BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for rate increase by Progress Energy Florida, Inc.

Docket No. 050078-EI

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REBUTTAL TESTIMONY OF

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I. Introduction and Purpose of Rebuttal Testimony.

Q. Mr. Sullivan, did you file direct testimony in this proceeding?

A. Yes, I did.

Q. What was the purpose of your direct testimony?

A. The purpose of my direct testimony was to address Progress Energy Florida, Inc's ("PEF's" or the "Company's") capital structure and the impact long-term purchase power contracts ("PPAs") have on our financial policy.

Q. **Have any of the intervenor witnesses addressed PEF's capital structure and the impact of the PPAs on PEF's financial policy in their testimony?**

A. Yes, they have. Mr. Rothschild, on behalf of the Office of Public Counsel ("OPC"), Mr. Gorman, on behalf of White Springs Agricultural Chemicals, Inc. d/b/a PCS Phosphate – White Springs ("White Springs"), and Ms. Brown, on behalf of the Florida Retail Federation ("FRF"), have all filed testimony on these issues.

Q. **Have you read their testimony?**

A. Yes.

Q. What is your understanding of the intervenors' recommendations regarding PEF's capital structure?

A. Mr. Gorman proposes to adjust the Company's proposed capital structure by removing the impacts to the Company's proposed capital structure arising from the Crystal River 3 nuclear unit ("CR3") outage costs incurred by the Company and the off balance sheet obligations related to the Company's PPAs. (Gorman at page 13, lines 8-16). He argues that, even with these adjustments, the Company can achieve its current BBB credit rating.

Ms. Brown proposes to adjust the Company's capital structure by removing the impact of the CR3 outage costs, claiming that this adjustment reduces the Company's equity ratio to 53.86% for financial reporting purposes. (Brown, at page 17, lines 6-7). However, she <u>includes</u> the impact of the PPAs on PEF's equity ratio for financial reporting purposes. In other words, Ms. Brown agrees with PEF's adjustment to take into account the off balance sheet PPA obligations and with PEF's target capital structure to obtain a single A rating. In fact, she claims that, even with her CR3 adjustment, PEF's equity ratio will be directly in the middle of the range to achieve the single A rating that the Company has targeted. (Brown at page 17, lines 7-8).

Mr. Rothschild proposes to adjust PEF's proposed capital structure by removing the impacts of the CR3 outage costs and the PPAs on PEF's capital structure. He goes further though and proposes to apply the Progress Energy, Inc. ("Progress Energy") consolidated capital structure on PEF's rate base, thereby reducing the Company's equity ratio even further to 41.8% equity, a reduction of over

20% in the equity ratio from the Company's proposed capital structure for financial reporting purposes and almost a 10% reduction in the Company's current book equity ratio. Neither Mr. Gorman nor Ms. Brown go this far; they accept that Progress Energy's capital structure should not be substituted for PEF's capital structure.

Q. Do you agree with the intervenors' recommended adjustments to PEF's proposed capital structure?

A, We certainly accept Ms. Brown's agreement to our adjustment to account for the impact of the off balance sheet PPAs on our capital structure. We disagree, however, with her adjustment and the other intervenors' adjustments to eliminate the impact of the CR3 outage on PEF's capital structure. Mr. Portuondo will address their recommendations with respect to the CR3 equity adjustment to the Company's proposed capital structure.

With respect to Mr. Gorman's and Mr. Rothschild's proposed recommendations regarding the financial impact of the PPAs on PEF's capital structure, their adjustments are inaccurate and miss the point of the very financial impact the PPAs have and that the Company is trying to address with its proposed capital structure. Simply put, they recommend that this Commission should ignore the PPAs' financial impact on the Company's capital structure. Ignoring this financial impact, however, will further weaken the Company's credit profile and thus its access to the credit markets when credit is needed the most, placing the Company and its customers at risk of a downgrade with resulting higher costs of capital. In fact, since the filing of my direct testimony, Standard & Poor's ("S&P") has informed us of a change in their calculation of imputed debt associated with these contracts which will increase the amount of debt imputed by $209 million. To ignore this adjustment is to blatantly ignore an obvious adjustment made by S&P when assessing the credit quality of PEF.

