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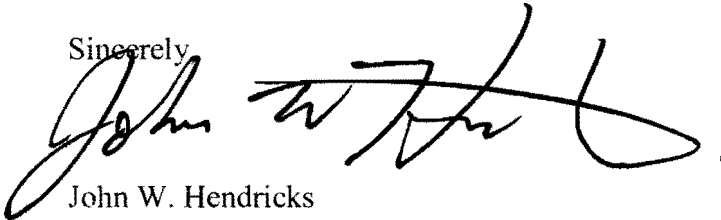
Re: Docket No. 120015-EI: Prefiled Testimony and Exhibits for
Settlement Agreement Hearing

Enclosed for filing in the above Docket are the original and fifteen copies of my prefiled
testimony and exhibits.

Please call or email me if you have any questions regarding this filing.

Thank you for your assistance.

Sincerely,



John W. Hendricks
941-685-0223
jwhendricks@sti2.com

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AFD	<u>5</u>
APA	<u>1</u>
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I hereby certify that a true and correct copy of the forgoing has been provided by electronic delivery on November 2, 2012 to the following:

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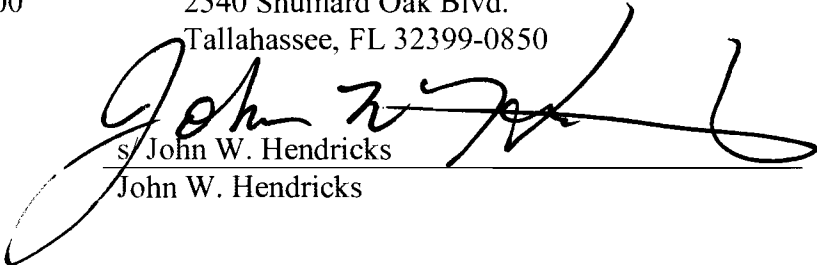
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s/ John W. Hendricks
John W. Hendricks

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DIRECT TESTIMONY OF JOHN W HENDRICKS

ON PROPOSED SETTLEMENT AGREEMENT

DOCKET NO. 120015-EI

NOVEMBER 1, 2012

1 **1. INTRODUCTION**

2

3 **Q Please state your name and address.**

4 **A** My name is John W Hendricks. My address is 367 S. Shore Drive, Sarasota, Fl
5 34234.

6

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

8 **A** Yes.

9

10 **Q Are you sponsoring any exhibits in this case?**

11 **A** Yes. I am sponsoring the following exhibit.

12

13 • JWH-7 – Tax Efficiency in the GBRA Process

14

15

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

17 **A** The purpose of my testimony is to address the issues identified in the Third Order
18 Revising Order Establishing Procedure, Order No. PSC-12-0529-PCO-EI. It is my
19 assessment that the Stipulation and Settlement (S&S) agreement would result in a
20 rate structure that would be economically inefficient and fail to appropriately balance
21 between the interests of the utility and its ratepayers, or among the different types of
22 ratepayers. Specifically, I will explain my concerns about the “Settlement Issues”
23 identified in the order that deal with the proposed GBRA, a proposed incentive

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1 mechanism, and the public interest question. These are not general objections to the
2 GBRA process or incentive mechanisms, but to these specific proposals in the
3 context of this FPL rate case.

4
5 **Q 1. Are the generation base rate adjustments for the Canaveral Modernization**
6 **Project, Riviera Beach Modernization Project, and Port Everglades**
7 **Modernization Project, contained in paragraph 8 of the Stipulation and**
8 **Settlement, in the public interest?**

9 **A** There are several advantages for the utility that will substantially increase costs and
10 risks for ratepayers which have not been acknowledged or appropriately taken into
11 account in the S&S document.

12
13 One is elimination of the possibility of “regulatory lag” in getting these three large
14 modernized generation plants into the rate base. A recent EEI report (Edison
15 Electric Institute, Rate Case Summary, Q2 2012, p. 2) indicated that the typical
16 regulatory lag for rate cases is about 10 months. If FPL were to experience this
17 typical lag for each of these three facilities, the total revenue requirement would be
18 reduced by over \$300 million over the term of the proposed agreement. The GBRA
19 effectively eliminates the regulatory lag for these large additions to the generation
20 base and will expose ratepayers to higher base rates sooner. The substantial value to
21 FPL of eliminating regulatory lag should be recognized as a major factor in weighing
22 the balance of this S&S proposal.

