

**BEFORE THE FLORIDA
PUBLIC SERVICE COMMISSION**

**DOCKET NO. 080677-EI & NO. 090130-EI
FLORIDA POWER & LIGHT COMPANY**

**IN RE: PETITION FOR RATE INCREASE BY
FLORIDA POWER & LIGHT COMPANY**

REBUTTAL TESTIMONY & EXHIBITS OF:

TERRY DEASON

DOCUMENT NUMBER-DATE

08139 AUG-68

FPSC-COMMISSION CLERK

1 **BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**

2 **FLORIDA POWER & LIGHT COMPANY**

3 **REBUTTAL TESTIMONY OF TERRY DEASON**

4 **DOCKET NO. 080677-EI**

5 **AUGUST 6, 2009**

6
7 **Q. Please state your name and business address.**

8 A. My name is Terry Deason. My business address is 301 S. Bronough Street, Suite
9 200, Tallahassee, Florida 32301.

10 **Q. By whom are you employed and in what capacity?**

11 A. I am employed by the law firm Radey Thomas Yon and Clark as a Special
12 Consultant specializing in the fields of energy, telecommunications, water and
13 wastewater, and public utilities generally.

14 **Q. Please describe your educational background and professional experience.**

15 A. I have over thirty-two years of experience in the field of public utility regulation
16 spanning a wide range of responsibilities and roles. I served a total of seven years
17 as a consumer advocate in the Florida Office of Public Counsel on two separate
18 occasions. In that role, I testified as an expert witness in numerous rate
19 proceedings before the Florida Public Service Commission. My tenure of service
20 at the Florida Office of Public Counsel was interrupted by six years as Chief
21 Advisor to Florida Public Service Commissioner Gerald L. Gunter. I left the
22 Florida Office of Public Counsel as its Chief Regulatory Analyst when I was first
23 appointed to the Florida Public Service Commission in 1991. I served as

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1 Commissioner on the Florida Public Service Commission for sixteen years,
2 serving as its chairman on two separate occasions. Since retiring from the Florida
3 Public Service Commission at the end of 2006, I have been providing consulting
4 services and expert testimony on behalf of various clients, including public
5 service commission advocacy staff and regulated utility companies, before
6 commissions in Arkansas, Montana, New York and North Dakota. My testimony
7 has addressed various regulatory policy matters, including: regulated income tax
8 policy; storm cost recovery procedures; austerity adjustments and prudence
9 determinations for proposed new generating plants and associated transmission
10 facilities. I have also testified before various legislative committees on regulatory
11 policy matters. I hold a Bachelor of Science Degree in Accounting, summa cum
12 laude, and a Master of Accounting, both from Florida State University.

13 **Q. Are you sponsoring an exhibit?**

14 A. Yes. I am sponsoring the following rebuttal exhibit:

15 ▪ TD-1, Biographical Information for Terry Deason

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

17 A. The purpose of my rebuttal testimony is to offer my opinion and recommendation
18 as to certain assertions made by Office of Public Counsel witnesses Brown, Pous
19 and Woolridge, Florida Industrial Power Users Group witness Pollock and South
20 Florida Hospital and Healthcare Association witnesses Baudino and Kollen. My
21 rebuttal testimony addresses the appropriate regulatory treatment of a theoretical
22 depreciation reserve surplus, the critical role of subsequent year rate adjustments,
23 the proper equity ratio for Florida Power & Light (FPL or the Company), the

1 **Q. Why are they not uncommon?**

2 A. Estimating asset lives and salvage values is not an exact science. The
3 assumptions and forecasts used to establish these parameters change with the
4 passage of time and are impacted by factors beyond the control of utility
5 management and utility regulators. This is why the Commission requires periodic
6 depreciation studies for electric utilities to be filed every four years.

7 **Q. What are some of the factors which can impact depreciation parameters?**

8 A. There are many such factors. They include “wear and tear,” obsolescence,
9 environmental impacts, governmental requirements, changes in technology and
10 economic changes. All of these factors can have significant impacts on the need
11 for early retirements of some assets and the potential for extensions of the useful
12 lives of other assets.

13 **Q. What does a theoretical reserve surplus represent in a regulatory sense?**

14 A. It is best to answer this question by clarifying what a theoretical reserve surplus
15 does not represent. It does not represent a “pool of cash” sitting in an account
16 which can be tapped to fund refunds or to fund the provision of utility service
17 below the cost to provide that service on a going forward basis. Neither does a
18 theoretical reserve surplus represent over-billings to customers for past service.

19 **Q. Witness Pous states that a utility has an incentive to favor higher
20 depreciation expense and higher depreciation reserves. Do you agree?**

21 A. No, I do not agree. A utility’s incentive is to deploy capital when needed, to earn
22 a fair return on that capital and to recoup that capital in the form of ratable
23 depreciation allowances. Because the source of profit for a regulated utility is an

1 authorized rate of return on shareholder supplied capital in rate base (invested
2 capital), it would be counter to its own interest to prematurely erode its earnings
3 base by excessive depreciation rates. Only if a utility were earning a non-
4 compensatory return would there be an incentive to prematurely recover capital
5 from one investment and redeploy it where a compensatory return could be
6 earned. I do not believe that witness Pous is suggesting that FPL's past earned
7 return or its requested authorized return is non-compensatory.