Mr. Rothschild's proposal to superimpose Progress Energy's capital structure on PEF's capital structure is, for reasons I will explain, unreasonable and unfair. It will also negatively impact how PEF is viewed by the market, further undermining PEF's credit profile and thereby increasing the Company's risk of a downgrade. Tellingly, none of the other intervenors even suggested such an unreasonable proposal, further indicating the audacity of his recommendation.

Q. What would be the impact on PEF if the Commission were to accept Mr. Rothschild's and OPC's proposed capital structure, return on equity, and $360 million annual revenue decrease?

A. If the Commission accepted Mr. Rothschild's and the Office of Public Counsel's ("OPC's") proposed capital structure and return on equity, the likely result would be a significant degradation of PEF's financial condition given the significant capital expenditures associated with its growing customer base and increasing environmental compliance costs. I would expect the rating agencies would immediately place PEF on a "credit watch" with negative implications while they analyze the impact of the significant reduction from PEF's proposed base revenue increase that Mr. Rothschild's and OPC's proposals would bring about. The impacts would include an immediate and significant reduction in the Company's cash flows, making the

Company more dependent on access to external financing. When a company must access the capital markets to fund any cash flow shortfalls for its nondiscretionary capital spending, the rating agencies view this as a negative development leading to weakening credit ratios. This is the case with PEF, as with any other regulated electric utility with the obligation to serve all new and existing customers.

PEF did not have a choice to reconnect customers during last year's storms and incurred significant expenditures to restore electric service. This is an obligation that cannot be overstated and underscores the importance of having a strong credit rating. Perhaps most importantly, then, the impacts of Mr. Rothschild's and OPC's proposals, if adopted, would signal a dramatic reduction in investor confidence in the Florida regulatory environment, increasing investor perceptions of greater regulatory risk with these and other utility issues. All of these impacts would likely weaken PEF's credit standing and, thus, its credit ratings, serving only to increase the future cost of capital to the Company and its customers.

Q. Why does Mr. Rothschild recommend that Progress Energy's consolidated capital structure should be substituted for PEF's proposed capital structure?

A. Mr. Rothschild's recommendation is not actually based on a reason for selecting the consolidated entity's capital structure for PEF but his reasons for rejecting the Company's proposed capital structure. Mr. Rothschild then <u>assumes</u> the Progress Energy capital structure is reasonable for PEF because the Progress Energy capital structure is similar to (but not the same as) the Progress Energy targeted capital structure and consolidated bond rating.

To explain further, Mr. Rothschild claims that the Company's proposed capital structure will not produce the Company's targeted single A bond rating because on a consolidated basis, according to Mr. Rothschild, the determinative factor affecting the Company's bond rating is the Progress Energy debt. Until the Progress Energy debt is reduced, he claims, nothing will change with respect to PEF's bond rating, no matter what PEF does. He concludes, then, that PEF customers will pay more under PEF's proposed capital structure but receive nothing in return for it.

From this unreasonable premise Mr. Rothschild jumps to the erroneous conclusion that the Company proposed its capital structure in order to subsidize Progress Energy's unregulated operations. Further, he concludes that subsidization is actually occurring, and that PEF's current equity includes Progress Energy debt. To prevent this alleged current and future subsidization of unregulated operations under PEF's proposed capital structure from occurring, he argues the Commission should impose Progress Energy's consolidated capital structure on PEF's rate base.

Apparently recognizing that his recommendation radically reduces even the equity in PEF's <u>existing</u> capital structure, Mr. Rothschild attempts to show that this recommendation will not harm PEF's credit standing thus subjecting PEF and its customers to greater, not lower, costs. He claims the Progress Energy consolidated capital structure is reasonable for PEF because: (1) Progress Energy's current capital structure is close to Progress Energy's targeted capital structure; (2) Progress Energy's current capital structure is sufficient for the BBB rating PEF currently has and that Progress Energy is targeting; (3) the Progress Energy consolidated capital structure allegedly is close to the industry average capital structure for the proxy utility group used by Dr. Vander Weide; and (4) again, the PEF rating is constrained by the Progress Energy debt. As I explain below, all this shows is that Progress Energy is appropriately moving toward its target capital structure; it says nothing about PEF's target capital structure.

