response to a flood, the merger of operating companies, and the
22 reduction in the number of employees.
23
24 In addition to these specific circumstances, there have been other instances
25 where a utility was awarded an authorized return on equity that was at the
26 upper end of the range of reasonable returns for the purpose of rewarding the
27 Company for its management performance.

28 Q. **Do you agree with Mr. Larkin's and Mr. Dismukes' contentions that the**
29 **Company has already been rewarded through the revenue sharing**
30 **mechanism as a result of increasing revenues and that the Company**
31 **benefited by approximately $113 million dollars due to refunds of**
32 **revenues?**

1 A. No. Mr. Larkin either misunderstands or has mischaracterized the revenue
2 sharing agreement. The revenue sharing plans approved in 1999 and 2002
3 provided customers with two substantial base rate reductions totaling $600
4 million and will have resulted in more than $3.6 billion in savings to
5 customers by the end of this year. In exchange for the ability to enhance its
6 earnings through efficient management, the Company gave up the opportunity
7 for additional earnings potential from unanticipated positive revenue growth -
8 earnings potential that would have been available to it under traditional
9 ratemaking. Revenues above certain thresholds were refunded to customers,
10 thus lowering their effective cost of electricity even further. These refunds
11 amounted to approximately $226 million of additional customer savings
12 during the terms of the two agreements - revenues that would otherwise have
13 resulted in higher earnings for the Company.
14
15 Far from benefiting from the revenue sharing refund provision, FPL was
16 disadvantaged by it. FPL was willing to agree to this provision only because
17 of other provisions in the agreements – namely the absence of an authorized
18 range for return on equity and the incentive therefore to manage the business
19 for long-run efficiency. In the present circumstances FPL does not enjoy the
20 prospect of operating without an ROE cap and it is as a substitute for the
21 incentives built into the prior agreements that we are proposing the ROE
22 performance incentive.
23

1 Furthermore, what Mr. Larkin's and Mr. Dismukes' positions fail to
2 acknowledge is that many of the efficiencies and productivity improvements
3 will provide savings and value to customers well into the future. Over the
4 long-term, the customer benefits from an operation that can deliver efficient
5 electrical service at a cost that is lower than it otherwise would have been.
6 The 50 basis point performance incentive has been proposed to promote and
7 encourage ongoing high levels of performance.

8 Q. **Is it relevant whether or not the Company has realized any benefits under**
9 **prior revenue sharing agreements?**

10 A. No. Whether or not the Company realizes a benefit through productivity
11 efficiencies achieved during the terms of the revenue sharing plans is not
12 relevant for purposes of determining whether to grant the Company's ROE
13 performance incentive request. FPL's request in the present case is based on
14 its recent and current levels of performance, which translate into direct
15 benefits to customers, and the prospect of motivating continued efforts to
16 improve performance and maintain or improve the Company's relative
17 position. As I stated in my direct testimony, FPL does not dispute that
18 traditional ratemaking regulation provides strong incentives for *adequate*
19 performance. The policy question that we believe the Commission should
20 consider is how to motivate sustained efforts to move beyond "good" or
21 "adequate" and deliver the superior levels of performance that FPL has been
22 able to achieve.

1 **Q. Does the existing regulatory structure that provides for an authorized**
2 **range of return consisting of a band of ± 100 basis points provide an**
3 **effective performance incentive as argued by Mr. Larkin?**
4 A. No. The ± 100 basis point band reflects acknowledgement of an inherent
5 amount of variability within a utility's earnings through the normal business
6 cycle, and allows the regulator some flexibility in determining whether to
7 adjust rates, thereby promoting regulatory efficiency. As a practical matter, a
8 100 basis point band above the midpoint provides very little incentive for
9 superior performance, though it may promote some "fine tuning" of the cost
10 structure. It is relevant to note that normal weather variability will cause
11 swings in excess of ± 80 basis points of ROE. To the extent it does provide
12 any incentive it is, from a policy perspective, a relatively poor one for at least
13 two reasons. First, because it is a normal part of the traditional ratemaking
14 process it is not contingent upon a demonstration of superior performance;
15 therefore, it does not distinguish between average performers and superior
16 performers – it is equally available to both, and therefore does nothing to
17 promote superior performance. Second, perversely, it may actually serve as a
18 disincentive to superior performance, since a company performing well on the
19 cost dimension (operating at or close to the top of its allowed range), or one
20 that has just made some improvement, has no incentive to improve further.
21 As my earlier testimony notes, there are strong incentives built into the
22 traditional ratemaking framework promoting good, average, prudential
23 performance. What is lacking (relative to the incentives inherent in

1 unregulated markets) is the positive incentive to seek to be well above
2 average. Yet the long run benefit to the customer from promoting superior
3 performance can be very large. The ROE performance incentive, awarded at
4 the discretion of the Commission on the basis of superior overall performance,
5 taking into account cost, reliability and customer service, can serve to provide
6 this incentive.