8 **Q. What method does the Commission employ to set depreciation rates?**

9 A. The Commission has generally relied on the remaining life approach.

10 **Q. What is the remaining life approach?**

11 A. As the name implies, it is an approach that uses the remaining life of an asset over
12 which to depreciate the remaining (undepreciated) cost of an asset, net of any
13 salvage.

14 **Q. Why does the Commission rely on the remaining life approach?**

15 A. It is a generally accepted method and has the advantage of being self correcting.
16 By this I mean that the method acknowledges that there can be either theoretical
17 reserve surpluses or deficits and that these can be corrected over the remaining
18 lives of the assets in question. By this method, there are not large single-year
19 swings in depreciation expense. This is also consistent with the Commission's
20 policy to require comprehensive depreciation studies every four years.

21 **Q. Are there other principles by which the Commission has historically set**
22 **depreciation rates?**

1 A. Yes, there are three broad principles that the Commission has relied upon when
2 setting depreciation rates. The Commission has historically used these principles
3 to reach reasonable results. First, the Commission has used the principle of
4 matching costs and benefits. This principle is consistent with the purpose of
5 depreciation, to recognize the utilization of an asset (cost) ratably with the service
6 it provides over its useful life (benefit). Adherence to the remaining life method
7 is consistent with this principle.

8

9 Second, the Commission has historically made decisions to protect customers for
10 the long term. This is particularly true in the case of theoretical reserve deficits,
11 where the Commission has attempted to eliminate them in recognition of the fact
12 that theoretical reserve deficits can have long term cost impacts by increasing rate
13 base.

14

15 Third, the Commission has maintained a separation between the setting of
16 depreciation rates and their immediate impacts on rates. Stated differently, the
17 Commission has not allowed impacts on rates to be the primary driver in setting
18 depreciation rates. Rather, depreciation rates have been set based upon
19 depreciation studies and objective estimates of lives and salvage values, not as
20 part of a base rate proceeding. This has the advantage of promoting greater
21 objectivity in setting depreciation rates.

22 **Q. Is it inappropriate to set depreciation rates concurrently with the setting of**
23 **base rates in a rate proceeding?**

1 A. It is not inappropriate to do so. The establishment of depreciation rates and their
2 impact on base rates can be reflected simultaneously. However, the temptation to
3 have depreciation rates set according to their impacts on base rates, and not the
4 consistent application of generally accepted depreciation practices, should be
5 avoided.

6 **Q. What is being recommended by witnesses Kollen, Pollock and Pous in this**
7 **proceeding?**

8 A. These witnesses take slightly different approaches, but all three recommend a
9 rapid flow through of the theoretical reserve surplus in order to achieve a large
10 short term but unsustainable reduction in FPL's revenue requirements.

11 **Q. Do you agree with their recommendations?**

12 A. I do not. Their recommendations violate the three principles I earlier identified.
13 Their recommendations constitute a significant deviation from the generally
14 accepted and long established use of the remaining life method to set depreciation
15 rates. Their recommendations also have the effect of rapidly flowing through
16 theoretical benefits to the long term detriment of the general body of ratepayers.
17 Their recommendations also appear to be driven by the temptation to have
18 depreciation policy driven by immediate base rate impacts, which is
19 fundamentally the wrong approach.

20 **Q. Why do their recommendations appear to be driven by immediate base rate**
21 **impacts?**

22 A. Their recommendations to rapidly flow back the difference between the
23 theoretical reserve and the booked reserve is conveniently aided by two facts.

1 The theoretical reserve is currently in a surplus position, and FPL is seeking a
2 base rate increase. If either of these two factual situations were changed, I am not
3 sure we would see the same recommendations from these witnesses, i.e., to
4 eliminate the deficit over a short period of time by significantly raising
5 depreciation expense, with a commensurate increase in base rates.

6 **Q. Why do you believe the recommendations would differ?**

7 A. If the theoretical reserve were in a deficit position, their recommendations to set
8 aside the self-correcting function of the remaining life method would have the
9 effect of increasing base rates above what they otherwise would be. If FPL were
10 not in a base rate proceeding, their recommendations would result in a rapid
11 amortization of the theoretical reserve with no beneficial impact on base rates. If
12 FPL were to file for a base rate increase after the rapid amortization of the
13 theoretical reserve surplus were completed, there would be no surplus available
14 for recognition at that time. I do not believe that the intervenors would find either
15 of these scenarios acceptable. The impacts of these scenarios illustrate the better
16 policy of setting depreciation rates on the consistent application of a generally
17 acceptable methodology (remaining life in this case) and avoiding setting
18 depreciation rates on their immediate and potentially volatile impacts on base
19 rates.

20 **Q. Witness Pous asserts that the Commission has a long and identifiable policy**
21 **of correcting material reserve imbalances by amortizing the reserve**
22 **differences over periods much shorter than the remaining life of the**
23 **investment. Do you agree?**

1 A. I agree that the Commission on occasion has amortized theoretical reserve
2 deficiencies. However, I disagree with the characterization that this is a long and
3 identifiable policy which should dictate how FPL's theoretical reserve surplus
4 should be treated in the present case.

5 **Q. Does witness Pous cite Florida cases to support his assertions?**

6 A. Yes, he cites three specific cases, one involving a telephone company, one
7 involving a gas utility and one involving FPL. However, a closer reading of these
8 cases and the facts surrounding the decisions do not support witness Pous' claim
9 of an identifiable policy which should control in the present case. I note that all
10 of these cases involved the consideration of theoretical reserve deficits outside the
11 scope of a base rate proceeding, thus with no corresponding increase in customer
12 rates to accommodate the rapid elimination of the deficit. These are significantly
13 different factual situations from the present case.

