BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 120015-EI
FLORIDA POWER & LIGHT COMPANY

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

REBUTTAL TESTIMONY & EXHIBITS OF:

TERRY DEASON

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JULY 31, 2012

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I. INTRODUCTION

Q. Please state your name and business address.

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

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

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

Q. Please describe your educational background and professional experience.

A. I have thirty-five years of experience in the field of public utility regulation spanning a wide range of responsibilities and roles. I served a total of seven years as a consumer advocate in the Florida Office of Public Counsel ("OPC") on two separate occasions. In that role, I testified as an expert witness in numerous rate proceedings before the Florida Public Service Commission ("Commission"). My tenure of service at the Florida Office of Public Counsel was interrupted by six years as Chief Advisor to Florida Public Service Commissioner Gerald L. Gunter. I left OPC as its Chief Regulatory Analyst when I was first appointed to the Commission in 1991. I served as Commissioner on the Commission for sixteen years, serving as its chairman on two separate occasions. Since retiring from the Commission at the end of 2006, I have been providing consulting services and expert testimony on

behalf of various clients, including public service commission advocacy staff and regulated utility companies, before commissions in Arkansas, Florida, Montana, New York and North Dakota. My testimony has addressed various regulatory policy matters, including: regulated income tax policy; storm cost recovery procedures; austerity adjustments; depreciation policy; subsequent year rate adjustments; appropriate capital structure ratios; and prudence determinations for proposed new generating plants and associated transmission facilities. I have also testified before various legislative committees on regulatory policy matters. I hold a Bachelor of Science Degree in Accounting, summa cum laude, and a Master of Accounting, both from Florida State University.

Q. Are you sponsoring an exhibit?

A. Yes. I am sponsoring the following rebuttal exhibits:

- TD-1, Biographical Information for Terry Deason

Q. For whom are you appearing as a rebuttal witness?

A. I am appearing as a rebuttal witness for Florida Power & Light Company ("FPL" or "the Company").

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to certain assertions and recommendations made by intervenor witnesses Kollen, Lawton, Ramas and Schultz. The issues I address in rebuttal to these witnesses are: Construction Work In Progress; Property Held for Future Use; Working Capital; Incentive Compensation; Directors and Officers Liability Insurance; Advanced

Metering Infrastructure (the "Smart Meter Program"); and Return on Equity ("ROE") Performance Adder.

II. CONSTRUCTION WORK IN PROGRESS ("CWIP")

Q. What is CWIP?

A. CWIP is Account 107 of the Federal Energy Regulatory Commission Uniform System of Accounts ("USOA"). This account includes the total of work order balances for electric plant that is in the process of being constructed.

Q. Is CWIP a necessary part of providing quality utility service?

A. Yes, it is. A well managed utility focused on providing quality and cost effective service will deploy capital to construct new and/or modernize existing facilities to meet these objectives.

Q. Recognizing that CWIP is a necessary part of providing quality utility service, should it be permitted to earn a return?

A. Yes, it should. Otherwise the utility will not be given an opportunity to realize a fair return on its investment in electric plant.

Q. How should this be accomplished?

A. It should be accomplished in one of two ways. First, balances in CWIP could be allowed to accrue an Allowance for Funds Used During Construction ("AFUDC"). The Commission has adopted Rule 25-6.0141, F.A.C., which sets forth the calculation of AFUDC and the eligibility requirements of those

construction projects which qualify. The second way is to allow CWIP to be included in rate base when rates are set.

Q. Is there a fundamental difference between the two approaches?

A. Yes, there is. Accruing AFUDC adds to the capital costs of a project. The return is an accounting entry only and is actually realized when the capital asset is included in rate base and is depreciated. Including CWIP in rate base avoids increasing the capital cost of the project through AFUDC and earns a return in rates while the project is being constructed.

Q. What does Rule 25-6.0141, F.A.C., say about the return to be earned on CWIP?

A. The Rule recognizes that the return on CWIP can be earned in either of the two fundamental ways that I just described. Further, the Rule establishes the criteria for CWIP projects to be eligible for AFUDC. Generally, to be eligible for AFUDC, a CWIP project must be large in size (greater than 0.5 percent of all existing plant on the books of the utility) and have a long construction time (greater than one year from the project's commencement). CWIP projects not eligible for AFUDC are generally included in rate base.

Q. Why did the Commission require that CWIP projects must be large in size and long in construction duration to be eligible for AFUDC?

A. The Commission recognized that most construction projects are relatively small in size and of short duration. The Commission further recognized that these projects were generally routine and recurring in nature. It was determined that it was not administratively efficient to require the accrual of

AFUDC on such projects. Further, due to their routine, recurring nature, they were better addressed as a component of rate base. The overall reasonableness of these projects could then be reviewed in the context of rate cases and surveillance reports.

Q. What does witness Kollen recommend for CWIP for FPL?

A. Mr. Kollen recommends a reduction of the amount of CWIP in FPL's rate base to $250 million, or approximately one-half of the amount included pursuant to Rule 25-6.014, F.A.C.

Q. What is the basis of witness Kollen's recommended disallowance?

A. Mr. Kollen recommends on page 25 of his testimony that the Commission "prospectively modify" the criteria in Rule 25-6.0141, F.A.C., to increase the amount of CWIP projects eligible for AFUDC and thereby reduce the amount of CWIP to be included in rate base. Specifically, he recommends a minimum construction period of only six months and a project threshold cost of only $0.5 million. Currently, the Rule requires a minimum construction period of one year and a project threshold cost of 0.5 percent of total plant in service, which for FPL is a project threshold cost of approximately $175 million in the test year.

Q. Do you agree with witness Kollen's recommendation?

A. No, I do not agree. It would be inappropriate to make such a significant unilateral change to Commission policy that has been adopted after a due process procedure and codified in a rule. It is not entirely clear what Mr. Kollen means by recommending a prospective modification to the AFUDC

criteria in Rule 25-6.0141. His proposal appears, however, to be an attempt to adopt a new policy without the benefit of a thorough evidentiary review or the due process protections of a rulemaking proceeding, a proceeding that would be open to all interested parties and not just those parties to this rate case. At worst, it is an attempt to unjustifiably reduce FPL's revenue requirement in this case and ill-advisedly defer cost recovery to the future.

Q. Witness Kollen argues that his proposal to defer cost recovery to the future is appropriate? Do you agree?

A. I do not agree with his conclusion. I do agree with his statement that "all costs associated with the construction or completion of an asset that is constructed or acquired to provide service should be recovered from customers over the period that the asset provides service to those customers." Mr. Kollen has misapplied this concept to conclude that a return on $250 million invested by FPL to serve its customers should be disallowed in this rate case and deferred to the future. The costs to construct the assets in question are being incurred to provide service and/or benefits to existing customers. Customers expect and deserve to have facilities in place to serve them when needed and to modernize existing facilities when it is cost-effective and/or improves service. Most of the construction projects in question will be completed in one year or less. When those specific projects are completed, they will likely be replaced by new similar projects of a recurring nature. Thus they are necessary to provide high quality cost-effective service to existing customers on an on-going consistent basis.

Q. Is it the case that all CWIP projects exceeding the dollar threshold and taking longer than one year to construct should always accrue AFUDC and never be in rate base?

A. No, the Commission on occasion has recognized the need to place large longer-term construction projects in rate base.

Q. Why has the Commission done this in some instances?

A. As I stated earlier, AFUDC is an accounting entry that does not generate immediate cash earnings. A large construction project can put financial strains on a utility and insufficient cash flows can threaten bond ratings. The Commission has recognized this and on occasion has allowed a greater amount of CWIP in rate base to maintain a utility's financial integrity. In addition, paragraph (1)(f) of Rule 25-6.0141, F.A.C. permits a utility to file a petition to include a construction project in rate base that would otherwise qualify for AFUDC treatment.

Q. Witness Kollen references paragraph (1)(g) of Rule 25-6.0141, F.A.C. Are you familiar with this provision?

A. Yes, I am. This provision was added to the Rule in 1996, while I was serving on the Commission. It gives the Commission limited discretion to exclude a portion of CWIP from rate base and allow it to accrue AFUDC instead.

Q. What was the context within which the Commission adopted this provision?

A. The Commission was considering a number of changes to the Rule. The overall purpose of the amendments was to increase the threshold of project

qualification in order to limit AFUDC treatment to only those projects with a significant financial impact on any given utility.