7 **Q. Mr. Larkin argues that FPL's declining cost per customer is due to**
8 **customer growth rather than particular steps taken by the utility. Do you**
9 **agree with his statement?**

10 A. No. While there are modest scale effects in the industry, these are not the
11 principal driver of FPL's excellent unit cost position. Mr. Landon's testimony
12 clearly shows that FPL has a lower cost per customer when compared to other
13 large utilities that enjoy similar scale. Mr. Larkin contends that with the
14 exception of fuel, the cost of providing electric service is essentially fixed,
15 although he provides no data, studies or analysis to support his position. This
16 simply is not the case. Indeed, today in many parts of its service territory FPL
17 faces structurally increasing unit costs to serve new customers. For example,
18 redevelopment in heavily urbanized areas of Miami-Dade and Broward
19 counties necessitate new facilities installed at much higher cost than
20 embedded rates. These challenges are not faced by many utilities with lower
21 growth rates, yet FPL's unit cost performance is superior in spite of the
22 additional handicap.

1 **Q. How are customers benefited by the Commission providing an ROE**
2 **performance incentive?**
3 A. There is no doubt that superior performance produces customer benefits in the
4 form of reliable electric service at lower costs. However, the question that
5 intervenor witnesses all seem to raise is whether there is any correlation
6 between superior performance and the performance incentive requested by the
7 Company. Certainly this is a matter for the Commission's judgment.
8 However, I would note that the Commission has previously endorsed the
9 principle of providing incentives, has approved rate agreements incorporating
10 incentive mechanisms, and has utilized an ROE performance incentive such as
11 FPL is proposing here. Presumably, therefore, the Commission has found that
12 there is such a correlation. Ultimately, the Commission must decide whether
13 as a matter of policy in exercising its ratemaking function it will distinguish
14 between a poor performer, an average performer, and a superior performer. It
15 has done so in the past, and I believe it should do so in this instance for the
16 reasons I have described above.
17
18 **CAPITAL STRUCTURE**
19 **Q. Do you agree with Mr. Kollen's statement on Page 36, lines 2 through 4,**
20 **that "The Commission should consider FPL on a standalone regulated**
21 **utility basis. On a standalone basis, the FPL common equity ratio should**
22 **be set within the range for a single 'A' utility pursuant to the S&P**
23 **guidelines"?**

1 A. Not entirely. I agree that the Commission should establish a capital structure
2 for FPL that reflects the specific conditions of the utility. However, I do not
3 agree that this should translate mechanically to setting an equity ratio based on
4 the S&P guidelines for a single 'A' rated utility. Rather, I believe the
5 Commission should take into account the totality of FPL's circumstances and
6 set an equity ratio that will allow the company to maintain roughly the same
7 level of financial strength as it and its customers have enjoyed for the past
8 several years. Continuation of the current 55.83% equity ratio will achieve
9 this objective.

10 **Q. Do you agree with Mr. Kollen's assertion that FPL's equity ratio is**
11 **excessive?**

12 A. No. FPL's equity ratio, as adjusted for purchase power obligations, is
13 55.83%; this is only slightly outside the range of 48% to 55% for an S&P 'A'
14 rated utility with a business position of "4." An equity ratio in the upper end
15 of the range is appropriate given FPL's substantial continuing financing
16 requirements to support growth and the necessity of maintaining continuous
17 access to capital, even during times of adverse industry and market conditions.

18 **Q. Do you agree with Mr. Kollen's statement that "...FPL Group Capital is**
19 **extremely highly leveraged" (Page 34, Line 8)?**

20 A. No. Mr. Kollen appears to be basing his statement on a naïve assessment of
21 Generally Accepted Accounting Principles (GAAP) capitalization ratios,
22 which is quite inappropriate for FPL Group Capital's specific circumstances
23 and which fails to take into account several adjustments made by the rating