14
15 The General Telephone Company case (Docket No. 840048-TL) took place
16 during the 1984-85 time period. At that time, the Commission had just
17 transitioned away from the whole life to the remaining life depreciation
18 methodology. There was a controversy over whether the Federal
19 Communications Commission could or would preempt Florida in the setting of
20 intrastate depreciation rates. In addition, the Commission was concerned about
21 substantial developments in the areas of technology and competition that had the
22 potential to result in significant amounts of stranded investment. Within this
23 context, the Commission decided to amortize a theoretical reserve deficit of \$32

1 million over five years. I believe the Commission's decision was influenced by
2 two considerations. First, given all of the uncertainty at the time, it was
3 inconclusive that the self-correcting function of the remaining life approach
4 would be sufficient to correct the theoretical reserve deficit. Second, consistent
5 with a principle I earlier identified, the Commission took steps to mitigate the
6 long term rate base impacts of a reserve deficit, outside of a rate proceeding and,
7 therefore, without increasing customer rates to reflect these changes.

8
9 The City Gas Company case (Docket No. 890203-GU) took place in 1989.
10 Again, this case involved a theoretical reserve deficit outside of a rate proceeding.
11 The Commission decided to retain the benefit of an already existing annual
12 expense of \$48,000 to be applied to the theoretical reserve deficit. By taking this
13 action, the Commission observed that it would "correct that overstatement of rate
14 base in seven years, rather than the 19 years remaining under the present
15 amortization pattern." Again, the motivation was to more quickly eliminate the
16 rate base impacts of a reserve deficit, outside of a base rate proceeding and, again,
17 without a corresponding increase in base rates.

18
19 The cited electric case (Docket No. 970410-EI) involved FPL in a relatively
20 unique factual situation in 1997. The Commission had two years earlier approved
21 a plan, outside of a base rate proceeding, to eliminate perceived deficits in nuclear
22 production accounts. The subject of the 1997 case was whether the existing plan
23 should continue, but in a modified manner. The backdrop at that time involved

1 two major considerations. First, there was much debate in Florida, and actual
2 movement in other jurisdictions, to transform the electric industry to a
3 competitive market. With this trend, there was a justified concern that significant
4 amounts of investment would become stranded. Second, FPL was experiencing
5 strong growth in customers and sales (materially different from the current
6 situation). This enabled the Commission to direct revenues received above
7 certain thresholds to be applied toward eliminating the potential stranded
8 investment. The Commission was fully cognizant of the material impacts
9 stranded investment was having in other jurisdictions and saw an opportunity to
10 address this looming problem, outside of a base rate proceeding. The
11 Commission approved the plan and issued it as proposed agency action (PAA).
12 Within the PAA order, language was added essentially stating that the terms of
13 the plan could be altered or terminated in the event the retail electric market in
14 Florida was deregulated. The Commission's decision to approve the plan had the
15 effect of reducing FPL's rate base in the long term, the benefits of which are
16 reflected in the current case.

17
18 Obviously, the unique factual situation I just described distinguishes this case
19 from the present case. This 1997 case does not support the action recommended
20 by witness Pous to flow through a theoretical reserve surplus. In the present case,
21 there is the opportunity for the self-correcting function of the remaining life
22 method to address the theoretical reserve surplus, particularly given the large
23 amounts of investment that I understand the Company is making over the next

1 few years. In the 1997 case, the Commission had a sense of urgency that moves
2 toward retail electric competition would preclude the opportunity to allow the
3 self-correcting function of the remaining life approach to address stranded
4 investment.

5 **Q. What is your recommendation in this case?**

6 A. I recommend the consistent application of the remaining life approach.

7 **Q. If the Commission were to follow your recommendation, would the benefits**
8 **of the theoretical reserve surplus be lost?**

9 A. No, not at all. Consistent application of the remaining life approach recognizes an
10 immediate and significant reduction of rate base and an immediate and significant
11 reduction in annual depreciation expense. This reduces customer rates, both now
12 and in the long term. Therefore, the beneficial effects are recognized without the
13 significant rate fluctuations inherent in the intervenors' approach.

14

15 **SUBSEQUENT YEAR ADJUSTMENT**

16

17 **Q. Witnesses Kollen and Pollock recommend that the Commission reject the**
18 **requested subsequent year adjustment. Do you agree?**

19 A. No. I do not agree for a number of policy and factual reasons.

20 **Q. Why do you disagree as a matter of policy?**

21 A. The Commission has statutory and rule authority to consider subsequent year
22 adjustments and to set rates accordingly. A company seeking a subsequent year
23 increase, or an affected party seeking a subsequent year decrease, must show with

1 reasonable certainty that there will be future changes sufficient to justify the
2 subsequent year rate change. As such, the use of subsequent year adjustments is a
3 valuable and useful regulatory tool that is necessary for the Commission to meet
4 its statutory obligations to all parties. To reject out-of-hand the use of a
5 subsequent year adjustment, as witnesses Kollen and Pollock suggest, would
6 eliminate this tool and be inconsistent with established regulatory policy in
7 Florida.

8 **Q. Why is the use of a subsequent year adjustment a valuable regulatory tool?**

9 A. The use of a subsequent year adjustment can minimize or eliminate regulatory lag
10 for a longer period of time, without the need for back-to-back rate cases.