Q. Why did the Commission believe this was needed?

A. The Commission was reviewing the thresholds in the context of possible industry restructuring. It was believed that limiting the amount of AFUDC would get regulated costs more comparable to true economic costs and more consistent with Generally Accepted Accounting Principles or GAAP.

Q. Did the Commission consider the benefits for customers?

A. Yes, the Commission recognized that setting a higher threshold for AFUDC accrual would have the effect of lowering total project costs in rate base and that this would ultimately lead to lower rates.

Q. Did the Commission consider the possibility that the higher threshold could result in current customers paying for projects that would only benefit future customers?

A. Yes, the Commission considered this and determined that this would not likely be the result of the higher threshold. Commission staff's recommendation dated April 18, 1996, in Docket No. 951535-EI, Proposed Revisions to Rule 25-6.0141, F.A.C., recognized that large long term construction projects would still accrue AFUDC and that other projects should be in rate base. Staff's recommendation stated:

> However, large, long term projects, such as power plants, will still accrue AFUDC unless the Commission specifically approves inclusion in rate base. Not all construction is solely

for the benefit of future ratepayers. There are many projects which are built in order to increase the reliability of service or replace aging or obsolete equipment and facilities. In some cases, facilities in high growth areas reach capacity and must be expanded.

Q. Should paragraph (1)(g) of Rule 25-6.014, F.A.C., be used to approve witness Kollen's proposal to disallow $250 million of CWIP from FPL's rate base in this proceeding?

A. No, it should not. This provision was enacted to give discretion to the Commission to exclude a portion of CWIP from rate base should the Commission determine that the potential impact on rates was such that the exclusion may be required. Therefore, before this provision is used to exclude a portion of CWIP, the Commission must make a finding that the resulting impact on rates of including the CWIP would be inappropriate or unduly burdensome. Exercising this provision should only be done in truly extraordinary situations.

Q. Has the Commission ever used this provision to disallow CWIP projects from rate base?

A. No, not to my knowledge.

Q. What was the amount of CWIP that was allowed in rate base in FPL's last rate case?

A. The Commission allowed $687 million, which is greater than the amount being requested in the current case.

Q. What is the revenue impact of the disallowance suggested by witness Kollen?

A. Mr. Kollen calculates the annual revenue impact to be $26 million. I have not determined the exact impact of $26 million of FPL's rates. However, I am confident that it would not be considered extraordinary such that the utilization of paragraph (1)(g) would be justified.

III. PROPERTY HELD FOR FUTURE USE ("PHFU")

Q. What is PHFU?

A. PHFU is the original cost of electric plant owned and held for future use in electric service under a definite plan for such use. It includes both property acquired but never previously used, as well as property used by the utility but retired from service pending its reuse in the future. The original cost amounts are booked in Account 105 Electric plant held for future use, as prescribed by the USOA.

Q. Does Account 105 also include land and land rights?

A. Yes, it does. The parameters for land and land rights are generally the same as those set forth for electric plant in the USOA, with one notable exception.

Q. What is the exception?

A. When describing the types of electric plant eligible for inclusion in Account 105, the USOA includes the term "definite" when describing the plan for its use. In describing the types of land and land rights eligible for inclusion in

Account 105, the USOA does not use the term "definite." The USOA simply prescribes that land and land rights be planned for future electric use.

Q. Why is this a significant distinction?

A. Electric plant is held to a higher standard by prescribing that there be a definite plan for its future use. In contrast, the USOA recognizes that land and land rights may need to be acquired for possible future use. The USOA does not prescribe that the land and land rights have a definite future use.

Q. Does this distinction have implications for regulatory policy?

A. Yes, it does. Appropriate and responsible regulatory policy recognizes that, unlike electric plant that usually would be acquired only a short time before it is to be placed into service, land and land rights may need to be acquired many years in advance of their designated use. It would be an inappropriate and unreasonable standard to require all land and land rights to have a "definite" plan for use at the time of initial acquisition. This is not to suggest that regulated utilities should be encouraged to acquire land and land rights in a speculative manner. Certainly all regulatory land acquisitions should be made consistent with a utility's plans to cost-effectively and reliably serve all future demands from its customers.

Q. Has the Commission recognized the need of regulated utilities to acquire property in advance of its designated use?

A. Yes, as early as 1971, the Commission articulated an expanding policy on the inclusion of PHFU in a regulated utility's rate base. In Order No. 5278, issued November 30, 1971 in Docket No. 70532-EU, In re: Petition of Tampa

Electric Company for an increase in rates and charges and for approval of a fair and reasonable rate of return, the Commission stated:

> This Commission has long recognized that in Florida, public utilities cannot, in the exercise of good business judgment, indefinitely postpone the acquisitions of property necessary to future expansion. In many instances, a deferral of acquisition of necessary property would be very costly and imprudent and the management would be subject to criticism for delay.... Until recently, this Commission allowed the inclusion of Property Held for Future Use if it were acquired as a result of a definite plan for its use, and its use was imminent. Since we last considered this matter, there has been a growing controversy over the locating of power plants, both nuclear and fossil fuel, which makes it imperative that we review our policies, practices, and procedures in this area.

Q. Does witness Ramas address PHFU in her testimony?

A. Yes, she recommends the disallowance of $117.5 million of PHFU from FPL's rate base. The great majority of her recommended disallowance ($109 million) is the cost of two future generating plant sites (Fort Drum and McDaniel/Hendry, the "McDaniel Site"). The remaining $8.5 million is the cost of nine properties for future transmission facilities.

Q. What is the basis for her recommended disallowances?

A. Ms. Ramas recommends disallowance of the two future generating plant sites

because FPL "has no specific in-service dates" for the plant sites. Ms. Ramas recommends disallowance of the nine transmission properties because the expected utilization of the properties is either beyond ten years or has not yet been announced.

Q. Do you agree with witness Ramas' recommended disallowances?

A. I do not agree with her recommended disallowances. Her stated reasons are contrary to Commission precedent and contrary to good regulatory policy. If adopted, her recommended disallowances would be inconsistent with the long-range planning requirements which are necessary for the reliable and cost-effective provisioning of service to customers. In essence, Ms. Ramas' recommended disallowances would not be in the customers' best interest.

Q. What is the Commission's policy in regard to PHFU?

A. The Commission has a policy that has evolved somewhat over time, but has consistently recognized the need for adequate long-term planning and the need to have property available to fulfill service commitments to customers reliably and cost effectively. This is clearly evident from the Commission's 1971 order involving Tampa Electric that I earlier cited. In this same order, regarding its decision to allow a future power plant site in rate base and the need for adequate planning, the Commission stated:

> In this regard, failure to provide for the long-range planning necessary for adequate and reliable power supply could well be considered an imprudent act and inconsistent with the public interest.

Q. What is the standard the Commission has applied to determine whether specific future use properties should be included in rate base?

A. The Commission's standard is one of reasonableness or what amount of PHFU is reasonably needed to cost-effectively provide reliable service to existing and future customers. Applying this standard requires a review of specific properties to determine whether their acquisition and retention are reasonable to provide service over an adequate planning horizon. The Commission's reasonableness standard cannot be determined by arbitrary and rigid time limitations on the properties' ultimate use. To do so would be contrary to Commission policy and ultimately work to the disadvantage of utilities' customers.

Q. Does witness Ramas' recommend disallowances utilize arbitrary and rigid time limitations?

A. Yes, they do. In regard to the transmission properties, she recommends that all properties with expected in-service beyond ten years and those without an announced in-service date be excluded from rate base. Her recommendation is not based upon an individual study of each property to determine whether each is reasonably needed over the planning horizon.

Q. Has the Commission spoken to the need to make an individual study of properties held for future use?

A. Yes, in Order No. 5619, in Docket No. 71370-EU, the Commission recognized that there is no hard and fast rule to determine the amount of PHFU to include in rate base. The Commission stated:

Under past Commission policy, we have recognized that the deferral of acquisition of property for future use to meet foreseeable needs could be imprudent and costly. Thus, we have no hard and fast rule as to what should be or should not be included but must make an individual study for each tract so held.

Q. Has the Commission previously addressed a proposal to limit PHFU to an arbitrary ten year rule?

A. Yes, in a 1992 rate case involving Tampa Electric, there was a proposal to apply a ten year rule to PHFU. The Commission rejected this approach. In Order No. PSC-93-0165-FOF-EI, the Commission stated:

> Public counsel's witness, Mr. Schultz, applied a 10-year rule to plant held for future use, suggesting that property either owned by Tampa Electric for longer than ten years or whose projected in-service date is greater than ten years in the future should be removed from rate base. We disagree with this methodology [*51] because it arbitrarily disallows rate recovery for power plant distribution substation, and transmission substation sites that Tampa Electric plans to use to meet future growth beyond a point in time ten years from now. It is well known that, in Florida, these sites are becoming increasingly more difficult to find, purchase and permit.