1 agencies and investment community to FPL Group Capital's capital structure
2 when evaluating credit strength. Similar to the purchase power obligation
3 adjustment made to FPL's capital structure, the investment community and
4 the rating agencies make certain adjustments to FPL Group Capital financial
5 statements when evaluating balance sheet strength. The two largest
6 adjustments are for nonrecourse debt and equity-linked securities.
7 Nonrecourse debt is project debt whose repayment is secured solely by the
8 particular asset financed and the cash flows generated by the project, with no
9 obligation to repay in whole or in part from corporate funds. Consequently,
10 the rating agencies and investment community distinguish and exclude
11 nonrecourse project debt from FPL Group Capital's capital structure in their
12 credit evaluation. Equity-linked securities are issued in conjunction with a
13 forward equity purchase commitment providing for common equity to be
14 issued on a specific date into a variable number of shares of the common stock
15 of the company, with the number of shares depending on the market price at
16 the time specified. These adjustments have a material effect on FPL Group
17 Capital and FPL Group's capitalization. For example, Standard and Poor's
18 deducted approximately $900 million of project debt in 2004 and assumed the
19 conversion of $1.1 billion of equity linked debentures to equity when
20 evaluating FPL Group's credit strength. In fact, making appropriate
21 adjustments reduces FPL Group's effective leverage to a level close to FPL's
22 capital structure.

1 **Q. Is FPL Group Capital's leverage at all relevant for the Commission to**
2 **consider in determining a capital structure for FPL?**
3 A. No. Florida Power and Light and FPL Group Capital are two very different
4 businesses. FPL maintains an equity ratio appropriate for its own needs, while
5 FPL Group Capital faces different and in some ways easier circumstances.
6 FPL has an obligation to serve, with substantial near-term unavoidable capital
7 requirements to meet the needs of FPL's rapidly growing customer base.
8 Furthermore, FPL must maintain a strong balance sheet to support its fuel
9 hedging program and ensure quick access to capital and the ability to absorb
10 the temporary balance sheet deterioration caused by items such as fuel under-
11 recoveries and storm fund deficiencies.
12
13 In contrast, FPL Group Capital's portfolio consists of businesses with no
14 similar obligation to serve and operating in markets where credit requirements
15 are quite different. The absence of the obligation to serve provides significant
16 flexibility and management discretion, particularly in the timing of capital
17 expenditures. While FPL is likely to be free cash flow negative for the next
18 several years at least, with little flexibility to delay or defer capital expansion,
19 FPL Group management has the flexibility to increase or decrease FPL Group
20 Capital's commitments to meet changing circumstances. In addition, FPL
21 Group Capital has the further ability to isolate and "walk away" from many of
22 its projects were they to become financially distressed. The failure of one
23 specific project would have no necessary connection to the performance of

1 others within the portfolio; in contrast, FPL is a single, integrated system, the
2 failure of one part of which would necessarily entail devastating consequences
3 for other parts.

4 Q. **What should the Commission conclude from the similarities and**
5 **differences between FPL and FPL Group Capital?**

6 A. FPL Group Capital's circumstances and capital structure is different from
7 FPL's and not relevant to FPL's situation. The Commission should determine
8 a capital structure for FPL that is appropriate for its unique circumstances.

9 Q. **Do you agree with Mr. Kollen's proposed adjustment to FPL's capital**
10 **structure?**

11 A. No. The capital structure that is currently in place at FPL is appropriate: it is
12 well received by the capital markets, as evidenced by FPL's current credit
13 ratings and overall credit profile, as well as the tight trading spreads of FPL
14 bonds; and it provides the financial flexibility and resilience needed for FPL's
15 rapidly growing peninsula service territory. It would be unwise for the
16 Commission to weaken the Company's financial strength in a period where
17 liquidity and capital access are more important than ever. It is important for
18 the Company to maintain a strong equity ratio given its high growth service
19 territory and exposure to temporary funding requirements for fuel costs and
20 storm expenses which creates more variability in capital requirements. It has
21 been and continues to be appropriate for FPL's circumstances.

22 Q. **Is an adjustment necessary to reflect the effect of parent debt on federal**
23 **corporate income tax in accordance with Rule 25-14.004(3)?**

1 A. No. Rule 25-14.004 contemplates tax benefits generated by the parent
2 company of a utility subsidiary that has issued debt and invested equity in its
3 subsidiary. FPL Group, Inc., the parent company of FPL, has not issued any
4 such debt. In addition, Rule 25-14.004(3) does not contemplate making an
5 adjustment to a consolidated capital structure. This section specifically
6 excludes the retained earnings of subsidiaries from the capital structure of the
7 parent. This required exclusion results in a non-consolidated equity value for
8 the parent company. Therefore, any debt related to this rule must be debt of
9 the non-consolidated parent company.
10
11 **COST OF DEBT**
12 Q. **Both Mr. Kahal and Mr. Woolridge suggest an adjustment to the cost**
13 **rate to be applied to prospective long-term debt issues during the forecast**
14 **period. Do you agree with their adjustments?**
15 A. No. Mr. Kahal cites "current market data and recent cost of debt experience,"
16 and Mr. Woolridge cites "current yields on these bonds (30-year A-rated
17 public utility bonds) as well as the recent trends in interest rates," as the basis
18 of their cost of debt assumptions.
19
20 The problem with their approach is that setting debt cost assumptions at
21 current rates in a rising interest rate environment will ensure that the Company
22 does not fully recover its financing costs. FPL based its interest rate
23 assumptions for the test year on the projected rates in the December 2004

