BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 080317-EI

IN RE: TAMPA ELECTRIC COMPANY'S
PETITION FOR AN INCREASE IN BASE RATES
AND MISCELLANEOUS SERVICE CHARGES

REBUTTAL TESTIMONY

OF

SUSAN D. ABBOTT

ON BEHALF OF TAMPA ELECTRIC COMPANY

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Q. Please state your name, business address, occupation, and employer.

A. My name is Susan D. Abbott. My business address is 546 5th Avenue, New York, New York 10036. I am employed by New Harbor Incorporated as a Managing Director.

Q. Are you the same Susan Abbott who filed direct testimony in this proceeding?

A. Yes I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to address serious errors and shortcomings in the prepared direct testimonies of Mr. Tom Herndon, testifying on behalf of The Florida Industrial Power Users Group and The Florida Retail Federation; Mr. Kevin O'Donnell, testifying on behalf of The Florida Retail Federation; and Dr. J. Randall Woolridge, testifying on behalf of the Citizens of the State of Florida.

Q. Please summarize the key concerns and disagreements you have regarding the substance of Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon's testimonies.

A. My key concerns and disagreements are as follows:

- All three seemed to have missed the point of my testimony. It was not written in support of return on equity. Instead, it was written to provide the Florida Public Service Commission ("the Commission") with a detailed understanding of the importance of financial integrity to the company's access to capital.

- None of the three acknowledged the importance of what the rating agencies do and how they do it, or what effect ratings have on access to funds for the company. Several statements were made in their testimonies that indicate some confusion about the ratings process.

- Dr. Woolridge, Mr. Herndon, and Mr. O'Donnell underestimate how investors perceive risk, both in a general sense and relative to specific issues. Such underestimations can have dire consequences for the customers of capital intensive companies like Tampa Electric.

- All three demonstrate a lack of understanding about recent conditions in the debt markets including the availability and cost of funds.

Q. Why do you believe Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon misinterpreted your testimony?

A. Dr. Woolridge and Mr. O'Donnell apparently believe that my testimony was, or should have been, in support of a particular return on equity. It is Tampa Electric witness Dr. Donald Murry's responsibility to support a particular return on equity. I never intended, and in fact never addressed the issue of the appropriate return on equity. Mr. Herndon at least acknowledges the focus on A level ratings, but then ties it completely to a stated return on equity. All three missed the focus and importance of the issue of financial integrity. It is critical for the Commission to appreciate the importance of financial integrity to a company with a large construction program and the need to purchase large amounts of fuel and purchased power on a regular basis. Solid creditworthiness is essential for both access to the financial markets, and to make capital expenditures and to purchase fuel, materials, and supplies necessary to produce electricity for ratepayers. My testimony is meant to help the Commissioners make a fully informed decision by providing insight into 1) how financial integrity is regarded by the rating agencies, 2) how rating agency actions affect a company's access to capital, and 3) what the financial metrics would be with and without the rates requested, both cases assuming a 55 percent equity level, as a way to gauge the effect on Tampa Electric's financial integrity of any decision the Commission makes. Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon make no attempt whatsoever to provide information on what their recommendations would do to the financial integrity of Tampa Electric.

Q. How do Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon reflect their interpretation of your testimony?

A. In his direct testimony, Dr. Woolridge states on pages 85, lines 19 through 21 and 86, lines 1 and 2, that I do "not perform any studies to evaluate the adequacy of Dr.

Murry's 12 percent rate of return recommendation." Mr. O'Donnell states on page 41, lines 28 and 29, that my testimony implies that a "certain return on equity and capital structure [is needed] in order to ensure the utility will have a credit rating that [I deem] suitable for the company's credit needs." He also complains that I do not provide a return on equity or capital structure recommendation. Mr. Herndon states on page 18, lines 11 and 12, of his direct testimony that I suggest that "an A level profile will automatically result from a certain ROE".