Q. Ms. Ramas refers to the Company's Ten Year Site Plan as a basis of her recommended disallowance. Is this appropriate?

A. No, it is not. A utility's Ten Year Site Plan was never intended to be nor has it ever been used by the Commission to determine the appropriateness or inappropriateness of including an asset in a regulated utility's rate base. Ten Year Site Plans are filed pursuant to Section 186.801(1), F.S., and are recognized to be "tentative information for planning purposes only" which "may be amended at any time...." In addition, in its Review of the 2011 Ten Year Site Plans, the Commission states:

> Since the Ten-Year Site Plan is not a binding plan of action for electric utilities, the Commission's classification of these Plans as suitable or unsuitable does not constitute a finding or determination in docketed matters before the Commission.

Q. Witness Ramas recommends the disallowance of $109 million associated with two future generating sites. Do you agree with her basis for these recommended disallowances?

A. No, I do not. Once again she has not conducted an evaluation of the reasonableness of these sites. Rather, she recommends their disallowance because there are, in her words, "no specific plans to develop these sites and/or place them into service at any time in the foreseeable future." Her description of these properties is an assertion that the ultimate facts in this case may or may not support. Nevertheless, even if her assertion is factually correct, it is not a justifiable reason to exclude these sites from rate base.

Q. Why so?

A. As I stated earlier, the USOA does not require there to be a definite plan of use with a definite time frame. But more importantly, requiring there to be a specific plan for development belies the purpose of acquiring property to cost-effectively and reliably provide service to existing and future customers. For a public utility to wait to acquire property, property that often times must possess very specific locational, geologic, hydrologic, and environmental attributes, until the utility has a firmly established plan of development, could prove costly and could threaten reliability. In fact, waiting could even be considered imprudent as stated by the Commission in Order No. 5619 which I just quoted.

A cardinal virtue of proper planning is not only to anticipate needs but also to maintain options to enable a utility to provide service in an ever changing environment. Requiring a definite plan of development would be short-sighted, would limit the ability of a utility to adapt to changing circumstances, and could ultimately lead to higher costs. This is why it is better to evaluate each property individually and make an informed judgment of its reasonableness.

Q. Has the Commission addressed the need for property to be acquired and retained prior to there being a specific plan for its use?

A. Yes, the Commission has. In Order No. 5619, in Docket No. 71370-EU, the Commission recognized that a deferral of acquisition of property could be

imprudent and costly. The Commission also addressed the growing amount of time lag between the study of a site and when construction begins. The Commission stated:

> In recent years, the lag time has been extended considerably from the time the first study is made until the final approval is given and construction begins. Obviously, it would be folly then to insist that the Company defer the purchase of land for future use until all doubts as to its use have been resolved. (emphasis added)

And in Order No. PSC-93-0165-FOF-EI, in Docket No 920324-EI, the Commission included Tampa Electric's Port Manatee plant site in rate base, even though there were no current plans for its use:

> Public Counsel argues that Tampa Electric has no current plans for the Port Manatee plant site. Staff agrees that, at the current time, the company has not identified a particular generating unit to be built at the site. However, as discussed before, it will be more difficult to find an alternate plant site in the future. By allowing the Port Manatee site to remain in rate base, Tampa Electric will already have a viable generating site for future power plants.

Q. If the Commission were to adopt witness Ramas' recommended disallowances, would there be consequences?

A. Yes, there would be. Disallowing the costs from rate base, as she recommends, would be tantamount to declaring the properties in question as being unneeded and imprudent to retain. As a consequence, FPL would have to evaluate whether the properties should be retained. While I cannot and do not speak for FPL in this regard, I would expect the properties would be sold. This would mean the properties would no longer be available to serve customers. FPL would then be in the position of acquiring similar properties at some time in the future, assuming similar properties with the same attributes would be available. There would also be a question of the price that would have to be paid at that time.

Q. Has the Commission previously addressed these potential consequences?

A. Yes, in the same order addressing Tampa Electric's Port Manatee plant site that I just cited, the Commission stated:

> Power plant sites in Florida are becoming increasingly more difficult to find, purchase and permit. Tampa Electric has a potential power plant site at Port Manatee. Utilities purchase power plant sites in advance, because the value of the land will generally appreciate at a rate greater than the utility's overall rate of return. If the Commission found that the Port Manatee site was an imprudent investment and did not allow Tampa Electric to earn a rate of return on the property, Tampa Electric

would be encouraged to sell the site now. Tampa Electric would then have to search for, and purchase, another site for a future power plant, at a much greater cost.

Q. Would there be any other consequences of adopting witness Ramas' recommended disallowances?

A. Yes, there would be. Aside from the immediate consequence of losing the properties in question as future sites, adopting Ms. Ramas' recommendation would send a message to FPL and other Florida utilities to take a shorter look into the future and be less aggressive in actively seeking and acquiring properties that they believe are needed to cost-effectively and reliably serve their customers. By using either rigid time limitations or imposing a requirement for a definite plan of development, utilities would logically wait longer to acquire needed property and increase the risk of having to acquire less than optimal sites, pay more for the sites that are available, or both. This would not be in the customers' best long-term interest.

Q. Are there additional reasons the Commission should avoid sending such a message to FPL and Florida's other utilities?

A. Yes, there are. There are many dynamics in play which would call for even longer planning horizons, not shorter.

Q. What are these dynamics to which you refer?

A. Over my 35 years of experience in utility regulation, I have observed dynamics which make planning for future demand more difficult yet more essential for customers to be served cost-effectively and reliably. Perhaps

most important is the rapid growth Florida has experienced and the reduction in the number of sites available for future development. This dynamic is further compounded by an increase in conservation areas in Florida, increased demands on Florida's limited water resources, an increase in environmental standards and requirements, and an escalation of "not-in-my-backyard" concerns from citizens. On top of these dynamics is the fact that the time required to locate, acquire, and get all necessary permits has generally increased.

Another significant dynamic is the need to have generation sites located close to load centers. This need is further amplified by the difficulty of obtaining new transmission right-of-way and the escalating cost of constructing transmission lines. Further, the overall increase in fuel costs and the resulting higher cost of line losses make the location of generation an even more essential factor.

And lastly, Florida has an established policy of increasing its fuel diversity. To obtain this goal and to be able to adapt to an era of technological, environmental, and financial uncertainty, it is imperative that options for future generation and transmission facilities be maintained. Putting arbitrary time limitations or requiring specific development plans are counter to this goal.

Q. In your testimony you have cited a number of Commission cases concerning PHFU. Has the Commission made a more recent decision concerning PHFU?

A. Yes, in the most recent Gulf Power rate case, Docket No 110138-EI, the Commission addressed PHFU.

Q. What was the Commission's decision in that case?

A. The Commission evaluated various properties being held for future use by Gulf Power. The Commission allowed in rate base properties associated with: the Carryville site, Plant Smith, Plant Daniel, and the Mossey Head Generating site. The Commission disallowed the North Escambia County Nuclear Plant site.

Q. Does the Commission's decision to disallow the North Escambia site as property held for future use change any of your opinions on this case?

A. No. First, the Commission allowed four generation-related properties to be included in rate base. Second, the Commission did not apply the standard that Ms. Ramas espouses in this case: the North Escambia site was not disallowed because there were no definite plans for development or because the plans exceeded ten years. Third, the absence of a need determination should not be a prerequisite for the rate base inclusion of a plant site. Fourth, the possibility of sharing a plant site with a sister company is not a factual contention in this case and thus could not be a reason to disqualify any of the FPL properties from inclusion in rate base. Fifth, all of the dynamics impacting the need for adequate long range planning to reliably and cost-effectively serve customers,

which I just discussed, are in no way diminished by this decision. If anything, this order and the subsequent Commission deliberations on the motion for reconsideration only highlight the need for these dynamics to be considered.

IV. WORKING CAPITAL

Q. What is working capital, as that term is used in a ratemaking context?

A. Just as the term implies, working capital is that amount of capital invested in those assets necessary to meet the day-to-day obligations of an enterprise. These assets are commonly referred to as working assets or current assets. Another way of looking at the concept is to define working capital as that amount of a utility's capital that is not invested in long term assets such as plant and equipment. But under either definition, working capital is an investment-oriented concept and is a necessary part of providing service. As such, it is included as a component of a utility's rate base.