1 edition of Blue Chip Financial Forecasts (Blue Chip). Blue Chip is an
2 independent survey that polls approximately 50 of the top economists'
3 projections for U.S. and foreign interest rates, currency values and various
4 economic indicators. Projections are presented for each contributor as well as
5 a top 10 average, bottom 10 average and consensus. FPL utilizes the
6 consensus forecast for long-term corporate bonds as the best estimate of future
7 debt cost rates. This provides the best estimate of what actual financing costs
8 are likely to be in the test year.
9
10 While the Company's original cost of debt projections were based on
11 projections from the Blue Chip December 2004 edition, the June 2005 edition
12 continues to anticipate bond yields will rise significantly over the 2005-2006
13 period covered by its projections.
14
15 **2007 ADJUSTMENT FOR TURKEY POINT UNIT 5**
16 **Q. Mr. Selecky has testified that the Commission should not approve an**
17 **adjustment for the revenue requirements for Turkey Point 5 because**
18 **FPL's projected return on equity for 2007 of 11.5% is within the range of**
19 **return on equity requested in this proceeding. Do you agree?**
20 A. No. One of the outcomes of a rate proceeding is the establishment of revenue
21 requirements that will enable the Company to recover the cost of providing
22 electric service and provide the Company with the opportunity to earn a fair
23 rate of return on its investment. If rates are set to meet these conditions in

1 2006 then they cannot possibly meet that condition in 2007 and beyond, since
2 the addition of Turkey Point 5 will add to the revenue requirements such a
3 large, discrete amount as to push the earned return down to the bottom end of
4 the proposed range, *ceteris paribus*. If, for example, x% is determined to be a
5 fair and reasonable rate of return for the rate effective year, then building a
6 rate structure knowing that in the following year the earned rate of return will
7 drop by over 60 basis points due solely to the addition of only a partial year of
8 the revenue requirements associated with the commercial operation of a new
9 low cost generating facility, in my view does not provide a meaningful
10 opportunity to earn a fair and reasonable rate of return. The fact that the
11 outcome might still be within the ± 100 basis point band is not relevant
12 because the band is established with the expectation that currently unknown
13 factors are as likely to be positive as negative. In this case, there is an
14 immediate and known bias toward the bottom of the range.
15
16 Systematically handicapping this relationship such that the only way the
17 Company can hope to reach its allowed rate of return is through the fortuitous
18 development of currently unknown but positive factors is not consistent with
19 the purpose of ratemaking. The addition of Turkey Point 5 is a significant
20 known and measurable investment with substantial operating and financing
21 costs that are not reflected in FPL's projections for 2006. Further, Turkey
22 Point 5 will have an immediate, substantial, negative impact on FPL's
23 earnings in 2007. A material reduction in ROE in the year following a rate

1 case should not be the result of the successful completion of the least cost
2 generation alternative approved by the Commission to meet the needs of
3 FPL's customers.

4 Q. **If the Company is still earning within its authorized range for return on**
5 **equity, how would it be harmed?**

6 A. FPL's earned return on equity in 2007 will be materially lower due to the
7 construction of Turkey Point 5 than it would have been had the 2007 need
8 been met through purchased power. If the 2007 need were meet through
9 power purchases, the Company would seek recovery of capacity payments
10 through the Capacity Clause and earned returns would not be impacted.
11 Failure to provide an adjustment to base rates in 2007 for Turkey Point 5
12 effectively penalizes the Company for delivering to customers the least cost
13 alternative for meeting their needs. The ±1% range around the established
14 ROE is to accommodate unknown or unpredictable factors that may affect
15 future results. The impact of Turkey Point 5 is known and predictable.