II. Capital Structure.

Q. Is it reasonable to apply Progress Energy's consolidated capital structure to PEF's rate base?

A. No. Progress Energy is a holding company with no operations of its own. Rather, Progress Energy's capital structure reflects the consolidated capital structure of many different legal entities that are involved in a variety of different industries. The Progress Energy consolidated capital structure, therefore, does not reflect PEF's capital structure. PEF's cost of capital is a function of its financial capital structure and adjustments to its financial capital structure made by the rating agencies, i.e. the adjustment for the off balance sheet PPA obligations that I will also discuss. It is not a function of Progress Energy's capital structure and it would be inconsistent with well established regulatory practice of using the utility's capital structure when setting rates. PEF's financial capital structure is driven by its specific capital needs given the particular circumstances of its regulatory environment. Simply superimposing the Progress Energy consolidated capital structure onto PEF ignores the realities of PEF's regulatory environment and the capital structure it needs to succeed in that environment. Mr. Rothschild further seems to speculate in his testimony (Rothschild at page 13, lines 19-22) that a subsidiary capital structure may contain equity raised in the form of debt by its parent. This type of transaction, referred to as "double leverage," was addressed by the Florida Public Service Commission ("FPSC" or the "Commission") in Docket No. 780912-TP, Order No. 9551, 1980 Fla. PUC Lexis 184. In that Order, the Commission rejected the use of a double leverage adjustment.

Q. How does PEF's regulatory environment drive PEF's financial capital structure?

A. As I explained in my direct testimony, PEF, like other regulated electric utilities, has the obligation to serve its customers. This obligation arises from the fact that PEF is providing an essential service. Other companies, when market conditions turn and the costs of providing the company's services or products increase beyond the marginal return to the company on that service or product, can and do cut or withhold their investment in production of their services or products until market conditions improve. Regulated electric utilities like PEF do not have that option. They must continue to invest in the capital necessary to provide service to their customers because they have an obligation to provide service under all market conditions. This obligation to serve requires access to capital markets under all market conditions.

Q. Does PEF recover its costs invested in capital from customers?

A. PEF does have the opportunity to recover its reasonable and prudent costs, including costs of investment, from its ratepayers. This is, however, no guarantee that the Company will recover all of its costs and the rating agencies understand that no such guarantee exists. There is also the issue of timing. Adjustments to the Company's recovery of its costs invested in providing service take time especially through base rate adjustments but also through the various recovery clauses. This means the Company begins to recover its costs months and sometimes years after the Company has made the investments. When it comes to capital spending, however, the Company cannot easily change the timing of its spending given the demands of its obligation to provide service. This means that the Company must issue securities whenever those demands must be met, regardless of the market conditions at the time. Accordingly, the Company needs to be able to issue low-cost debt securities during all market conditions.

Q. How does the Company propose to meet its regulatory obligations to provide the necessary capital investment?

A. PEF's target is to obtain a single A rating from all three rating agencies. Its current senior unsecured credit rating is BBB, which is the next-to-lowest investment grade rating. As I explained in my direct testimony, a stronger credit rating assures PEF access to low-cost debt during both good and difficult market conditions. This is necessary for PEF given the significant capital investments the Company faces in the near and long term to meet its obligation to serve.

For example, the Company continues to experience new customer growth and growth in energy demand that, when coupled with the Company's 20% reserve margin requirement, requires the Company to invest in new generation on a regular basis in the future. The Company added a new 500 megawatt generation unit in 2003 and 2005, and will add another new 500 megawatt generation unit in 2007, with expected similar generation investment thereafter. This future generation investment will likely include the consideration of new base load coal or nuclear generation. Similarly, the Company faces substantial capital investments to meet ever growing environmental compliance requirements in the future. Finally, the Company continues to face additional investment requirements in its system to provide the quality electric service that customers demand. All of these capital investment requirements amount to billions of dollars.