11 **Q. What is regulatory lag?**

12 A. Regulatory lag is the period of time from when a change in rates (up or down) is
13 needed and when the rate change can be legally implemented. It can have a
14 significant impact on a utility's ability to earn its authorized return when capital
15 expenditures and inflation are high. Regulatory lag is inherent in the regulatory
16 process, and ways to minimize its impacts should be part of good regulatory
17 policy. Subsequent year adjustments are an accepted and recognized method of
18 addressing forecasted financial and operating conditions that affect a utility's
19 opportunity to earn the approved rate of return.

20 **Q. Has the Commission previously used subsequent year adjustments to set**
21 **rates?**

22 A. Yes, the Commission has done so and the use of subsequent year adjustments has
23 become standard practice in Florida.

1 **Q. Has the use of subsequent year adjustments been a recent development in**
2 **Florida?**

3 A. No, subsequent year adjustments have been used as far back as 1984. In a case
4 involving FPL (Docket No. 830465-EI, Order No. 13537), the Commission not
5 only determined that it had the legal authority to consider a subsequent year
6 adjustment, the Commission determined that a 1985 “subsequent year” was
7 appropriate to use to set rates.

8
9 This determination was appealed to the Florida Supreme Court in *Floridians*
10 *United for Safe Energy, Inc. v. Public Service Commission*, 475 So.2d 241 (Fla.
11 1985). In its decision approving the use of the subsequent year, the Court
12 explained:

13 At the heart of this dispute is the authority of the PSC to combat
14 “regulatory lag” by granting prospective rate increases which
15 enable the utilities to earn a fair and reasonable return on their
16 investments. We long ago recognized that rates are fixed for the
17 future and that it is appropriate for PSC to recognize factors which
18 affect future rates and to grant prospective rate increases based on
19 these factors.

20 **Q. Should the Commission simply reject the subsequent year adjustment being**
21 **requested by FPL in this proceeding?**

22 A. No. The Commission must give the proposed subsequent year adjustment due
23 consideration as a matter of precedent and policy and not reject it out-of-hand.

1 The Commission has an obligation to scrutinize the subsequent year request and
2 approve a subsequent year rate change, if it is justified based on the information
3 provided by the Company.

4 **Q. In response to a previous question, you responded that there are also factual**
5 **reasons for why you disagree with the recommendation to reject the use of a**
6 **subsequent year adjustment. What are your factual reasons?**

7 A. In his testimony, witness Pollock makes a number of factual assertions, interposed
8 with some policy implications. I disagree with these assertions and discuss their
9 policy implications.

10 **Q. Would you please elaborate?**

11 A. Yes, I will. On page 33 of his testimony, witness Pollock states, "Rates should
12 not be set on speculation about the future." First, it is a given that rates are set
13 prospectively and to best establish future rates you must consider future costs and
14 future revenues. If by use of the term "speculation" witness Pollock is stating that
15 rates should not be set on unsubstantiated and unscrutinized future data, I agree.
16 However, FPL is not proposing such in its subsequent year adjustment. FPL is
17 fully aware that its data must be substantiated and will be thoroughly scrutinized.
18 To that end, FPL has filed a complete set of Minimum Filing Requirements and
19 supporting testimony consistent with Commission requirements. Only if the
20 merits of the filing are considered by the Commission, can a proper assessment of
21 the proposed subsequent year adjustment be done. Witness Pollock's
22 recommendation is to simply reject the analysis of the case FPL has filed. This is
23 not an appropriate regulatory response.

1 On page 32, witness Pollock states that FPL is really asking the Commission to
2 guarantee that it will achieve the authorized return and that such a guarantee is
3 contrary to accepted regulatory practice. I agree that regulatory policy does not
4 include a “guarantee” of a specific authorized return, but it does include a
5 reasonable opportunity to earn the authorized return. I strongly disagree that
6 FPL’s requested subsequent year adjustment constitutes a guarantee. FPL is
7 merely asking the Commission to review its operations and costs in the
8 subsequent year and to set rates appropriately. FPL must then manage its
9 business with the rates granted and hopefully earn a reasonable return. This is
10 certainly not a guarantee.

11

12 On page 34, witness Pollock asserts that the rates from the subsequent year
13 adjustment “may be in effect for a long time and ratepayers may be paying more
14 than necessary.” Even in the unlikely event that rates were to be set too high, I
15 disagree with witness Pollock’s assertion that rates could be too high and that the
16 rates would continue for a long time. This assertion totally ignores the
17 Commission’s comprehensive earnings surveillance program and its historical
18 propensity and alacrity to initiate rate decreases when earnings are excessive.
19 What is missing from witness Pollock’s statement is an understanding that the
20 purpose of the subsequent year adjustment is to have fair rates that are in
21 existence for a long time. If that is the result, regulation will have done its job. A
22 necessary and valuable tool to do its job should not be discarded as witness
23 Pollock suggests.

1 On page 38, witness Pollock states that Florida utilities may file for a limited
2 proceeding. I agree that this is available to Florida utilities and that limited
3 proceedings can serve a useful purpose in Florida's regulatory scheme. However,
4 I disagree with the assertion that a limited proceeding is a satisfactory substitute
5 for a comprehensive review of operations and earnings contemplated within the
6 subsequent year adjustment. It is ironic that a limited proceeding, which has been
7 so vehemently criticized by a number of intervenors historically for its lack of
8 comprehensiveness and earnings review, is now being suggested to be a
9 satisfactory substitute for a comprehensive subsequent year adjustment.