16 Q. **Mr. Larkin suggests at page 6 of his direct testimony that the costs of**
17 **additional capacity can be added through a capacity adjustment clause**
18 **and thus not affect FPL's average base rate cost per customer. Do you**
19 **agree with his statement?**

20 A. There is no debate that capacity costs recovered through the fuel and
21 purchased power cost recovery clause do not affect the average base rate cost
22 per customer and would not require a base rate increase. They still, of course,
23 affect the <u>total</u> rate that the customer sees. But unless Mr. Larkin is

1 suggesting that the cost of self build options, determined by the Commission
2 to be the low cost option, also could be recovered through the fuel and
3 purchased power cost recovery clause, his point only emphasizes the bias that
4 could exist in favor of purchased power if the Commission fails to properly
5 reflect the costs of a low cost self-build resource option in the Company's base
6 rates in timely fashion. While I agree that purchasing power is an option, it is
7 not always the best available option, as has been confirmed in the last two
8 Commission Need Determination proceedings, resulting in capital
9 expenditures by FPL in excess of $1.4 billion that are not being recovered
10 through the fuel and purchased power cost recovery clause. The majority of
11 additional capacity added by FPL consists of lower cost repowerings and the
12 construction of new plants that the Commission agreed were more cost-
13 effective from the customers' perspective than any available power purchases.
14 These capacity additions all require significant investment. Mr. Larkin's
15 theory simply does not apply to FPL's actual circumstances.

16 Q. **How will customers benefit from the construction of Turkey Point 5?**

17 A. Turkey Point 5 was determined by the Commission to be the least cost option
18 to satisfy the increased need for generation for FPL's customers. In Order No.
19 PSC-04-0609-FOF-EI, the Commission found that "Final cost comparisons
20 from the RFP evaluation demonstrated that Turkey Point 5 offered a $271
21 million (cumulative present value revenue requirements, CPVRR) advantage
22 compared to the next most competitive proposal. An independent evaluation
23 confirmed FPL's conclusions. Turkey Point 5 is FPL's best, most cost-

1 effective alternative for meeting the 2007 needs of FPL's customers." Among
2 other benefits, Turkey Point 5 will reduce the fuel component of customers'
3 bills by displacing older, less efficient units for many hours of the year.

4 **Q. Mr. Larkin argues that the adjustment for Turkey Point 5 is not**
5 **consistent with ratemaking principles in general and, specifically,**
6 **principles applied in Florida. Do you agree with this assessment?**

7 A. No. I have indicated above why it is obviously inconsistent with ratemaking
8 principles in general not to include the adjustment. In addition, my
9 understanding is that the Florida Legislature has specifically provided for such
10 an adjustment. Section 366.076, F.S. (2003) explicitly provides that the
11 Commission may consider adjustments to base rates in limited scope
12 proceedings. The Commission has exercised that authority in the past. For
13 example, the Commission has allowed for incremental rate increases for
14 Florida Power & Light in 1982 (Docket No. 820097-EU) and 1983 (Docket
15 No. 830465-EI). On page 39 of Order No. 11437, Docket No. 820097-EU,
16 the Commission reasoned that requiring the utility to initiate another full
17 revenue requirements case merely to place this plant in rate base would
18 involve significant regulatory lag detrimental to the utility and substantial
19 amounts of unnecessary rate case expense to be borne by customers. The
20 Commission also previously has approved an additional base rate increase for
21 Florida Progress Energy, then Florida Power Corporation, 30 days after the
22 commercial operation of its Crystal River Unit 5 plant. Docket No. 830470-
23 EI, Order No. 13771.

1 **Q. Messrs. Selecky and Kollen suggest that FPL should be directed to file for**
2 **a rate increase closer to the time that Turkey Point 5 is placed into**
3 **service. Why is FPL filing for this limited scope adjustment now?**
4 A. Addressing Turkey Point 5 within the context of the current base rate
5 proceeding is much more efficient. FPL's 2006 test year, which permits a
6 thorough and detailed review of all FPL's costs, ends only six months from
7 the projected in-service date of Turkey Point 5. A subsequent rate proceeding
8 so close to the conclusion of the current proceeding will provide little new
9 information. Given the cost and resources necessary to prepare for a full
10 requirements rate proceeding, we believe it is prudent to address the Turkey
11 Point 5 adjustment within the current proceeding. Additionally, by Order No.
12 11437, the Commission recognized that a limited scope adjustment is more
13 efficient, as a full revenue requirements case would involve substantial
14 amounts of unnecessary rate case expenses.
15 **Q. Mr. Kollen argues that the 2007 adjustment for Turkey Point 5 should be**
16 **denied because the projected data for 2007, "fails to consider the effect of**
17 **the Commission's decisions on the various issues related to the 2006 test**
18 **year and the Company's real-world responses to those decisions." Do you**
19 **think that this is a reasonable basis for disallowing the adjustment?**
20 A. No. Mr. Kollen states that "if the Commission determines that the Company's
21 requested O&M expense is excessive in the 2006 test year and the Company
22 responds by reducing O&M expense, then that benefit also would be achieved
23 in 2007 and the twelve months ending May 31, 2008, thus reducing the