The Company must be sufficiently positioned to access the capital markets for these billions of dollars at the lowest cost to its customers under any market conditions. That is, the Company and customer will both benefit if the Company achieves its targeted single A bond rating. The customers are paying for the insurance of better access to low-cost securities to meet the Company's indisputable capital investment needs whenever those investments must be made and they will reap the benefits of the lower cost sources of capital in all market conditions including the difficult ones.

Mr. Rothschild ignores PEF's single A rating target and frequently refers to the Company's target rating as a BBB rating, which is the target rating for Progress Energy consolidated. However, if the consolidated company's target credit rating is used for PEF this will preclude PEF from ever obtaining its single A target credit rating.

Q. Do the intervenors claim that a target single A bond rating for PEF is unreasonable?

A. No. Mr. Gorman apparently believes a BBB rating is sufficient but he does not argue that a single A rating is unreasonable. Mr. Rothschild also argues that a BBB rating is sufficient and that a single A rating cannot be achieved by PEF unless the parent debt is reduced, but he does not claim that a target of a single A rating for the regulated utility would be unreasonable. Ms. Brown seems to assume that a target single A rating is reasonable but erroneously argues that PEF meets the target capital structure for a single A rating excluding the impact of the CR3 outage.

Q. Do you agree with Mr. Rothschild that the Progress Energy debt is the determinative factor in achieving the Company's target capital structure?

A. No. It is one factor among many that the rating agencies take into account when addressing the appropriate credit rating for Progress Energy and its subsidiaries, including PEF. Mr. Rothschild cannot say that the Company will not achieve its single A rating if the parent debt level remains the same any more than the Company can say it will achieve its single A rating. The rating agencies consider the entire picture, taking into account the financial structure and capital needs of the parent company and its subsidiaries in their unique business and economic environments. Equally important for the Company is the outcome of this rate proceeding, as noted in the rating agency reports cited in the Progress Energy annual report at page 25 of Mr. Rothschild's testimony. Whether due consideration will be given to the Company's need to access capital in all markets to meet its substantial capital investment requirements is important to the rating agencies too. The disadvantages from further deterioration of PEF's credit position are clear, if S&P lowers Progress Energy's senior unsecured rating from its current rating, as reported in the annual report, it would be one rating category from a noninvestment grade rating. The effect of a noninvestment grade rating would be to increase borrowing costs. This means that the Company and its customers will pay more for its securities for its capital investment requirements.

Q. Has the Company included parent debt in PEF's equity?

A. No, of course not. Mr. Rothschild is simply wrong in this assertion and he does not support it with anything more than his own speculation about the alleged "special incentive" parent companies have to put extra equity on the books of regulated subsidiaries. (Rothschild at page 13, lines 19-22). Tellingly, the S&P article he cites says <u>nothing</u> about this alleged "special incentive" of holding companies to issue debt and contribute it down to the regulated utility as equity. (Rothschild, Exhibit No. ___ (JAR-14). Further, the article does not support Mr. Rothschild's assertion at page 14, lines 3-5 that "S&P is specifically aware of the problems associated with a high equity ratio reported on the books of regulated subsidiaries when such extra equity disappears at the consolidated level." This is Mr. Rothschild's conclusion, not S&P's. The article addresses the effect regulation can have on the rating of the parent and subsidiary and S&P makes clear that its analysis is conducted on a "case-by-case basis" where the "key is a regulator's demonstrated willingness to protect creditworthiness." (Rothschild Exhibit No. ___ (JAR-14, page 41 of 47). S&P

further explains in the article that "regulatory treatment should be transparent and timely and should allow for consistent performance --- if it is to be viewed positively in the ratings context." (Rothschild Exhibit No. ___ (JAR-14, page 40 of 47).