Q. If you were not submitting direct testimony in order to support the recommended return on equity, why did you submit testimony?

A. I stated very clearly on page 3, lines 11 through 21, of my direct testimony that I was providing testimony regarding the rating agencies, how their decisions affect the credit standing and, therefore market access, of any company they rate, and how important an understanding of the consequences of the decision in this case is to Tampa Electric's creditworthiness. Finally, I stated that I was providing support for Tampa Electric's targeted credit ratings.

Q. But shouldn't Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon expect ratings analysis to include consideration of allowed returns on equity?

A. Yes. Any credit analysis includes an examination of allowed returns on equity. However, more important to creditworthiness than the level of returns allowed is how ROE, capital structure and rate design work together in light of the level of a company's business risk to generate cash flow that is adequate to support a company's credit ratings. Mr. Herndon fatuously states that I suggest that the company's ratings would "automatically" improve if it were granted its requested return on equity. After 20 years of working at a rating agency, and more than ten years working with them from the outside, I know that nothing is "automatic" about what they do, and the return on equity is far from the only thing the rating agencies look at. What I did suggest was that approval of the requested rate increase and capital structure would improve the company's financial profile to the point where A ratings by the rating agencies would be warranted.

Q. Why have you concluded that none of the three intervenor witnesses demonstrates an understanding of the rating agencies?

A. All three intervenor witnesses made statements in their direct testimony that indicate a lack of appreciation of how the rating agencies operate, what their influence is in the marketplace, and why their behavior is important to the Commission.

Q. Can you elaborate?

A. Yes. Let me take each witness's statements individually. Dr. Woolridge argues two erroneous points of view. First, he argues that the inclusion of the cost of purchased power agreements ("PPAs") as a debt equivalent in Tampa Electric's capital structure is inappropriate because the cost of PPAs is passed through to customers through a Commission-endorsed adjustment clause. He further argues that the 25 percent risk factor the company included in its calculation should be disregarded because Dr. Woolridge believes there is no evidence to conclude that Standard & Poors ("S&P") actually uses a 25 percent risk factor in Tampa Electric's case. He also concludes that because Moody's approaches PPAs as a debt equivalent differently than S&P that the topic should be ignored.

Q. Why is Dr. Woolridge mistaken in his approach to this issue?

A. The inclusion of PPAs as debt equivalents has been incorporated as a core part of utility credit analysis by the rating agencies since the early 1990s. S&P has always taken a more systematic approach to the issue than has Moody's. S&P has published numerous articles on the topic, and clearly stated in its May 7, 2007 update on the topic, "in cases where a regulator has established a power cost adjustment mechanism that recovers all prudent PPA costs, we employ a risk factor of 25 percent…" Florida has established such an adjustment mechanism, and therefore, Tampa Electric qualifies for S&P's 25 percent risk factor adjustment. In addition, as Tampa Electric witness Gordon Gillette discusses in his rebuttal testimony, S&P has told Tampa Electric that this is the risk factor they use when making adjustments to the company's balance sheet. Even though there is a purchased power cost pass-through mechanism in Florida, S&P apparently believes there is enough residual risk to reflect a 25 percent risk factor in its analysis, indicating that they do not believe the pass-through clause entirely mitigates the risk of the PPAs.

Q. How do you respond to the claim that Moody's does not adjust for PPAs, and, therefore, those adjustments should be ignored?

A. The truth is that Moody's does calculate a debt equivalent for PPAs. They just do not put as much weight on them as does S&P, and may not, under certain circumstances, reflect the adjustment in their metrics. Nevertheless, the concept that if rating agencies make different adjustments, those adjustments should somehow be negated makes no sense. That approach shows a lack of understanding of how investors view ratings and risk.

Q. Why is that?

A. If the inclusion of PPA obligations as debt equivalents results in pressure on either a rating that becomes visible to investors in the form of a negative outlook, or a lower rating than another agency has for that same company, the investors will default or give more weight to the lower outlook or rating. That negatively affects a company's ability to access the market and affects the interest rates for new debt.