1 revenue requirements in those two periods." While I agree with Mr. Kollen's
2 statement that revenue requirements would be lower in those two periods, he
3 fails to recognize the obvious fact that base revenues will also be lower in
4 those two periods if O&M costs were to be excluded in determining revenue
5 requirements for 2006, with no net impact on FPL's expectations of earnings
6 or ROE. The projected return on equity for 2007 assumes the 2006 rate
7 request is approved. If a portion of O&M is disallowed in this proceeding and
8 FPL's base revenue request is reduced, earned returns in 2007 will be lower,
9 all other things equal. The best outcome for the Company if it does lower
10 costs is an 60 basis point drop in earnings due solely to implementing the
11 lowest cost resource option in the form of Turkey Point 5. The issues Mr.
12 Kollen has raised are quite simply irrelevant to the Turkey Point decision.

13 **Q. Messrs. Larkin and Kollen have questioned the reliability of the**
14 **projected data for the Turkey Point 5 adjustment. What evidence have**
15 **they provided to support this assertion?**

16 A. None. Messrs. Larkin and Kollen have made broad statements regarding the
17 reliability of the projections. They have not provided any relevant testimony
18 as to why the projections are unreliable. Certainly they did not participate in
19 the Commission's Determination of Need proceeding for Turkey Point 5. The
20 costs and associated revenue requirements for Turkey Point 5 can be, and
21 have been, reasonably estimated. As discussed by Mr. Yeager, there is a high
22 degree of certainty regarding the projected cost of Turkey Point 5 since FPL
23 has contracts in place for major equipment and Engineering, Procurement &

1 Construction, and it is highly unlikely the costs associated with these contracts
2 will change. These contracts represent the vast majority of construction costs
3 associated with the new unit.

4 Q. **Is Mr. Larkin's claim that the 2007 adjustment for Turkey Point should**
5 **be denied because the addition will generate $289 million of additional**
6 **revenue reasonable?**

7 A. No. Generally speaking, Mr. Larkin's analysis is flawed because revenue is
8 not derived by taking the maximum output of the unit adjusted by a capacity
9 factor and multiplied by an average rate. Revenue is a function of the number
10 of customers and their usage. Those factors are reflected in the Company's
11 forecasts sponsored by Dr. Green and are included in the overall revenue
12 requirements analysis of this case. By itself, the addition of Turkey Point 5
13 adds no revenue. Instead, it ensures that FPL can meet its commitment to
14 maintain a 20% reserve margin and sustain high system reliability. Mr.
15 Larkin's analysis also fails to recognize that there are transmission,
16 distribution and administrative costs associated with serving incremental
17 customer load.
18

19 **STORM ACCRUAL**

20 Q. **Are you surprised that each of the intervenors had a different**
21 **recommendation regarding the annual storm accrual amount and a**
22 **target reserve?**

1 A. No, not at all. It is likely that if five more witnesses had offered testimony,
2 we would have received five additional recommendations that differed. As I
3 indicated in my direct testimony, there is no precisely correct level either for
4 the annual accrual or the reserve. However, I believe the appropriate annual
5 accrual amount and target reserve level should be set so that they are
6 consistent with the Commission's long-standing policies. For reasons
7 explained in my direct testimony, FPL's proposal is consistent with the
8 Commission's past approach to storm cost recovery.

9 **Q. Please summarize your understanding of the Commission's policy on the**
10 **appropriate reserve balance and annual accrual.**

11 A. The Commission's policy, as articulated in Order No. 95-0264-FOF-EI, is to
12 determine a target reserve balance that is sufficient to protect against most
13 years' storm restoration costs but not the most extreme years. Such a level
14 should reduce FPL's dependence on a relief mechanism such as a special
15 customer assessment. The annual accrual should be set large enough to allow
16 the reserve to build modestly in year's of "normal" hurricane activity, yet low
17 enough to prevent unbounded storm fund growth.