10

11 And lastly, on pages 33 and 39, witness Pollock asserts that the use of cost
12 recovery clauses substantially limits the need for the subsequent year adjustment.
13 This assertion is incorrect. The existence or nonexistence of a cost recovery
14 clause is not relevant to the need for a subsequent year adjustment to set base
15 rates. Recovery clauses are designed to permit recovery, where justified, of
16 specific costs which are not considered in base rates and not part of a base rate
17 proceeding. Witness Pollock incorrectly asserts that the recovery of a non-base
18 rate cost in a non-base rate proceeding is grounds for ignoring an otherwise
19 legitimate base rate cost in a legitimate base rate proceeding. This assertion is
20 mixing apples and oranges.

EQUITY RATIO

1

2

3 **Q. In a regulatory context, what is meant by the term equity ratio?**

4 A. Equity ratio is the ratio of equity capital to all investor supplied capital (which
5 includes equity capital, preferred stock and debt). The equity ratio can be stated
6 on an "actual" basis, which does not reflect the very real considerations of off-
7 balance sheet obligations, or on an "adjusted" basis, which does reflect the off-
8 balance sheet obligations.

9 **Q. How is the equity ratio used in the rate making context?**

10 A. The equity ratio is part of a regulated utility's capital structure and is assigned a
11 cost factor commensurate with the cost to obtain and compensate equity investors
12 for the use of their capital. When combined with all other sources of capital in the
13 capital structure and their respective cost rates, an overall weighted cost of capital
14 is derived. It is this overall weighted cost of capital which is multiplied by a
15 company's rate base to yield its required net operating income.

16 **Q. Is it the "actual" equity ratio or the "adjusted" equity ratio that is used in the
17 capital structure to determine the overall weighted cost of capital?**

18 A. Normally it is the actual equity ratio as reported on the utility's books. Of course,
19 the Commission has the ability to adjust the actual equity ratio, up or down, for
20 ratemaking purposes and to make reconciling adjustments to remove non-rate
21 base components such that rate base and the capital structure can be equalized.

22 **Q. What then is the relevance of an equity ratio that is adjusted for off-balance
23 sheet obligations?**

1 A. As I indicated earlier, off-balance sheet obligations are very real and should be
2 considered as the debt equivalents they are. The adjusted equity ratio reflects
3 these debt equivalents and can be used to compare equivalent equity ratios across
4 companies with varying levels of off-balance sheet obligations. Thus, an adjusted
5 equity ratio can be used to judge the relative reasonableness of a company's
6 actual equity ratio.

7 **Q. Should an adjusted or hypothetical equity ratio be used in a regulated
8 utility's capital structure to determine its overall weighted cost of capital?**

9 A. As a general rule, an adjusted or hypothetical equity ratio should not be used in
10 the capital structure. Absent a showing of imprudence regarding its actual equity
11 ratio, the actual equity ratio should be used to determine the overall weighted cost
12 of capital. In fact, the Commission has stated a preference for using the actual
13 capital structure and equity ratio and has recognized the need for a regulated
14 utility to manage its capital ratios. In Docket No. 71342-EU, the Commission
15 confirmed the use of Gulf Power's actual capital structure and actual equity ratio
16 and stated:

17 Nevertheless, capital structures basically fall within the
18 prerogatives of management because of the impact that capital
19 ratios exert on the ability of a utility to maintain its credit and
20 attract capital. Management lives from day-to-day with the
21 intricate and complex problems of corporate finance, and has the
22 responsibility of seeing that the utility has the financial ability to
23 meet its service obligations. The invasion of this field of

1 management is justified only when the public interest requires the
2 exercise of extreme measures for its protection (sic) and benefit.

3 **Q. What equity ratios do witnesses Baudino, Pollock and Woolridge**
4 **recommend?**

5 A. The specific equity ratios vary by witness, but they all recommend that FPL's
6 actual equity ratio be adjusted downward, in some cases quite significantly.

7 **Q. What impacts do their recommendations have?**

8 A. As they describe in their respective testimonies, the impact is to reduce FPL's
9 revenue requirement, all other things being equal. Witness Pollock quantifies the
10 impact of his recommended equity ratio to be about \$192.9 million. This is an
11 extremely large adjustment for just one component of the capital structure.

12 **Q. In your previous answer, you used the phrase "all other things being equal."**
13 **Do you think it is realistic to hold all other things equal when making such**
14 **large adjustments to FPL's actual equity ratio?**

15 A. No, I do not. When making such large adjustments to something so integral to the
16 ratemaking process, it would be unreasonable to expect all other things to remain
17 equal.

18 **Q. What would change if the Commission were to adopt such large adjustments**
19 **to FPL's actual equity ratio?**

20 A. To adequately answer this question, it is necessary to review the history of FPL's
21 actual equity ratio and the Commission's decisions affecting it.

1 In Docket No. 990067-EI the Commission set an upward limit on FPL's adjusted
2 equity ratio of 55.83%. The Commission acknowledged the very real debt
3 equivalent of the off-balance sheet obligations by stating the upward limit in
4 terms of an adjusted equity ratio. The Commission also acknowledged that the
5 off-balance sheet obligations could change over time and that the equity ratio
6 limit stated in terms of an adjusted equity ratio was more dynamic and
7 meaningful. It also gave FPL better guidance from its regulators in managing its
8 actual equity ratio. The resulting actual equity ratio from this upward limit was
9 then used to monitor FPL's earnings. The Commission subsequently reaffirmed
10 its use in FPL's 2002 Stipulation and Settlement, Docket No. 001148-EI and its
11 2005 Stipulation and Settlement, Docket No. 050045-EI.