Q. How has the Commission historically determined the amount of cash working capital to include in an electric utility's rate base?

A. Prior to the early 1980's, the Commission employed what is known as the "formula approach". It assumed there was, on average, a 45-day delay between the time service was rendered and payment was received from customers for that service. The application was to multiply the utility's total operating and maintenance expense ("O&M") by a factor of one-eighth, 45 days being approximately one-eighth of a year. This was recognized as being

a "quick and dirty" approach that was generally believed to yield reasonable results.

Q. Why was it generally believed to yield reasonable results?

A. That belief was premised on the assumption that 45 days was an accurate measure of the average delay in payment, based on the results of lead-lag studies that had been used in other jurisdictions and at what was then called the Federal Power Commission. These lead-lag studies generally yielded an average delay of 45 days between the rendering of service and the receipt of payment.

Q. What method did the Commission begin using in the early 1980's.

A. The OPC had concerns that the formula approach was not accurate, did not reflect potentially unique operating characteristics between utilities, and resulted in rate base allowances greater than was necessary. The OPC sponsored testimony offering a different approach, based on an analysis of each utility's average balance sheet. Starting in the early 1980's, the Commission began using the balance sheet approach for each of the regulated electric utilities as they came before the Commission in rate cases. The balance sheet approach has been consistently used by the Commission for all of Florida's regulated electric utilities from that time until the present.

Q. Why did the Commission switch from the formula approach to the balance sheet approach?

A. Like the OPC, the Commission had concerns that the formula approach was too much of an approximation that did not take into account potential

differences between utilities. The Commission also desired an approach that would lend itself to a reconciliation between a utility's rate base and its capital structure. One of the first instances where the Commission adopted the balance sheet approach was a 1980 rate case involving Tampa Electric. In its Order No. 9599, the Commission found:

> As a concept, we believe and so find that the use of the balance sheet method of determining the amount of working capital to be included in the rate base has advantages over the formula method. We think it lends itself to a more precise determination of the amount of capital a utility is actually employing in its day-to-day operations. We also believe that it results in a closer correlation between the rate base and a company's capital structure. The formula method was devised many years ago to avoid a costly lead-lag study in every case. Since it does represent only an approximation, it also may or may not correspond with a particular utility's method of handling its receipts and disbursements.

Q. Has the Commission ever used a lead-lag study to determine the amount of working capital to allow in an electric utility's rate base?

A. The answer is certainly no for all cases since 1980. And I am unaware of any case where a formal lead-lag study was used prior to then. Rather, the Commission generally relied on the formula approach.

Q. Why did the Commission generally rely on the formula approach and not on lead-lag studies?

A. Lead-lag studies are complicated and costly to develop. They are based on varying assumptions on what to include, how to measure the leads and lags, and competing opinions of those sponsoring the studies. In addition, lead-lag studies do not facilitate a reconciliation of rate base and capital structure.

Q. Does witness Kollen make a recommendation for working capital based upon a lead-lag study?

A. Mr. Kollen does not present a lead-lag study in his testimony. He recommends that the cash working capital component be set at zero, as a proxy for what he believes a lead-lag study would yield.

Q. Is this appropriate and consistent with Commission policy?

A. It is neither appropriate nor consistent with Commission policy. It would be inappropriate to make such a substantial adjustment on mere conjecture that a lead-lag study would yield a zero result for FPL. Obviously, there is no such study to evaluate to judge its structure and the accuracy of its outcome. It would also be contrary to Commission policy to abandon the use of a verifiable method that considers the unique operating parameters of each utility, like the balance sheet approach. In short, Mr. Kollen's recommendation has the same shortcomings that caused the Commission to reject the formula approach.

Q. What would be the result of using the old formula approach as a surrogate for a lead-lag study, as opposed to using witness Kollen's surrogate of zero?

A. Let me be clear. I do not endorse the use of the formula approach or any other surrogate approach. However, application of the formula approach (one-eighth of O&M) would yield a cash working capital allowance for FPL in the 2013 Test Year of approximately $193 million. This would be a larger cash working capital allowance than that being requested by FPL. This shows that using surrogates to estimate cash working capital can result in a wide range of possible outcomes.

Q. Witness Kollen opines that the balance sheet approach is outdated in light of sophisticated cash management techniques, including electronic funds transfer. Do you agree?

A. I have no basis to agree or disagree because Mr. Kollen has presented no facts to substantiate his claim. I am skeptical though.

Q. Why are you skeptical?

A. I am skeptical for two reasons. First, the amount of capital necessary to finance day-to-day operations is tied to the delay in the payment of costs to provision service and the delay in the receipt of payment for service. There are delays in the payments to employees, vendors and investors which help offset the delay in the receipt of payments from customers. It is the netting of delays in receipts and in payments that yields the proper measure of working capital. Therefore, if sophisticated cash management techniques and

electronic funds transfers are available to FPL to maximize the delay in its payments, these same tools are available to customers to maximize their delay in payments to FPL. Therefore, I am not sure what the net result would be. There are no facts presented by Mr. Kollen to resolve this uncertainty. Second, if there is a net change in one direction or the other as a result of electronic funds transfer, this would be reflected in FPL's current assets and current liabilities on its balance sheet. Therefore, the balance sheet approach would reflect any net change in the timing of the average net flows.

Q. Witness Kollen criticizes the balance sheet approach because it is based on an end of month "snapshot" of certain balance sheet accounts. Do you agree with this criticism?

A. No, I do not. Mr. Kollen presents no facts to substantiate his criticism. He does present two hypotheticals, both of which are flawed.

Q. Please explain.

A. Mr. Kollen's first hypothetical assumes that the utility incurs expenses ratably over the month but pays all of its bills at the end of the month to reach a zero balance in accounts payable. His supposition is that there has been a manipulation of the balance sheet accounts to result in a higher amount of net working capital. However, this supposition is flawed because it ignores the source of the payment. To have paid the entire balance of accounts payable there would have to have been a substantial amount of cash, cash equivalents or credit mechanisms in place to enable such a large payment at the end of the month. Thus, in this simplistic hypothetical, making the substantial month-

end payments would have necessitated changes in other balance sheet accounts. In reality, FPL has a substantial amount of accounts payable on its books each month and there are no facts presented by Mr. Kollen to show that the amount of month-end accounts payable is not representative of operations throughout the month.

Mr. Kollen's second hypothetical is also flawed. It assumes a significant increase in accounts receivable at the end of the month. However, this is not consistent with FPL's continuous cycle billing to customers which tends to average out the amount of accounts receivable throughout the month.

Q. Should the Commission adopt witness Kollen's recommendation to allow a zero amount of cash working capital in FPL's rate base?

A. No, the Commission should not. Mr. Kollen is proposing to eliminate certain accounts from the balance sheet approach and substitute a surrogate of zero to approximate his opinion of what a lead-lag study would yield. In contrast, FPL has used a comprehensive balance sheet approach which includes all relevant balance sheet accounts. FPL's approach does not rely on surrogate values and is consistent with the approach the Commission has used since the early 1980s.

V. INCENTIVE COMPENSATION

Q. What is the recommendation of Mr. Schultz regarding non-executive performance-based variable compensation?

A. Mr. Schultz refers to performance-based variable compensation as incentive compensation and is recommending a disallowance of 50% of such compensation to non-executives. If accepted, the effect of his recommendation would be to deny cost recovery of these costs on a going forward basis.

Q. Do you agree with Mr. Schultz's recommendation?

A. No, I do not. His recommendation to disallow 50% of non-executive performance-based variable compensation is inconsistent with sound regulatory policy and basic principles of ratemaking.

Q. How is Mr. Schultz's recommendation inconsistent with sound regulatory policy and basic principles of ratemaking?

A. A fundamental tenet of sound regulatory policy is to provide recovery of all reasonable and necessary costs incurred to provide service to customers. And a basic principle of ratemaking is to include all such costs as test year expenses in calculating a regulated company's net operating income. Only if the Commission finds that the expenses in question are unreasonable or unnecessary should they be disallowed in calculating the company's revenue requirement.

Another fundamental tenet of sound regulatory policy is to encourage regulated utilities to be efficient and provide high quality service to their customers over the long term. Sacrificing efficiency or quality of service in the long run to achieve temporary rate reductions is not in the customers' interest. All regulatory decisions have consequences and good regulatory policy results when these consequences are adequately considered.