Q. You cited two issues Dr. Woolridge is mistaken about.

What is the second?

A. Dr. Woolridge emphasizes that debt imputed by S&P relative to PPAs is not GAAP accounting, and therefore investors will not see the liability on the company's financial statements.

The rating agencies use GAAP statements as a starting point in their analyses. However, since they are interested only in cash flow measures of creditworthiness, they make routine adjustments to financial statements to include or exclude items. The rating agency believes those items represent a fixed obligation or change the level of cash flow. They make these adjustments regardless of what the GAAP treatment of those items may be. In addition, the rating agencies routinely publish reports on the adjustments they make, so investors are well aware of what they are. Investors do not blindly accept GAAP statements as the whole truth of a company's creditworthiness. If Dr. Woolridge understood that, he would never have made the odd statement that investors would never see the adjustments the rating agencies make.

Q. What statements did Mr. O'Donnell make that indicates he does not understand the rating agencies?

A. Mr. O'Donnell, having obviously not understood the point of my testimony, interprets it as being in "support [of] the testimony of other witnesses" and therefore irrelevant. Had he read my testimony more thoughtfully, he would have seen that the case I made for financial integrity, as measured by the criteria used by rating agencies, was the core of my testimony. He also asserts a number of other things that are erroneous or irrelevant. He purports that my testimony indicated that rates should be set according to credit ratings, and then, either erroneously or with forethought, referred to the ratings as being set by "investment banks in New York" (page 42, line 1 and 2). He disparages the rating agencies for their "substantial conflicts of interest" (page 42, line 7), and states that if the Commission is targeting a credit rating as opposed to granting a company an opportunity to earn a particular return, company management is going to be incented to take risks they otherwise wouldn't take.

Q. Why are these issues indicative of Mr. O'Donnell's lack of understanding of the function of ratings?

A. Mr. O'Donnell is being provocative rather than helpful in his critique of my testimony. The "conflict of interest" that he refers to on page 42, lines 6 and 7, is grossly misunderstood by most and irrelevant to this case. It involves the erroneous assumption on the part of some that the rating agencies cannot be objective because they are paid by the issuers they rate. It is hard to see why, even if the assertion were true, it is relevant here. In addition, he suggests that I believe rates for electric service should be set by the rating agencies and that I do not understand the regulatory process. Further, the idea that a management concerned with its ratings is going to take risks it otherwise would not demonstrates a complete lack of understanding of rating agencies. Rating agencies do not like risk, and would, therefore downgrade or otherwise maintain a low rating on a company that increased its risk. Therefore, where is the incentive provided by a rating agency for company management to take risk? There simply is no incentive. Mr. O'Donnell's statements have nothing to do with the substance of my testimony, or Tampa Electric's financial integrity. He seems to have been unable to formulate a cogent argument as to why Tampa Electric's financial integrity is not important to the Commission, and has chosen instead to attack the rating process.

Q. How do you respond to these issues?

A. Much of what Mr. O'Donnell says in response to my testimony is irrelevant or not based on fact. I never stated nor even implied that rates for electric service should be set by the rating agencies. It is the Commission's job, and its alone, to determine the balance between the interests of the ratepayers and those of the company. My testimony was presented as a tool to help the Commission to achieve that balance. It needs to be recognized that in the end, a healthy utility benefits both ratepayers and financial constituents. A healthy utility can access markets when needed so as to pursue its capital requirements for the benefit of its customers. A healthy utility provides investors with the returns they expect so that they will continue to invest in the company, and again, allow access to funds used to satisfy the needs of the utility's customers.