Q. Will PEF's proposed capital structure subsidize Progress Energy's unregulated operations?

A. No. The capital structure is an important metric when establishing a credit rating. PEF's proposed capital structure is necessary to achieve its target single A credit rating for all the reasons I have previously provided. Progress Energy has a different target credit rating and, therefore, requires a different capital structure to attain that rating. The target credit rating for Progress Energy is based on the business risk of its entire enterprise of businesses. PEF is not asking for an adjustment to its capital structure to off-set parent company debt. It is asking for its proposed capital structure to attain a more financially sound credit rating, as I have explained, to prepare for the capital investments that will be required of PEF now and in the future to meet its obligation to serve.

Q. Does Rothschild Exhibit No. ___ (JAR-1) demonstrate that PEF is subsidizing unregulated operations?

A. No, it does not. In particular, page 3 of Exhibit No. ___ (JAR-1) fails to accurately account for the fact that Progress Energy's consolidated capital structure includes debt issued in connection with the 2000 acquisition of Florida Progress by then CPL Energy, Inc. The calculations performed on page 3 of Mr. Rothschild's Exhibit, therefore, include nearly *$3 billion of debt* that is related to regulated operations but not included in the capital structure of any Progress Energy subsidiary. Including this amount in his calculations grossly misstates the capital structure of the subsidiaries and in no way indicates the level of debt attributable to unregulated operations. As a result, the calculations are meaningless for purposes of determining the appropriate capital structure for PEF as well as the appropriate capital structure for Progress Energy's unregulated businesses. In addition, PEF's MFR Schedule D-2 page 4 of 4 shows the capital structure of the combined nonregulated businesses of Progress Energy. That schedule shows the percentage of common equity to be 65% of the total nonregulated capitalization, significantly different than the percentage calculated by Mr. Rothschild.

Further, as Dr. Cicchetti explains, the synergy benefits that were realized in the merger have been received by customers through the $125 million annual rate reduction over the four years of the base rate settlement agreement. Customers will also continue to receive benefits from the systemic synergies implemented through the combination of the companies in the merger. These benefits were achieved at a cost, namely the debt that was required to bring about the merger. Mr. Rothschild's proposal,to <u>reduce</u> the equity recognized at PEF for ratemaking purposes because of the debt at the parent company that was incurred to accomplish the merger, penalizes the Company for initiating the merger that yielded synergy benefits customers have received. This proposed penalty is simply unfair.

Q. Will Progress Energy continue to pay down the level of debt?

A. Yes, it will. As indicated even by Mr. Rothschild, Progress Energy's target capital structure includes more equity than it currently has, demonstrating that Progress Energy is moving toward greater debt reduction. Progress Energy will continue to do so as part of its plan to reduce the percentage of debt in the consolidated capital structure which will help the company achieve its target credit ratio.

Q. Does Progress Energy's target capital structure and credit rating justify using Progress Energy's capital structure for PEF?

A. No. This is circular. The Progress Energy target capital structure and target credit rating support applying Progress Energy's capital structure to PEF only if you first <u>assume</u> that the Progress Energy capital structure is the appropriate capital structure for PEF, which is what Mr. Rothschild does. As I explained, the target capital structure is an important metric when establishing a credit rating. The long term senior unsecured target credit rating for Progress Energy is BBB but the long term target credit rating for PEF is single A, not BBB. The two target ratings are different and require different capital structures. The guidelines for a company seeking an A rating like PEF with a business risk of "5" is a minimum of 50% equity up to as high as 58% equity. It is this capital structure that PEF is targeting in this proceeding.

Q. Do you agree with Mr. Rothschild's suggestion that the proxy utility group supports the application of Progress Energy's capital structure to PEF?

A. No. When setting a target capital structure, it is totally inappropriate to use anything other than the prescribed guidelines of the rating agencies. Rating agencies provide these guidelines for the obvious reason that issuers would know the appropriate capital structure target for a particular credit rating. There is no need to use a proxy group as suggested by Mr. Rothschild.

Q. Do you agree with Mr. Rothschild's claim that his recommended capital structure will not put downward pressure on PEF's bond rating?