12
13 By these actions, the regulatory process in Florida, which includes FPL, the
14 Commission and all of the signatories to the Stipulation and Settlements, sent a
15 strong and clear message to the investment community that FPL's financial
16 integrity would be maintained by the use of a strong, but reasonable, equity ratio.
17 These actions also sent a strong and clear message to FPL's customers that FPL
18 would remain a financially strong utility with the capability to meet its obligation
19 to provide safe and reliable service, even in the face of uncertain challenges that it
20 may face.

21
22 A significant departure from this long standing policy on equity ratio, as
23 recommended by witnesses Baudino, Pollock and Woolridge, would send a

1 negative message to the investment community with potential negative
2 consequences for customers. Instead of being a win-win situation, it could
3 quickly become a lose-lose situation.

4 **Q. What challenges did FPL and its ratepayers face during the intervening**
5 **years since the Commission adopted the use of FPL's adjusted equity ratio?**

6 A. The challenges have been many and in some cases quite extreme. These
7 challenges have been identified and discussed in greater detail by other witnesses.
8 However, I will list some of the substantial challenges: an increase in the number
9 and severity of hurricanes impacting FPL's service territory; an increase in the
10 level and volatility of fuel prices; the need to provide increased reliability through
11 additional base load generation while maintaining FPL's significant progress in
12 limiting CO₂ emissions; and the most severe economic downturn since the great
13 depression. Throughout these challenging times, FPL maintained access to
14 capital on reasonable terms enabling FPL to deploy capital to meet the needs of its
15 customers and provide savings through increased efficiencies. All of this was
16 done while FPL's base rates remained unchanged.

17 **Q. Can the successes of meeting these challenges be solely attributable to FPL's**
18 **equity ratio?**

19 A. Of course not. However, I am convinced that the Commission's guidance on the
20 appropriate equity ratio and FPL's management of its equity ratio consistent with
21 that guidance was and continues to be a significant and integral component of the
22 successes that were and continue to be achieved.

1 **Q. You referred to FPL's consistent management of its equity ratio. Why is this**
2 **significant?**

3 A. It is significant for a number of reasons. First, it signifies the importance FPL
4 places on regulatory compliance. Second, it shows that FPL is committed to and
5 understands the importance of maintaining its financial integrity for its own
6 benefit as well as its customers. FPL could have taken steps to temporarily
7 enhance its earnings by allowing its equity ratio to decline between rate reviews.
8 However, FPL chose not to sacrifice its long term financial integrity for
9 temporary earnings enhancements. In essence, FPL's actions clearly denote the
10 importance of maintaining financial integrity through a strong but reasonable
11 equity ratio.

12 **Q. Now that FPL has found it necessary to seek a base rate increase, can**
13 **customers afford to continue FPL's equity ratio?**

14 A. Now is the time that customers can least afford a reduction in the equity ratio as
15 suggested by witnesses Baudino, Pollock and Woolridge. As I indicated earlier,
16 such significant declines in the equity ratio will have adverse consequences for
17 customers which could be long term in nature. I believe that any temporary
18 benefits in lower rates will be short lived by comparison.

19 **Q. The intervenor witnesses state that the equity component of the capital**
20 **structure is the highest cost component. Is this correct?**

21 A. It is true that equity has a higher cost than debt. However, the assertion that the
22 equity component should be minimized to lower the overall cost is misplaced.
23 Significant reductions in the equity ratio will increase FPL's financial risk and its

1 cost of capital, both debt and equity. This could have the unintended consequence
2 of raising FPL's overall weighted cost of capital, not lowering it.

3
4 The goal of a proper equity ratio and capital structure is to minimize the overall
5 weighted cost of capital and maintain consistent access to capital on reasonable
6 terms, even in the face of severe capital needs such as storm restorations. By this
7 standard, FPL's equity ratio and capital structure have performed well and met the
8 goal.

9 **Q. Witness Pollock recommends that FPL's equity ratio be reduced to an**
10 **average of A-rated electric utilities. Witness Baudino recommends that**
11 **FPL's equity ratio be adjusted downward to the low end of a range suggested**
12 **by a Standard & Poor's ratio analysis matrix. Are these approaches**
13 **appropriate?**

14 A. No, they are not. The goal should not be to set the standard at an average or at the
15 low end of a range to achieve average or low end results. The goal should be to
16 set it at a level that helps a utility achieve superior results at average rates. This
17 has been the result of the Commission's current equity ratio standard for FPL.

18 **Q. How then should the Commission approach the setting of FPL's equity ratio?**

19 A. The Commission should determine whether its current policy of setting FPL's
20 equity ratio should be changed. In taking this initial step I would urge extreme
21 caution. The Commission should avoid the temptation to unnecessarily change a
22 proven and consistent approach for the allure of temporary and perhaps illusory
23 base rate impacts. To put it in the vernacular, "If it ain't broke, don't fix it."