Mr. Schultz's recommendation violates both of these tenets of sound regulatory policy.

Q. Please explain how Mr. Schultz's recommendation violates the tenet of recovery of reasonable and necessary costs.

A. Mr. Schultz has made no allegations or presented any evidence that the total compensation paid to FPL employees, including performance-based variable compensation, is unnecessary or unreasonable. Neither he, nor any other OPC witness, has presented an analysis of the employment market to determine what amount of compensation is reasonable and necessary to attract the workforce needed to efficiently and reliably run an electric utility. This is in contrast to the testimony of FPL's witness Slattery who explains that the overall compensation is reasonable, that it is necessary to attract and retain a qualified workforce, and that it is at or near the median of employee compensation paid by other regulated utilities.

The sole basis for Mr. Schultz's recommended disallowance is his position that the costs of the pay plan should be shared by both the customers and shareholders. Significantly, Mr. Schultz argues for disallowance of incentive compensation even if a company justifies the total compensation based on market studies.

Mr. Schultz's recommendation is further flawed because he makes no analysis of the reasonableness of the net amount of compensation that remains after incentive compensation is eliminated. He has not provided any evidence that shows the level of compensation that remains will ensure that FPL is competitive in the market in terms of its ability to attract and retain qualified employees.

Consequently, Mr. Schultz's testimony is totally devoid of any consideration of reasonableness regarding either the overall amount of compensation or of the net amount he has recommended.

Q. Has the Commission addressed performance-based variable compensation for other Florida utilities?

A. Yes. A prior Florida Power Corporation rate case also provided for cost recovery of incentive (performance-based variable) compensation finding that: "Incentive plans that are tied to achievement of corporate goals are appropriate and provide an incentive to control costs." Order No. PSC-92-1197-FOF-EI, issued October 22, 1992, in Docket No. 910890-EI, In Re:

Petition for a rate increase by Florida Power Corporation. And in a Tampa Electric Company ("TECO") rate case, the Commission found that TECO's total compensation package, including the component contingent on achieving incentive goals, was set near the median level of benchmarked compensation and allowed recovery of incentive compensation that was directly tied to results of Tampa Electric:

> TECO's Success Sharing Plan has been in place since 1990 and its appropriateness was approved in the Company's last rate case in 1992. Lowering or eliminating the incentive compensation would mean TECO employees would be compensated below the employees at other Companies, which would adversely affect the Company's ability to compete in attracting and retaining a high quality and skilled workforce. We therefore decline to do so.

Order No. PSC-09-0283-FOF-EI, issued April 30, 2009, in Docket No. 080317-EI, In re: Petition for a rate increase by Tampa Electric Company.

The Commission has also approved incentive compensation in three prior rate cases for Gulf Power, the most recent of which resulted in an order issued in April of this year. Order No. PSC-12-0179-FOF-EI, issued April 3, 2012, in Docket No. 110138-EI, In re: Petition for increase in rates by Gulf Power Company. The Commission's finding in the 2001 Gulf rate case contains language similar to the TECO case:

> To only receive a base salary would mean Gulf employees would be compensated at a lower level than employees at other companies. Therefore, an incentive pay plan is necessary for Gulf salaries to be competitive in the market. Another benefit of the plan is that 25% of an individual employee's salary must be re-earned each year. Therefore, each employee must excel to achieve a higher salary. When employees excel, we believe that the customers benefit from a higher quality of service.

Order No. PSC-02-0787-FOF-EI, in Docket 010949-EI, In re: Request for rate increase by Gulf Power Company, (page 45 or order).

In this case, FPL is seeking recovery of the same type of incentive compensation allowed in the above noted cases.

Q. Are there any Florida Court decisions relevant to the issue of Commission disallowance of compensation expenses?

A. Yes, two cases are instructive in this regard and both dealt with the Commission's disallowance of executive compensation.

In *Florida Bridge Company v. Bevis*, the Florida Supreme Court reversed a decision of the Commission disallowing a portion of the Company President's salary. The Court observed:

> Indeed, the Commission has made no attempt to determine whether the president's compensation is excessive in view of

> the services he provides. The arbitrary ratio by which the Commission reduced the salary and expense account[,] the ratio of days physically absent from the home office to the total number of workdays in the test year[,] has no support in logic, precedent, or policy.

363 So. 2d 799, 800-01 (Fla. 1978)

The Court found the Commission's action "was arbitrary and constitutes a substantial departure from the essential requirements of law." Id.

The First District Court of Appeal reached a similar conclusion in Sunshine *Utilities of Central Florida, Inc. v. Florida Public Service Commission*, in finding fault with the Commission's disallowance of a portion of the Company president's salary:

> In determining whether an executive's salary is reasonable compared to salaries paid to other company executives, the comparison must, at a minimum, be based on a showing of similar duties, activities, and responsibilities in the person receiving the salary.

624 So. 2d 306, 311 (Fla. 1st DCA 1993)

Q. How are these cases related to the disallowance of performance-based variable compensation recommended by Mr. Schultz?

A. It relates to the point I made earlier in my testimony regarding Mr. Schultz's failure to determine whether overall compensation expense is reasonable and necessary. The Florida Supreme Court and the First District Court of Appeal reversed the Commission's decision because the basis for the disallowances did not address the reasonableness of the salaries as compared to the market.

Mr. Schultz's analysis is similarly flawed because he has made no attempt to compare the total compensation paid to FPL employees to the market for similar services, duties, activities and responsibilities. Nor has he or any other witness, presented evidence that the salaries for any employee are excessive. Instead he recommends a portion be disallowed based on how it is paid: Because it is performance-based variable pay, rather than base salary, it is subject to disallowance notwithstanding whether the total amount of compensation is reasonable. The focus of any disallowance should be how much is paid, not how it is paid.

Q. How does Mr. Schultz's recommendation fail to encourage efficiency or maintain or improve the quality of service?

A. His recommendation would have longer term consequences that could affect efficiency and service, and his recommendation takes away a valuable managerial tool that is effective in increasing efficiency and maintaining or improving the quality of service provided to customers.

Q. What do you mean by "takes away a managerial tool"?

A. Accepting Mr. Schultz's recommendation would, by necessity, cause FPL to rethink its long standing approach to employee compensation. If a significant amount of otherwise valid and reasonable costs were disallowed simply because of the method by which they are paid, FPL would be justified in implementing a different pay structure. While accepting Mr. Schultz's recommendation would deny FPL the opportunity to recover necessary costs currently, adopting a different compensation plan with no at-risk pay and a greater reliance on base pay would presumably eliminate the issue in future rate proceedings. But by moving more salary to base pay, employees don't have to re-earn that pay by meeting goals that typically include efficiency and service objectives. A compensation structure that pays employees regardless of performance diminishes management's leverage to motivate and focus employees on appropriate goals.

In essence, the Commission would be substituting its judgment for that of FPL's management as to how best to motivate and compensate its employees. Consequently, the incentive for FPL's employees to be motivated and productive would be lost.

Q. Is it your position that Commission precedent supports the recovery of all of the non-executive performance-based variable pay? And why has this been the precedent in Florida?

A. While the Commission reviews each utility's compensation costs on the facts unique to that utility, the Commission has consistently recognized that

incentive compensation/performance-based variable pay, is an accepted and desirable way to achieve corporate goals and to control costs for the benefit of customers. The Commission has also determined that incentive compensation is an appropriate component to include within overall compensation to judge whether the overall compensation paid to employees is reasonable.

I believe there are a number of reasons for this precedent. First, the Commission's policy is consistent with the basic tenets of sound regulatory policy that I described earlier. Second, the Commission has recognized that having good management at utilities is essential for regulators to achieve their mission of having safe, reliable and reasonably-priced service delivered to customers. The Commission has further understood that management needs sufficient tools and incentives to achieve these goals and that regulators should not attempt to "micro-manage" their regulated utilities. And third, the Commission has appropriately recognized that not all issues in a rate proceeding are a simple situation of "us vs. them", where every issue has a clear winner and a clear loser. While at-risk compensation has been and is currently being characterized as an "us vs. them" issue, in reality it is not. Incorporating performance-based variable pay as part of an overall compensation plan is a good example of a "win-win" situation.

Q. What do you mean by a "win-win" situation?

A. Including performance-based variable pay as part of an overall compensation plan enables all stakeholders to win. Shareholders get to invest in a company

with employees motivated to achieve appropriate corporate goals. Management gets to apply compensation tools that they think are best to motivate and fairly compensate employees. And most importantly, customers get to pay no more than a reasonable amount in their rates but get a work force that is motivated to be efficient, to reduce costs where possible and to maintain a high level of safe and reliable service.