Q. Does Mr. Herndon understand rating agencies in your opinion?

A. Mr. Herndon, aside from making the overly broad statement that I suggested an upgrade to an A would be automatic, joins Mr. O'Donnell in making inflammatory statements about the rating agencies, I assume in an attempt to discredit them. He states that the mistakes the rating agencies have made "led us to the current financial situation" (page 18, line 11). The current financial crisis resulted from the failure of the subprime real estate financing market. The rating agencies, while among those receiving criticism for their part in the crisis, are still highly respected and valued for their opinions on utilities and other corporate and municipal borrowers. The credit rating process is not perfect, but is still relied upon by investors to make decisions. It is still the best tool available to the Commission to evaluate the impact of its own decisions on the company's creditworthiness. Assigning blame for the credit crisis is irrelevant, but the crisis does make financial integrity that much more critical. Further, Mr. Herndon makes another statement at lines 8 and 9 on page 18 of his testimony that recent experience "amply demonstrates that their work is art, not science". That is not new. It has never been science, and whether that is true or not is irrelevant. I do, however, agree with Mr. Herndon that ratings are valuable aides in making investment decisions, but "not the final answer" (page 18, line 14).

Q. Why do you believe Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon have misinterpreted the issue of risk?

A. While utilities are considered less risky than a lot of companies operating in other sectors, they are not without risk. Messrs. O'Donnell and Herndon appear to be somewhat dismissive of the risks utilities retain, while Dr. Woolridge does acknowledge that utilities have greater than average financial risk. Yet, he too is somewhat dismissive of that risk. Mr. Herndon does say, "the utility business is not completely risk free" (page 10, line 18). Mr. O'Donnell delineates the costs that aren't covered by cost recovery clauses but then states, if the company can't generate enough revenue to cover costs, it can simply apply to the Commission for a rate increase, as if that were a simple exercise that will be followed by easy recovery of their costs. Utilities are at greater risk than other companies because they can not institute price increases to reflect increased costs unilaterally. They must wait on the regulatory process and hope they receive sufficient rate relief. While both Messrs. O'Donnell and Herndon cite the various cost recovery clauses the FPSC allows which do diminish risk to a certain degree, they have not demonstrated that they understand that the utility industry suffers from high levels of financial risk.

Q. What do you mean by "financial risk"?

A. Rating agencies construct ratings by examining both business risk and financial risk. Business risk includes such issues as regulatory practices, the growth rates for electric service in the service territory, fuel use, customer mix, etc. Financial risk relates to how much leverage a company has and how well its cash flow covers its obligations. As I explained in my direct testimony, S&P evaluates all companies for business risk on a scale of "Excellent" to "Vulnerable", and for financial risk on a scale of "Modest" to "Highly Leveraged". Although 133 of the 180 utilities S&P rates have "Excellent" business risk profiles, meaning their business risk is low, 106 are deemed to have "Aggressive", or high financial risk, while 65 have "Intermediate" financial risk. Only one is deemed to have "Modest" financial risk. As a result, even their "Excellent" business risk positions only generate an average industry rating of BBB. In today's markets, BBB utilities can not access the markets at all at times, or can do so, but only at very high cost.