1 Extreme caution is warranted for two reasons. First, the Commission's policy for
2 setting FPL's equity ratio is long standing and has been clearly communicated to
3 all affected parties, including the intervenors, the company's customers and its
4 stockholders. Changing such an entrenched regulatory policy upon which affected
5 persons have grown to rely causes uncertainty and all of the negative
6 consequences accompanying uncertainty. Second, the existing policy has yielded
7 significant positive benefits for both investors and customers. It should not be
8 discarded in a cavalier manner.

9
10 FPL's equity ratio should be evaluated on FPL specific risk factors, including
11 FPL specific off-balance sheet obligations. This risk evaluation should be done to
12 yield an equity ratio that truly minimizes FPL's overall rate of return and not just
13 the weighting of the equity component. To reduce the equity ratio and have the
14 cost of debt and equity increase is not necessarily a good result. And lastly, I
15 would urge the Commission to not simply rely on utility averages or low-end
16 ranges as witnesses Baudino and Pollock suggest.

17
18 **GENERATION BASE RATE ADJUSTMENT (GBRA)**

19
20 **Q. What is GBRA?**

21 **A.** GBRA is a regulatory tool developed in conjunction with the 2005 Stipulation and
22 Settlement. It provides a reasonable means, within established parameters, to

1 facilitate cost recovery of prudent and cost efficient generating assets outside the
2 scope of a base rate proceeding.

3 **Q. What are those parameters?**

4 A. The parameters to which I refer can also be thought of as safeguards. The
5 safeguards within GBRA include:

- 6 • GBRA's applicability is limited to power plants approved pursuant to the
7 Florida Power Plant Siting Act (PPSA).
- 8 • Rate adjustments pursuant to GBRA cannot become effective until after
9 the commercial in-service date of any applicable power plant.
- 10 • The amount of the GBRA must be confirmed by the Commission using
11 the Capacity Clause projection filing process.
- 12 • Any capital costs below projections must be flowed back via a true-up to
13 the Capacity Clause.

14 **Q. Why is it a significant safeguard that GBRA projects must be approved**
15 **pursuant to the PPSA?**

16 A. It is significant because of the rigorous process and the high standards that must
17 be met under the PPSA, which include determinations that the power plant is
18 needed and that it is the most cost effective alternative. I have personally
19 participated in twenty-five "Need Determinations" in Florida under the PPSA and
20 know this to be the case.

21 **Q. Witness Kollen criticizes the GBRA as being "without the normal regulatory**
22 **scrutiny and resulting cost-control discipline." Do you agree?**

1 A. I do not. As I just stated, any project eligible for GBRA must have been
2 determined, by this Commission, to be needed and to be the most cost effective
3 alternative. In addition, there are provisions within GBRA that limit costs above
4 those approved pursuant to the PPSA. GBRA does not limit regulatory scrutiny.
5 GBRA is a tool to facilitate cost recovery outside of a base rate proceeding which
6 includes necessary regulatory scrutiny.

7 **Q. Why is it important that this regulatory tool be available to the Commission?**

8 A. There are at least five significant policy reasons. First, generating plants are large
9 investments which can have an immediate and material impact on a utility's rate
10 base once the plant reaches commercial operation. In regulatory jargon, they are
11 "lumpy" investments, meaning they do not occur every year but have significant
12 impact when they do occur. GBRA can provide fair, efficient and timely cost
13 recovery without the potential of a base rate proceeding (that is not otherwise
14 needed) every time a new power plant reaches commercial operation.

15
16 Second, GBRA places initial cost recovery of a new generating unit on a more
17 consistent basis as that afforded purchased power agreements. Thus, GBRA can
18 act as a means to "level the playing field" when considering which different types
19 of capacity additions to pursue.

20
21 Third, GBRA allows the planning, construction and operation of a new generating
22 unit, and the reliability benefits and fuel savings it brings, to be done without
23 having to coordinate it with the planning, filing and litigation of a base rate

1 proceeding. Management should be free to optimize the deployment of new
2 generating units to maximize customer benefits. GBRA provides a means to
3 provide reasonable cost recovery so that this can be facilitated.

4
5 Fourth, GBRA provides a more efficient and consistent method to match the
6 benefits and the costs of new generating capacity. This is particularly true for the
7 potentially large savings from reduced fuel costs that will be immediately
8 reflected in the fuel adjustment clause.

9
10 Fifth, GBRA facilitates the sending of timely and accurate price signals to
11 customers. New generation, even though efficient with significant fuel savings, is
12 capital intensive with upward pressure on rates. The impact of new generation
13 needs to be communicated to customers through correct and timely price signals.
14 This enables customers to make better decisions about cost effective conservation
15 and demand side management programs and alternatives.

16 **Q. Witness Brown states that the GBRA would transfer risks from FPL to its**
17 **ratepayers. Do you agree with this characterization?**

18 A. No, I do not. The real issue is not one of risk transfer. A regulated utility, by law
19 and policy, has the obligation to serve and to deploy capital as needed.
20 Ratepayers have an obligation to pay for the cost of the services they consume,
21 including the cost of new power plants. Thus the real issue is how regulation can
22 best facilitate each party to meet its respective obligations. The GBRA does this.
23 If one were to inappropriately put the issue in terms of risk, I believe GBRA

1 minimizes risk for both parties. Without GBRA, the only reasonable means to
2 accomplish timely and accurate cost recovery is through the filing of numerous
3 base rate proceedings. In my judgment, this could place ratepayers at greater risk.