Q. Mr. Deason, do you understand that Mr. Schultz is not recommending FPL not pay the entire non-executive performance-based variable pay; he is simply recommending that only 50% recovered in rates?

A. Yes, I understand his recommendation. That recommendation, coupled with his statements on page 23, lines 3 through 8, regarding the use of compensation studies to justify total compensation paid to employees, is an implicit acknowledgement that the total compensation, including 100% of performance-based variable pay, is a necessary and reasonable business expense.

Disallowing a reasonable and necessary business expense, or requiring the company to share part of the expense, is nothing more than a backdoor approach to reducing the allowed ROE. Funds that should go to shareholders as a fair return on investment instead would be diverted to cover costs that should otherwise be recovered in rates.

VI. DIRECTORS AND OFFICERS LIABILITY INSURANCE

Q. What is the recommendation made by Mr. Schultz regarding Directors and Officers Liability ("DOL") Insurance?

A. Mr. Schultz is recommending the disallowance of 50% of the cost of DOL insurance premiums.

Q. Do you agree with this recommendation?

A. No, I do not.

Q. Why not?

A. I disagree for reasons similar to the points I made with regard to at-risk compensation. The amount requested by FPL for DOL insurance is reasonable and is an ordinary and necessary cost of doing business, and as such the entire amount should be recovered in rates.

Q. Why are DOL insurance premiums a necessary and reasonable cost of doing business?

A. DOL insurance is necessary to attract and retain knowledgeable, experienced and capable directors and officers. DOL insurance is purchased for the purpose of protecting the company and its directors and officers from normal risks associated with managing the company. Qualified and capable directors and officers would be reluctant to assume the responsibilities of managing a company without the assurance that their personal assets would be shielded from legal expenses, settlements or judgments arising from lawsuits. The assets of the Company are likewise protected from lawsuits that could divert

capital to cover any losses. Increasing scrutiny of corporate governance and the related risk exposure of directors and officers make insurance a necessity in maintaining a high quality board and senior management team. Adequate liability coverage gives directors and officers the level of comfort necessary to enable them to make forward-looking decisions that will provide operational and cost-efficiency benefits for customers.

Q. Mr. Schultz states that there are Commission cases that have allowed recovery of premiums for DOL insurance, have disallowed recovery, or have required the expense be shared with stockholders. Can you comment on those cases?

A. Yes. The Commission's rationale in the People's Gas case and in the Tampa Electric case is instructive regarding the need for DOL insurance:

> DOL Insurance has become a necessary part of conducting business for any company or organization and it would be difficult for companies to attract and retain competent directors and officers without it. Moreover, ratepayers receive benefits from being part of a large public company, including, among other things, access to capital. In addition, DOL Insurance is necessary to protect the ratepayers from allegations of corporate misdeeds.

Order No. PSC-09-0411-FOF-GU, page 37 issued June 9, 2009, in Docket No. 080318-GU, In re: Petition for rate increase by People's Gas System.

> We find that DOL insurance is a part of doing business for a publicly-owned company. It is necessary to attract and retain competent directors and officers. Corporate surveys indicate that virtually all public entities maintain DOL insurance, including investor-owned electric utilities.

Order No. PSC-09-0283-FOF-EI, page 64 issued April 30, 2009, in Docket No. 080317-EI, In re: Petition for rate increase by Tampa Electric Company.

Q. Does Mr. Schultz claim DOL insurance is not a necessary and reasonable expense?

A. No, he does not. He characterizes it as "a legitimate business expense" but further characterizes it as being "unique in that it is designed primarily to protect shareholders from their past decisions".

Q. Do you agree with his unique characterization?

A. No, I do not. DOL insurance is not designed to protect shareholders. DOL insurance is designed to protect the officers and directors of the corporation from lawsuits alleging harm from decisions of the officers and directors acting in their official capacity. This is an important distinction for two reasons. First, without adequate DOL insurance, any corporation would find it difficult to attract the best qualified individuals to serve as officers and directors. Second, and perhaps more importantly, it allows officers and directors to make decisions based on their best judgment and not on the goal of minimizing exposure to potential lawsuits. And this second reason is especially applicable to officers and directors of regulated utilities.

Q. Why is this second reason especially applicable to officers and directors of regulated utilities?

A. A regulated utility is in a relatively unique position as compared to typical for-profit companies. To be successful, a regulated utility must meet all of its obligations required by virtue of being a state-sanctioned regulated monopoly and must fulfill its commitments to all stakeholders, including its vendors, employees, creditors, stockholders, customers and regulators. Therefore, truly effective directors and officers must feel free to exercise their best independent judgment to balance all of those sometimes competing interests, without fear of lawsuits threatening their personal assets. It is both good public policy and good regulatory policy to encourage such informed, objective decision making that is enabled to a great extent by DOL insurance.

Q. Why is it good regulatory policy to encourage DOL insurance?

A. It is good regulatory policy to encourage DOL insurance to enable officers and directors to engage in thoughtful, objective decision making that carefully weighs the outcomes and resulting impacts on all stakeholders.

Q. Is there a real-world example of this?

A. Yes, perhaps the best example of this is the Commission's policy of encouraging settlements among the parties on matters in dispute. The best settlements are those where all parties engage in meaningful discussion and agree on sometimes significant concessions. When these concessions are believed to be in the best interest of a regulated utility and its stakeholders, the

officers and directors should feel free to exercise this judgment, without the fear of a lawsuit alleging the concessions were too great.

Q. In response to a previous question, you contrasted a regulated utility with a typical for-profit company. Are for-profit companies the only entities that find it necessary and appropriate to purchase DOL insurance?

A. No, many non-profit entities purchase DOL insurance for the same reasons, i.e., to enable them to have qualified officers and directors and to enable those officers and directors to engage in objective decision making. So entities that do not even have stockholders also find it necessary and appropriate to have DOL insurance. This fact is another reason why I disagree with Mr. Schultz's characterization that DOL insurance is primarily to protect shareholders from their past decisions.

Q. What would be the result of accepting witness Schultz's recommendation to disallow half of the cost of FPL's DOL insurance?

A. Mr. Schultz characterizes his recommendation as a sharing of costs based on who he believes benefits. As I just described, I believe his opinion on who benefits is incorrect. Nevertheless, the true effect of his recommendation is to disallow one-half of the cost of FPL's DOL insurance. This is tantamount to saying that one-half of the cost is unnecessary and imprudently incurred. If this is not the effective result, his recommendation violates one of the most basic tenets of regulatory theory, i.e., that all necessary and prudent costs should be allowed to be recovered in rates.

Q. From a policy perspective, what would be the effective outcome of his recommendation?

A. His recommendation would trigger three potential outcomes, none of which is desirable for a regulated utility and its customers. First, the company could simply decide to not have DOL insurance. This would result in the extremely undesirable consequences of which I earlier spoke. Second, the company could decide to not have DOL insurance and pay its officers and directors more to make-up for the greater risk exposure. Presumably the increased costs would then not be shared because they clearly would be prudent and necessary to attract and retain directors and officers and pay them a market level of compensation. And third, the company could retain its DOL insurance and not recover one-half of the cost of doing so.

Q. What would be the bottom-line impact of the third potential outcome?

A. Disallowing a reasonable and necessary business expense, or requiring the company to share part of the expense, is nothing more than another backdoor approach to reducing the allowed ROE. Funds that should go to shareholders as a fair return on investment instead would be diverted to cover costs that should otherwise be recovered in rates.

VII. SMART METER PROGRAM

Q. What do witnesses Kollen and Ramas recommend for expenses associated with the deployment of smart meters?

A. They both recommend that recoverable expenses be reduced based on forecasts that were submitted during FPL's 2009 rate case.

Q. Is this appropriate to do?

A. No, it is not appropriate. It violates one of the most basic tenets of ratemaking, that the test year be based on the most current, accurate data possible and that it be reflective of costs on a going forward basis. One of the reasons the Commission has historically rejected some test year requests is that some test years were considered "stale." This adjustment is reminiscent of this deficiency.

Q. Both witnesses Kollen and Ramas opine that their recommended adjustment is necessary to reflect post-test year savings associated with smart meters. Do you agree with this opinion?