A. No. Mr. Rothschild bases this assertion on the claim that his proposed capital structure is "consistent with the capital structure that has produced the current bond ratings." (Rothschild at page 24, lines 19-20). This assertion simply is not true. Progress Energy's current rating is BBB-, not BBB as reported by Mr. Rothschild, and that rating arises from a variety of factors considered by S&P, one of which is the current capital structure for Progress Energy of 41.8% common equity and PEF of 48.5% common equity, excluding the off balance sheet obligations resulting from the PPAs. (MFR Schedule D-2, pages 1 and 2 of 4). Considering the PPA off balance sheet obligations, the current common equity ratios are even lower, 39% for Progress Energy and 41.2% for PEF. (Id.). What Mr. Rothschild proposes is an identical capital structure for PEF and Progress Energy excluding the PPA off balance sheet obligations. This means a capital structure where the common equity ratio is 41.8% for <u>both</u> Progress Energy and PEF. This is far different from the 41.8% Progress Energy and 48.5% PEF common equity ratios supporting the current bond rating.

III. <u>PPAs Impact on PEF's Financial Policy.</u>

Q. How do the rating agencies treat long-term power supply contracts and what is the impact of their treatment of the PPAs on the Company?

A. As I explained in my direct testimony, while there are differences in methods, they all view long term PPAs with their fixed payments as essentially debt-like in nature. The main effect of the impact of this treatment of PPAs on PEF's financial structure is that the Company is considered to have more leverage than if you calculated its leverage ratio based only on the debt recorded on its balance sheet.

Q. Do the intervenors claim that the rating agencies do not view long term PPAs as debt-like in nature?

A. No, they agree that they do. Mr. Gorman, for example, agrees that credit rating analysts consider off balance sheet purchased power in evaluating a utility's credit. (Gorman at page 11, lines 20-21, page 12, line 1). Similarly, Ms. Brown testifies that "[a]s explained by Mr. Sullivan, the rating agencies treat off balance sheet obligations, such as long term purchased power contract commitments, as additional debt when assigning bond ratings. <u>This practice has the impact of reducing PEF's equity ratio to a level that PEF deems unacceptable</u>." (Brown at page 14, lines 12-16) (emphasis added).

Q. Does Ms. Brown agree with the Company's proposal to address the off balance Sheet impact of the PPA's on PEF's capital structure?

A. Yes, she does. Ms. Brown notes that, as shown in Mr. Sullivan's testimony, "the inclusion of the off-balance sheet obligations in the capital structure reduces the common equity ratio from 55.00% to 47.71%." (Brown at page 14, lines 16-19). She explains that this drops the Company's equity ratio below the range of 50% and 58% for a single A rating. She then notes that PEF makes an adjustment to its equity to allow the equity ratio to fall within the range for a single A rating "once the rating agencies make the off-balance sheet adjustment." (Brown at page 14, lines 19-22, page 15, lines 1-2). She acknowledges PEF's target for a 55% equity structure after recognizing the imputed debt associated with the PPAs and explains that PEF added an amount to equity "equal to the debt it anticipates the rating agencies to impute." (Brown at page 15, lines 4-7). Ms. Brown makes a similar adjustment to her schedule on Exhibit No. ___ (SLB-3, page 2 of 3).

Q. Do Mr. Gorman and Mr. Rothschild agree with PEF's adjustment to account for the impact of the PPAs on PEF's capital structure?

A. No, they do not. They propose that the Commission should ignore the admitted impact the off balance sheet PPAs have on the Company's capital structure, for a variety of reasons, none of which have merit.

Q. What are Mr. Gorman's arguments for rejecting the Company's proposal for recognition of the impact of the off balance sheet PPAs on PEF's capital structure?