18 **Q. Do you agree with Mr. Kollen's recommendation to recover the expected**
19 **annual storm damage expense of $73.7 million and to target an average**
20 **$0 storm damage reserve amount?**

21 A. No. This would be inconsistent with prior Commission orders. The
22 Commission explicitly considered and rejected this approach in Order No. 95-
23 0264-FOF-EI. If a storm fund reserve balance did not exist, the Company

1 would have to rely on emergency relief mechanisms in the event of every
2 major weather event. Emergency relief mechanisms, such as a special
3 customer assessment, tend to create volatility in a customer's bill. The
4 Commission has previously recognized that this is undesirable, since tropical
5 storms and hurricanes are a regular hazard of life in Florida.

6 Q. **Mr. Stewart performs an analysis to determine the impact on the Storm**
7 **Reserve Fund if a $120 million annual storm accrual had been**
8 **implemented in 1990. Do you agree with his analysis?**

9 A. No. Mr. Stewart's analysis is fundamentally flawed and irrelevant to FPL's
10 current circumstances. The circumstances today are so different compared
11 with 1990 that any analysis that assumes a $120 million accrual commencing
12 in 1990 is meaningless. First, no one would have suggested a $120 million
13 accrual at that time. T&D insurance coverage was still available at a
14 reasonable cost, and the reserve balance was not $0. Second, it is highly
15 unlikely that FPL's reserve balance would ever have gotten as high as $1.48
16 billion in 2003 as Mr. Stewart suggests. Both the fund level and annual
17 accrual are the subject of annual reports and would have been reconsidered in
18 the intervening years. In any event, a hypothetical and counter-factual re-
19 casting of history is irrelevant to today's circumstances and FPL's current
20 proposal, particularly in light of the Commission's ability to continue to
21 monitor the level of the fund.

22 Q. **A few of the intervenors (Ms. Brown, Mr. Stewart, and Ms. Merchant)**
23 **recommend an annual accrual ranging from $20 million to $40 million to**

1 **recover the smaller Category 1 or 2 storms, and they propose that storm**
2 **securitization or a surcharge could be used to recover any negative**
3 **balances in the storm reserve. Do you agree with their**
4 **recommendations?**
5 A. No. With an annual accrual of $120 million, as proposed by FPL, and
6 assuming five years of "good" storm loss experience (storm costs averaging
7 $15 million - $20 million per year) the target reserve level of $500 million
8 would be reached in approximately five years. Consistent with prior
9 Commission orders, FPL believes that a reserve balance is appropriate, as it
10 would not be good public policy to continually recover negative balances
11 through special customer assessments, since they create volatility in customer
12 bills. While FPL is pleased with the passage of the Securitization Bill, that
13 potentially will provide the Commission with another alternative to fund
14 storm costs, it cannot yet be relied upon as a viable option.
15 Q. **Why do you feel securitization cannot yet be relied upon as a viable**
16 **option?**
17 A. First, the funding of securitization bonds is a lengthy process. The Company
18 needs a plan in place now to alleviate future storm costs. At a minimum, the
19 securitization process takes approximately six to nine months, so it will not be
20 completed this year. Second, there is a major unresolved tax issue for
21 securitization. Appropriate tax treatment from the Internal Revenue Service is
22 necessary to make recovery through securitization an economically viable
23 option for FPL and its customers. Specifically, the IRS must confirm that the

1 issuance of the financing order will not be a taxable event. FPL cannot
2 predict whether the IRS will grant the necessary tax treatment. Third, the
3 Commission would have to act on a financing petition filed by FPL. While
4 we are confident the Commission would look favorably on a prudent
5 financing petition, we are not yet in a position where we can submit one.
6 Accordingly, FPL believes it is appropriate to set an annual accrual assuming
7 the existing regulatory framework and modify this value if and when
8 securitization is a reality.

9 **Q. Assuming the Company receives the necessary tax treatment, the**
10 **Company completes the whole process, and securitization becomes a**
11 **reality in a year or so, do you feel you still need to collect a $120 million**
12 **annual accrual?**

13 A. If securitization becomes a reality, and assuming the securitization charges
14 were reflected as a separate line item on the customers' bills and a target
15 reserve level of approximately $500 million were re-established, it would be
16 appropriate to reduce FPL's proposed accrual to some degree. However, I
17 believe this can be addressed if and when the occasion arises in a limited
18 scope proceeding. For now, FPL and this Commission must deal with today's
19 reality, which is that the storm reserve is essentially depleted and must be
20 rebuilt through accruals from base rates. FPL and the Commission must
21 implement rates today that allow FPL to begin to replenish the storm damage
22 reserve, while moving toward a reasonable target given current expected