A. I disagree for three reasons. First, as I just described, the adjustment is based on stale data and more current data is available to ascertain the costs and savings associated with the deployment of smart meters. Second, the adjustment does not result in a test year that is reflective of costs on a going forward basis. Rather, the adjustment picks one specific subset of overall O&M expenses and uses stale data as a surrogate to estimate savings. Neither Mr. Kollen nor Ms. Ramas attempts to adjust other areas of O&M expense

that will be increasing beyond the 2013 Test Year. This actually distorts total test year O&M expense. And third, the savings associated with the deployment of smart meters will be recognized in the future as the savings materialize.

Q. Witness Ramas states that it would be unfair to have the capital costs of the smart meters in base rates without the net O&M savings being reflected. Do you agree?

A. I agree that capital costs and any resulting savings should be matched when possible. However, it is common for capital dollars to be invested before net savings are achieved. The delay in this realization of savings cannot be wished away. To make an adjustment to do so would only distort this relationship.

Q. Witness Kollen states the Commission should hold FPL to its 2009 rate case projections of net savings. Do you agree?

A. I do not agree. The Commission has the authority and responsibility to evaluate and scrutinize all projections. However, once done and approved, it would be inappropriate to hold a company to its projections. There will always be economic, technological, financial, and operational changes that will result in schedule changes and costs being over or under the projected levels. The real issue is whether those changes were prudently managed by the company to minimize increases and maximize savings to the extent reasonably within management's control to do so. Absent a finding of such

imprudent actions, the current costs should be evaluated on the most current and accurate information available.

Q. Witness Kollen states that had the SFHHA known that there would be no future O&M savings, they may have opposed the smart meter deployment in the last rate case. Is this an appropriate reason to make his recommended adjustment?

A. It is not an appropriate reason. First and foremost, Mr. Kollen is incorrect that there are no O&M savings associated with the deployment of smart meters. The most current and accurate information projects future net savings. And second, there are no such guarantees in the ratemaking process. As I stated earlier, there will always be changes that affect the scheduling and the level of costs for such a major deployment. The Company has the risks that such costs escalate quicker and/or greater than projected.

Q. Was this the case with the 2009 projections of the smart meter program?

A. Yes, Mr. Kollen's own exhibit shows that during the intervening years 2010 through 2012 the amount of O&M costs exceeded those in the 2009 projections.

VIII. ROE PERFORMANCE ADDER

Q. What does witness Lawton recommend for FPL's requested ROE performance adder?

A. Mr. Lawton recommends denial of the ROE performance adder and proceeds

to express reasons for his recommendation.

Q. What are the reasons given by witness Lawton for his recommendation?

A. Mr. Lawton essentially gives four reasons for his recommendation to deny the ROE performance adder, arguing that the ROE performance adder:

- Constitutes a change of regulatory structure;
- Is antithetical to the concept of a monopoly;
- Results in an unneeded "bonus"; and
- Leads to unjust rates.

Q. Do you agree with Mr. Lawton that the ROE performance adder constitutes a change in regulatory structure?

A. I do not agree. To the contrary, the possibility of setting rates at a ROE above or below the mid-point of the range is a well-established practice in the state of Florida. Ironically, to simply reject the requested ROE performance adder based on philosophical grounds, as Mr. Lawton recommends, would constitute a change in regulatory structure.

Q. How is it that an ROE performance adder is a well-established practice in the state of Florida?

A. FPL's requested ROE performance adder is a request to set rates at a target ROE point above the mid-point to recognize exceptional performance. The reciprocal of this is to set rates at a target ROE point below the mid-point for less than satisfactory performance. Setting rates at a point above or below the mid-point is authorized by statute, is a regulatory tool historically used by the Commission, and has been upheld by the Florida Supreme Court. Further, the

concept of recognizing superior management or penalizing unsatisfactory management is recognized by authoritative sources as an appropriate regulatory tool.

Q. What is the specific statutory provision to which you refer?

A. I am referring to Section 366.041(1), F.S., which authorizes the Commission when setting rates to consider "the efficiency, sufficiency, and adequacy of the facilities provided and the services rendered; the cost of providing such service and the value of such service to the public...."

Q. Has the Commission utilized its discretion to set rates at a target ROE above or below the mid-point?

A. Yes, the Commission has. In fact, the Commission has set rates at targets both higher and lower than the mid-point in three different cases involving the same electric utility, Gulf Power.

Q. In what case did the Commission set rates at a target ROE below the mid-point for Gulf Power?

A. In a 1990 rate case the Commission authorized an ROE of 12.55% for Gulf Power. However, in recognition of mismanagement, the Commission set rates at 12.05% for a period of two years.

Q. Was this decision appealed to the Florida Supreme Court?

A. Yes, it was. In *Gulf Power Co. v. Wilson, 597 So. 2d 270* (Fla. 1992) (Gulf Power Case), the Court upheld the Commission's adjustment to ROE based on evidence of the utility's mismanagement, but explained that the discretion worked both ways:

This Court has previously recognized that this authority includes the discretion to *reward,* within the reasonable rate of return range, for management efficiency. In fact, Gulf Power has in the past received a ten basis point reward for efficient management through its energy conservation efforts. *Gulf Power v. Cresse, 410 So .2d* (Fla. 1982). We find that, inherent in the authority to adjust for management efficiency is the authority to reduce the rate of return for mismanagement, as long as the resulting rate of return falls within reasonable range set by the Commission. This concept of adjusting a utility's rate of return on equity based on performance of its management is by no means new to Florida or other jurisdictions.

Q. In what cases did the Commission set rates at a target ROE above the mid-point for Gulf Power?

A. The first time was in Docket No. 800001-EU, where the Commission set rates at 10 basis points above the ROE mid-point. In denying a Petition for Reconsideration filed by OPC, the Commission stated:

With regard to the ten basis points added to the return on equity capital used for ratemaking purposes, we believe that once we have identified an appropriate range for a fair rate of return consistent with the record, we have some discretion in fixing the point within the range to be used to determine revenue

requirements. In this instance, we exercised our authority in this regard to reward Gulf Power Company's visible efforts in promoting conservation, an objective which we hope that management of all utilities will strive to achieve. The action in this case was within our discretion and reconsideration thereof will be denied.

This action was upheld by the Florida Supreme Court and was referenced in the above quote from the Court.

Q. What was the second time that the Commission set Gulf Power's rates at a target above the ROE mid-point?

A. The second time was in a 2001 rate case, Docket No. 010949-EI. In this case, the Commission found the mid-point ROE to be 11.75%. However, in recognition of Gulf's high level of performance, the Commission set rates at 25 basis points above that level or 12.00%. In its Order No. PSC-02-0787-FOF-EI, the Commission stated:

> Gulf contends that it deserves an upward adjustment to its return on equity (ROE) as a reward for its continuing high level of performance in customer satisfaction, customer complaints, transmission and distribution reliability, and generating plant availability. Gulf's position is that increasing the ROE sends a message to the Company and the customers that superior performance is important. Furthermore, such an increase provides an incentive to continue to provide superior service....

> The testimony of Gulf witnesses Labrato and Fisher demonstrates that Gulf's service is excellent. In addition, testimony of customers at the customer service hearings was very favorable. We find that Gulf's past performance has been superior and we expect that level of performance to continue into the future.

Q. Witness Lawton's second reason is that an ROE performance adder is antithetical to the concept of a monopoly. Do you agree?

A. No, I strongly disagree. Far from being antithetical, a properly imposed performance based ROE adjustment that is symmetrical in its approach is an essential regulatory tool. It enables a regulatory authority to introduce elements of competition and incentives that otherwise may be lacking in more traditional approaches to ratemaking and enables regulators to directly express priorities in terms of service quality, cost control, and customer satisfaction to management. This was expressly recognized by the Florida Supreme Court in the Gulf Power Case:

> In a competitive market environment, the market would provide the necessary incentives for management efficiency and corresponding disincentives for mismanagement. However, for a utility that operates as a monopoly, this discretionary authority to reward or reduce a utility's rate of return within a reasonable rate of return range is the only incentive available.

Q. Witness Lawton's third reason for denial is that an ROE performance adder should not be necessary. What is his reasoning for this position?

A. Mr. Lawton states that the adder is not necessary because "FPL enjoys a privileged position" with "advantages that competitive enterprises must envy...." He further opines that a regulated utility like FPL has an obligation to provide "superior performance."