A. First, Mr. Gorman argues that the debt-like equivalence of PEF's PPAs is "reduced" based on his reading of the S&P literature. (Gorman at page 13, lines 2-4). He does not explain what he means by "reduced" but there is no real dispute regarding PEF's calculation of the off balance sheet impact of the PPAs as shown on page 8 of my direct testimony. As previously noted, this amount has been increased by S&P due to a change in the discount rate applied to the capacity payments. That is the true impact of the PPAs on PEF's adjusted capital structure for financial purposes, whether or not it is "reduced," and Mr. Gorman does not suggest an alternative figure.

Mr. Gorman and Mr. Rothschild also argue that PEF's current capital structure is sufficient to support its bond rating without PEF's adjustment to account for the impact of the off balance sheet PPA debt. This argument ignores the Company's target capital structure to obtain a single A rating. Neither Mr. Gorman nor Mr. Rothschild contend that a single A rating is unreasonable. And, as I explained before, by improving its credit rating PEF will improve its access to the capital markets, as well as other sources of funds, during all financial markets, good and bad.

Finally, Mr. Gorman asserts that PEF's proposal to recognize equity equivalent to the debt imputed to the Company's balance sheet for the off balance sheet PPAs is inconsistent with the principle of setting rates to recover PEF's actual costs of providing service. Mr. Rothschild echoes this argument, claiming that customers should not pay a return for equity that does not exist. This argument ignores who really determines the overall cost of capital, the market or regulatory bodies. Market forces, not regulatory bodies, determine a firm's cost of capital. In the case of the PPAs, the market recognizes the off balance sheet obligations as debt whether or not regulatory bodies choose to do so in setting rates. This off balance sheet debt must be accounted for because the market, not regulatory cost principles, demands it. And it is the market that will ultimately determine the cost of capital in the long run. Failure to recognize the PPAs, as the market in fact does, places the Company at risk of further weakening financial ratios that will impact the Company's access to capital on reasonably low cost terms when capital is needed the most. In the long run, suppressing these market forces will only lead to higher capital costs – and customer rates – and it will be too late then to adjust PEF's capital structure to take the PPAs into account. The Commission needs to act now to ensure that PEF's capital structure adequately positions the Company to obtain the necessary capital to provide quality service to its customers in all market conditions.

Q. Do you agree with Mr. Rothschild's assertion that PEF is really at 63% equity if placed on the same financial basis that is used by Progress Energy for setting its capital structure by rating agencies?

A. No. All three national rating agencies base their credit rating on a company's <u>adjusted</u> financial ratios. Mr. Rothschild is using the PEF equity ratio on a financial basis <u>before</u> it is adjusted. For PEF, the most significant adjustment made by S&P to its financial based ratios is an adjustment to impute debt associated with the PPAs. This adjustment significantly increases its leverage and reduces coverage ratios and must be taken into consideration.

Q. **Do you agree with Mr. Rothschild's claim that the Commission should not take into account the PPAs because Progress Energy does not take them into account?**

A. No, Mr. Rothschild is wrong. Progress Energy does take the PPAs at PEF and Progress Energy Carolinas into account as reported on an adjusted financial basis. This is demonstrated by MFR Schedule D-2, page 2 of 4, which shows the adjusted financial capital structure for Progress Energy. Mr. Rothschild relies on the Company's answer to OPC interrogatory number 112 to support his claim that Progress Energy does not make an adjustment to its capital structure to account for the PPAs. What Mr. Rothschild fails to point out is that the interrogatory asked about a debt-to-capitalization ratio referred to in the Company's annual report. Disclosures in the Company's annual reports are made in accordance with Generally Accepted Accounting Principles ("GAAP") pursuant to Securities Exchange Commission ("SEC") regulation. Under the regulation, adjustments such as the one made by rating agencies for off balance sheet PPAs are non-GAAP financial measures that are not reported in the annual report pursuant to SEC regulation.

Q. **Have you addressed the principle arguments raised by the intervenors that challenge the Company's proposed capital structure and adjustment to account for the impact of the PPAs on the Company's capital structure?**

A. I believe that I have. To the extent that I have not addressed some further argument to the contrary, however, the Company does not agree with it but rejects it for all the reasons that I have provided in my direct and rebuttal testimony.

Q. Does this conclude your testimony?

A. Yes, it does.