Q. What indicates that Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon are out of touch with market conditions?

A. Several things. First, Mr. Herndon illogically claims that a 7.5 percent return on equity would be attractive to investors. In the current market environment, if BBB utilities even have access to the markets, they are paying 9 percent and 10 percent for 10-year debt. No equity investor will accept an equity return that is less than the company's cost of debt, simply because the equity holder's risk is higher than the debt holder's. In fact, that subordinate position leads equity investors to demand a reasonable spread between the cost of debt and the return on equity. Mr. Herndon also compares his recommended return on equity to the risk free rate, which is quite low. In fact, the Treasury rate has been pushed down to stimulate economic growth, while the credit markets, when they are open, are requiring higher and higher spreads to that Treasury rate. The new issue bond market was closed entirely for two weeks in September. When it reopened, it opened to A and AA rated utilities and AAA corporations. Spreads, which had been in the 175 to 300 basis points range for A rated utilities at the low end, and split rated utilities in the BBB range at the high end, prior to the market closing increased to 350, then 400, and were recently at almost 700 basis points for unsecured 10 year debt of investment grade split rated companies. Dr. Woolridge claims that capital costs are at historic lows. This is the same misinformation provided by Mr. Herndon. Treasury rates may be at historic lows, but utilities do not borrow at Treasury rates. The evidence is clear that interest rates required by investors to lend money to utilities are higher than they have been since the recovery from the economic slump of the early 1990's. In addition, the difference in cost from one rating category to the next is higher than it has been in at least 20 years. More importantly, access is limited. Despite most utilities having aggressive construction spending needs, issuance of utility debt in the U.S. dropped in the third quarter of this year by half, from $20.1 billion to $9.7 billion, according to Dealogic.

Q. The absence of a study of the cost of an increase in Tampa Electric's ratings, assuming the requested return on equity is granted, has been criticized by both Mr.

O'Donnell and Mr. Herndon. How do you respond?

A. It is true that a study was not done. The more important issue than the cost of debt is the availability of funds. From 2009 through 2013, Tampa Electric has a $2.5 billion construction program that is being pursued to provide reliable service to its customers. Without base rate relief, only about half of the funding will come from internally generated funds. In order to borrow that amount of money, the company will need to carefully plan its issuances of debt. Since the market has become unreliable, and there is no way to determine if or when that condition will cease, it is important that the company have a level of financial integrity that will allow it to access the markets whenever it needs to. The only way to ensure access to the financial markets is to have an A rating.

Q. Do you agree with Dr. Woolridge's assertion that your ratings parameter exhibit shows that Tampa Electric is on the high end of the BBB range even without rate relief?

A. No. In my direct testimony, I presented information that illustrated Tampa Electric's financial metrics at the targeted 55.3 percent equity ratio, with and without the requested rate increase. However, Tampa Electric's witness Mr. Gillette provided a complementary exhibit to mine which included what the financial metrics would be without the proposed rate increase at Tampa Electric's 2007 equity ratio of 46 percent. The resulting financial metrics indicate the company needs both rate relief and the proposed equity ratio to be more assured of achieving credit rating parameters within its targeted single A debt rating.

Q. Please summarize your rebuttal testimony.

A. My rebuttal testimony explains my view that Dr. Woolridge, Mr. O'Donnell and Mr. Herndon either did not understand, or will not acknowledge that my direct testimony was in support of Tampa Electric's need for improved financial integrity in order to access the capital markets to successfully pursue an ambitious construction program undertaken for the benefit of ratepayers. None of them explored what their own recommendations meant to the financial integrity of the company, and they seem to have failed to understand the benefits to both consumers and financial partners of a financially healthy utility. I have demonstrated that, contrary to Dr. Woolridge, Mr. O'Donnell and Mr. Herndon's claims, the financial markets are both difficult to access and are demanding higher rates of interest, even for what would be considered "creditworthy" entities. I have also injected some balance into their views of how much risk the utility industry endures. My direct and rebuttal testimonies were written to illuminate the issue of financial integrity and how important it is to a company that needs to access the capital markets on a regular basis. Not one of the witnesses acknowledges my focus on cash flow and how a regulatory decision affects credit metrics. The Commissioners, while taking into consideration all of the relevant testimony provided them in this case, must understand that their decision, which is theirs alone to make, will have a profound impact on Tampa Electric's ability to access the capital markets, and at what price. Credit metrics combined with business risk factors dictate the level of a company's creditworthiness. Creditworthiness defines the ability of a company to access the capital markets. With a $3.5 billion construction program in progress, Tampa Electric needs to improve and then maintain its financial integrity in order to access the markets at will. This message was lost on Dr. Woolridge, Mr.

O'Donnell, and Mr. Herndon

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.