Q. Do you agree with Mr. Lawton's reasoning?

A. I disagree for at least two reasons. First, as I just explained, the fact that utilities are regulated monopolies is the very reason that incentive based regulatory tools, like ROE adjustments, are necessary. And second, certain factual assertions presented by Mr. Lawton do not give a complete picture. While there may indeed be some advantages to being a regulated utility, Mr. Lawton fails to mention the obligations and disadvantages of being a regulated utility.

Q. What are some of the disadvantages which Mr. Lawton does not mention?

A. Regulated utilities like FPL have an obligation to serve all customers when service is demanded. They do not have the option of not investing during times of uncertainty or financial difficulty. Neither do they have the option of departing unprofitable markets or not serving certain customers. Regulated utilities must justify their prices while competitive firms enjoy pricing flexibility and alacrity. Regulated utilities' earnings are set and closely monitored while competitive firms do not have governmentally imposed

restrictions on earnings. The fact that regulated utilities' earnings are set within a narrow range and actively monitored to insure that earning levels are not exceeded is the very reason that discretion in setting rates at a point other than the mid-point can be so very crucial to obtaining the goals of regulation.

Q. Do regulated utilities, like FPL, have an obligation to provide "superior performance" as witness Lawton opines?

A. Regulated utilities do have an obligation to serve, which I just described. In addition, regulated utilities in Florida have an obligation to provide "reasonably sufficient, adequate, and efficient service upon terms as required by the commission." This language is found in Section 366.03, F.S. Regulated utilities do not however, have an obligation to provide superior performance.

Q. Has the Commission ever required a utility to provide superior performance or found a utility to be in violation of a Commission rule or order for not providing superior performance?

A. No, not to my knowledge. The Commission has generally followed a standard of reasonably sufficient, adequate, and efficient, as prescribed in statute. When the Commission has imposed a lower ROE it has been for performance and a quality of service which was determined to be inadequate. Likewise, when the Commission has awarded a higher ROE it was for performance and a quality of service beyond that which would be considered merely adequate.

Q. Why has the Commission followed this practice?

A. It is the standard prescribed in statute. Beyond that, it constitutes good regulatory policy. Applying this standard and using its authority to adjust the ROE provides the Commission with a powerful and needed regulatory tool to get inadequate performance corrected and to have superior performance continue and even become a goal to which other utilities may aspire. This was certainly the intent of the Commission when it awarded Gulf Power a ten basis points higher ROE for its conservation efforts. Following Mr. Lawton's opinion and recommendation would effectively take this tool out of the hands of the Commission.

Q. Witness Lawton's final asserted rationale is that the performance adder can lead to unjust rates. Is this correct?

A. It is absolutely incorrect. First, by definition and function, the ROE adder will not set rates at an unjust level. To the contrary, rates will be set within the Commission's established range of reasonableness. This concept has been recognized and approved by the Florida Supreme Court. Second, and perhaps more importantly, Mr. Lawton's reasoning ignores the very purpose of an ROE performance adder. A properly structured and implemented performance adder is not intended to unjustly enrich a company. To the contrary, it is intended to introduce incentives designed to continue or even enhance superior performance, such that the net cost paid by customers through rates is less than it would be had the superior performance not been achieved. In fact, FPL's proposal in particular puts safeguards in place to

prevent the continuation of the adder should FPL's rate levels exceed those of other Florida utilities.

Q. Are there other benefits of a properly structured and implemented performance adder?

A. Yes, there are. Rates would not be unjust and incentives and safeguards would be in place as I just explained. Beyond that, there would be other benefits as well. FPL would have stronger financial metrics and an increase of cash flow. This would help maintain FPL's financial integrity and reduce the amount of outside funding needed for FPL's large construction budget.

Q. In response to a previous question you stated that recognizing superior management or penalizing unsatisfactory management is recognized by authoritative sources. Can you provide an example?

A. Yes, perhaps the most authoritative source was also referenced by the Florida Supreme Court in the Gulf Power Case. The Court quoted James C. Bonbright et al., Principles of Public Utility Rates, 366-67 (2d ed. 1988). The passage from which the Court quotes reads:

> While exceptional management is rarely explicitly rewarded, and mediocrity infrequently penalized, it suggests more systematic and deliberate efforts on the part of regulating agencies to distinguish, somewhat as competition is presumed to do, in favor of companies under superior management and against companies with substandard management. The distinction might take the form of an explicit and publicly

recognized differential in the allowed rate of return. There is ground for the conviction that the opportunity of a well managed utility to earn a return *liberally* adequate to attract capital is in the public interest as encouraging rapid technological progress and long-run policies of operation.

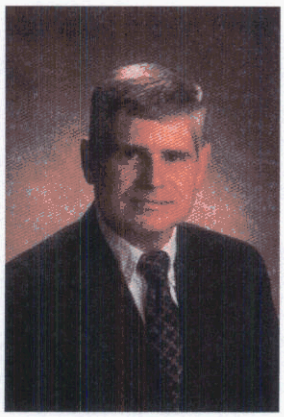
Q. Do you have any other general observations regarding the appropriate ROE and capital structure for FPL?

A. It is not the purpose of my testimony to propose a specific ROE or capital structure for FPL. However, it has been my observation, over thirty-five years of regulatory experience, that utilities that provide exceptional value to customers are those that have allowed ROEs and capital structures that maintain their financial integrity, provide incentives to promote efficiencies, and facilitate ready access to capital to invest in needed infrastructure. Low allowed ROEs and inefficient capital structures do not equate to customer benefits. They may temporarily lower revenue requirements in a given rate case, but this does not equate to exceptional customer value over the long-term.

Q. Does this conclude your testimony?

A. Yes, it does.

Terry Deason*



Special Consultant (Non-Lawyer)*
Phone: (850) 425-6654
Fax: (850) 425-6694
E-Mail: tdeason@radeylaw.com

Practice Areas:

- Energy, Telecommunications, Water and Wastewater and Public Utilities

Education:

- United States Military Academy at West Point, 1972
- Florida State University, B.S., 1975, Accounting, summa cum laude
- Florida State University, Master of Accounting, 1989

Professional Experiences:

- Radey Thomas Yon & Clark, P.A., Special Consultant, 2007 - Present
- Florida Public Service Commission, Commissioner, 1991 – 2007
- Florida Public Service Commission, Chairman, 1993 – 1995, 2000 – 2001
- Office of the Public Counsel, Chief Regulatory Analyst, 1987 – 1991
- Florida Public Service Commission, Executive Assistant to the Commissioner, 1981 – 1987
- Office of the Public Counsel, Legislative Analyst II and III, 1979 - 1981
- Ben Johnson Associates, Inc., Research Analyst, 1978 – 1979
- Office of the Public Counsel, Legislative Analyst I, 1977 – 1978
- Quincy State Bank Trust Department, Staff Accountant and Trust Assistant, 1976 - 1977

Professional Associations and Memberships:

- National Association of Regulatory Utility Commissioners (NARUC), 1993 – 1998, *Member, Executive Committee*
- National Association of Regulatory Utility Commissioners (NARUC), 1999 – 2006, *Board of Directors*

Terry Deason*

- National Association of Regulatory Utility Commissioners (NARUC), 2005-2006, *Member, Committee on Electricity*
- National Association of Regulatory Utility Commissioners (NARUC), 2004 – 2005, *Member, Committee on Telecommunications*
- National Association of Regulatory Utility Commissioners (NARUC), 1991 – 2004, *Member, Committee on Finance and Technology*
- National Association of Regulatory Utility Commissioners (NARUC), 1995 – 1998, *Member, Committee on Utility Association Oversight*
- National Association of Regulatory Utility Commissioners (NARUC) 2002 *Member, Rights-of-Way Study*
- Nuclear Waste Strategy Coalition, 2000 – 2006, *Board Member*
- Federal Energy Regulatory Commission (FERC) South Joint Board on Security Constrained Economic Dispatch, 2005 – 2006, *Member*
- Southeastern Association of Regulatory Utility Commissioners, 1991 – 2006, *Member*
- Florida Energy 20/20 Study Commission, 2000 – 2001, *Member*
- FCC Federal/State Joint Conference on Accounting, 2003 – 2005, *Member*
- Joint NARUC/Department of Energy Study Commission on Tax and Rate Treatment of Renewable Energy Projects, 1993, *Member*
- Bonbright Utilities Center at the University of Georgia, 2001, *Bonbright Distinguished Service Award Recipient*
- Eastern NARUC Utility Rate School - Faculty Member

RADEY THOMAS YON & CLARK, P.A.
301 South Bronough Street, Suite 200
Tallahassee, FL 32301
www.radeylaw.com