4 **Q. How could this place ratepayers at greater risk?**

5 A. With GBRA, there is the distinct likelihood that rate increases that otherwise
6 could be justified would be deferred or foregone. Without GBRA, they are more
7 likely to be filed along with their associated rate case expense. In addition,
8 ratepayers would lose the cost protections in GBRA which limit costs to those
9 approved in a PPSA proceeding.

10

11

INCENTIVE COMPENSATION

12

13 **Q. Witness Brown recommends disallowances of 50% of FPL's incentive**
14 **compensation costs because they benefit shareholders. Do you agree?**

15 A. I do not agree. Compensation to employees is a necessary cost of providing safe,
16 efficient and reliable service to customers. As such, 100% of reasonable
17 compensation costs should be included for ratemaking purposes. The fact that a
18 portion of the compensation is based upon attaining performance criteria is not
19 relevant.

20 **Q. Is this true even if some of the performance criteria are tied to metrics which**
21 **may increase shareholder value?**

22 A. Yes, the regulatory principle is the same. Reasonable and necessary
23 compensation costs should be included in rates. What is missing from Ms.

1 Brown's argument is recognition of the fundamental regulatory principle that
2 shareholder interests and customer interests should be aligned. Incentive
3 compensation does this. Ms. Brown attempts to pit shareholders' interest and
4 customers' interests against each other, which is inappropriate and
5 counterproductive.

6 **Q. How is Ms. Brown's recommendation inappropriate?**

7 A. The recovery of any reasonable and necessary cost benefits both shareholders and
8 customers. Shareholders are reasonably compensated and customers get an
9 essential service at a reasonable cost. The fact that the level of the compensation
10 is based upon earnings criteria does not violate this relationship. In fact, it
11 enhances the relationship because it can have the long term benefit of reducing
12 costs.

13 **Q. How is Ms. Brown's recommendation counterproductive?**

14 A. Incentive compensation is a generally accepted and proven means of increasing
15 employee productivity and retaining the most qualified and goals-oriented
16 employees. This provides significant benefits to customers. Not recognizing
17 50% of the incentive compensation would be a strong and clear message to utility
18 management that these benefits are not valued and that incentive compensation
19 plans should be discontinued.

20 **Q. If incentive compensation plans were discontinued would utility customers'
21 rates be lower?**

22 A. No, they would not be. Employees would still need to be compensated at a
23 reasonable level, through a higher level of fixed compensation. In fact,

1 discontinuing incentive compensation plans could have the unintended result of
2 increasing rates because of lost productivity, lost efficiencies and higher
3 employee turnover.

4

5

SUPERIOR PERFORMANCE

6

7 **Q. Has the Commission ever used its discretion to reward a utility for superior**
8 **performance?**

9 A. Yes, the Commission has done so in the past. However, the Commission has set a
10 relatively high bar before doing so.

11 **Q. Witness Baudino recommends that no consideration be given to FPL's**
12 **superior performance in setting its allowed return on equity. Do you agree?**

13 A. No, I do not agree. Using the possibility of a reward is a useful regulatory tool
14 that can be used to obtain significant benefits for customers. Even though Florida
15 has set a high standard, the fact that Florida has a policy of rewarding superior
16 performance has resulted in benefits to Florida customers. The use of such a
17 valuable regulatory tool should not be dismissed as witness Baudino suggests.

18 **Q. Why does witness Baudino recommend against consideration of a reward for**
19 **superior performance?**

20 A. Witness Baudino provides several reasons in his testimony. I disagree with all of
21 them.

1 First, witness Baudino states that ratepayers should expect exemplary
2 management. Given that FPL's management has performed in an exemplary
3 manner over a sustained period of time, I can understand that this can be
4 perceived as normal and could become an expectation. However, sustained past
5 performance should not be taken as an expectation. I do agree that ratepayers
6 have a reasonable expectation of competent management and a level of
7 satisfactory service. The real issue is whether the correct use of an accepted
8 regulatory tool can result in performance significantly above competent and
9 satisfactory.

10

11 Witness Baudino also states that a reward would over-compensate investors. I do
12 not believe this has been the case in Florida. Florida sets the allowed return on
13 equity within a range. Any return within the allowed range is deemed reasonable.
14 Therefore, any return within the range that recognizes superior performance
15 would not over compensate investors.

16

17 Witness Baudino asserts that a reward would result in excessive rates to
18 ratepayers. This is where I have the most disagreement with witness Baudino's
19 reasoning. A properly structured reward for truly superior performance would not
20 result in excessive rates. To the contrary, such a reward would result in rates
21 lower than they otherwise would be. What is lost in witness Baudino's assertion
22 is that a properly structured reward can have a multiplier effect.

1 **Q. What do you mean by the term multiplier effect?**

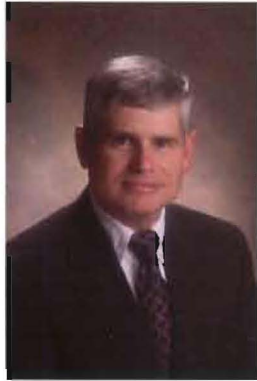
2 A. I use this term to describe the potentially large benefits that can inure to customers
3 in the form of better service and improved efficiencies from a relatively small
4 investment in a properly structured reward. In essence, the value of the benefits
5 becomes a multiple of the investment. Witness Reed's testimony addresses the
6 specifics of the benefits to which I generally refer.

7 **Q. Does this conclude your testimony?**

8 A. Yes, it does.

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