1 annual losses, as there are no guarantees that the funding of securitization
2 bonds will be completed.
3
4 **DIRECTOR'S AND OFFICER'S LIABILITY INSURANCE**
5 Q. **Do you agree with Ms. DeRonne's recommendation to remove the cost of**
6 **Directors and Officers (D&O) liability insurance from FPL's**
7 **jurisdictional O&M costs?**
8 A. No. Subsequent to the 2002 passage of Sarbanes Oxley and in light of
9 changing court standards, it is more important than ever for public companies
10 to maintain adequate D&O coverage. D&O liability insurance is a necessary
11 cost of doing business and as such should be reflected in FPL's base rates.
12 Simply stated, by law a corporation must have directors and officers. In
13 today's environment of increased scrutiny and exposure with respect to
14 corporate governance, the risk of liability to directors and officers has
15 increased considerably. Practically speaking, a company could not attract
16 competent, capable officers or directors without D&O liability insurance.
17 Thus, D&O insurance is a cost of business for any corporation. According to
18 a 2004 D&O Liability Survey, done by the Tillinghast business of Towers
19 Perrin, 99 percent of U.S. participants reported purchasing D&O insurance
20 coverage. Certainly, no company of FPL's size would be without such
21 coverage.
22 Q. **On page 18 of her direct testimony, Witness DeRonne states, "The**
23 **purpose of D&O liability insurance is to protect shareholders from the**

1 **shareholders' own decisions...The cost associated with the protection of**
2 **the shareholders' investment should be born by shareholders." Do you**
3 **agree with her claim?**

4 A. No. The purpose of D&O insurance is to enable the Company to attract and
5 retain qualified, capable directors and officers, without which FPL's
6 performance would surely not be as good as it is and without which it might
7 literally be unable to function over time. This is clearly of direct benefit to
8 customers. Unfortunately, the cost of providing reasonable protection to
9 ensure that directors and officers who prudently and faithfully fulfill their
10 obligations are protected adequately is greater today than it was a few years
11 ago.

12 Q. **Please explain why FPL's directors' and officers' insurance (D&O**
13 **insurance) premiums increased substantially between 2002 and 2003 and**
14 **again from 2003 to 2004?**

15 A. In 1998, FPL was successful in negotiating a 3-year fixed cost program with a
16 3-year single aggregate limit, at rates which we believe were well below
17 market at the time. The three-year single aggregate limit meant that only a
18 single limit would be available for all claims arising during that 3-year period
19 as compared to the normal situation where a new limit is purchased for each
20 year, which helped keep the premium low. In both 2001 and 2002, FPL was
21 successful in extending the 1998 program for additional years. By the end of
22 this program in 2003, there had been a single limit available for all claims
23 arising during the 5-year period of 1998 through 2002. The total premium for

1 this period was about $3.6 million, or an average of a little over $700,000 a
2 year.
3
4 With the 2003 renewal, two things occurred. First, the market for D&O
5 insurance changed sharply from its unprecedented low pricing of the prior 5
6 years or so and there were very significant price increases. Secondly, the
7 market ceased offering multi-year aggregate limit programs and insisted on
8 selling only a new fresh limit in each of the years since.
9
10 The result of these two changes was that FPL went from paying below-market
11 rates to a position much more typical of others in the industry, paying $6
12 million for its D&O program which renewed in 2003 for single year limits of
13 $170 million. In contrast, for limits of $190 million applicable to the prior 5-
14 year period mentioned above, FPL had paid a total of $3.6 million. In 2004,
15 the premium increased again to $8 million reflecting a continuing worsening
16 of the general D&O market.
17
18 While the large percentage increase is unfortunate, the current actual cost of
19 D&O is more in-line with the longer term record than was the abnormally low
20 cost of the 1998-2002 period. For example, in 1987, the premium was $6.0
21 million, or $10.0 million in current dollars, even though the company was
22 then much smaller (size is a major driver of overall D&O cost). In 1993, the
23 premium was $3.7 million or $4.8 million in current dollars- again, for a much
24 smaller company. Adjusted for size and inflation, today's D&O rates are
25 comparable to 1993 and well below those of 1987.

1 With each insurance renewal, FPL seeks the most competitive insurance
2 pricing available. With a volatile market like D&O, this will inevitably
3 translate into large fluctuations in insurance premiums. The overall D&O
4 market is much tighter today for cyclical reasons and, just as important, has
5 experienced secular increases due to changing legal standards and the effects
6 of the Sarbanes-Oxley Act of 2002 and related changes in corporate
7 governance. FPL has been affected by these changes, but we believe the
8 premiums we are now paying are competitive with those incurred by other
9 comparably sized companies in our industry.

10 **Q. Does this conclude your rebuttal testimony?**

11 A. Yes.