23

1 Also, by neutering the risk of regulatory lag, the GBRA eliminates one of the factors
2 that to some extent counterbalances the general tendency of regulated firms to
3 overinvest in capital to grow their revenue for shareholders. This increases the risk
4 of costly overinvestment and should also be taken into account in the balance.

5
6 A second issue is that, in this case, the GBRA eliminates the possibility of a rate case
7 for three large generation facilities that were approved in need determination
8 proceedings that occurred when the Commission and the parties had the expectation
9 that these investments would be subjected to the further scrutiny of a rate case before
10 entering the rate base. If the reasonable expectation in these need determination
11 proceedings had been that these large investments would automatically enter the rate
12 base, other parties would likely have participated and many other issues and
13 arguments would likely have been raised in these proceedings. The GBRA process
14 might be appropriate for new investments where parties in the determination of need
15 proceedings know this is the next step, but it raises serious process issues when a
16 GBRA is applied to projects whose need was approved under different circumstances
17 and assumptions.

18
19 A third issue is the tax-inefficiency of the proposed GBRA. Exhibit JWH-7
20 illustrates the fact that under the proposed GBRA the costs for “equity gross-up,”
21 which is calculated to cover the state and federal corporate income taxes on the
22 equity returns, constitutes over 30% of the total cost of long-term investor capital.
23 The gross-up cost alone in the first year of operation for the three facilities covered

1 by the GRBA would be about \$130 million and these costs would continue for many
2 years, declining slowly with amortization. This is due to the very high incremental
3 equity ratio of 60.969% as shown in the FPL Post-Hearing Brief (Appendix, p. 190).
4 The grossed-up cost of equity accounts for about 85% of the total cost of long-term
5 investor capital, and is shown as “All 3 as Proposed.” To illustrate the opportunity to
6 reduce gross-up costs, an example for a 50% equity ratio for investor capital in the
7 GBRA is shown as “All 3 Tax Efficient.” This example keeps the total investor
8 returns constant, but shifts to more debt and less equity, reducing the total cost by
9 about 6% by reducing the required gross-up costs. This would be an excellent way
10 to improve the balance of the proposed settlement by reducing ratepayer costs and
11 risks of future increases due to volatile equity costs, while still providing FPL
12 investors with the same income.

13
14 Fourth, if corporate income taxes are reduced as now being advocated by many
15 political leaders, large unintended windfall profits can be created during the fixed
16 term of the rates implemented under the GBRA (and other elements of the proposed
17 settlement), with only a very restrictive opportunity for revision provided. Each
18 major presidential candidate is advocating a reduction in the federal corporate tax
19 from the current 35% (Romney to 20%, Obama to 25%) and Gov. Scott has
20 proposed eliminating the 5% Florida corporate income tax. This would create a
21 windfall increase in equity return of about 15% to 30% if all other factors remained
22 the same.

23 Of course no one can predict what actually will happen, but these positions suggest

1 that a reduction of corporate income tax rates in the range between 25% and 50%
2 down from the current rates is a serious possibility, although any reductions might be
3 less than proposed, phased -in gradually, or restricted.

4
5 The only opportunity provided for the Commission or ratepayers to initiate actions to
6 make changes in the base rates during the term of the proposed settlement arises if
7 FPL's reported earnings exceed the 11.7% top end of the allowed range as defined in
8 the proposed Stipulation and Settlement Agreement (9.B on page 9). Depending on
9 the size and timing of the tax change, FPLs responses and how the calculations are
10 structured, this threshold might or might not be triggered by some corporate income
11 tax reductions that would nonetheless create substantial windfall profits.

12 FPL's response to my data request No. 6, which asked about other provisions in the
13 settlement agreement under which parties could seek to modify the agreement before
14 2017, indicated that there were none.

15
16 As it stands, the proposed GBRA process is not in the public interest because it fails
17 to balance the benefits and reduction of risks for the utility with comparable benefits
18 and risk reduction for the ratepayers. A more tax-efficient equity ratio for the GBRA
19 would be a good step toward reducing costs and risks for ratepayers at no cost to
20 investors, but additional reductions are required to balance the scales. The process
21 issues of bypassing the expected rate cases with the GBRA is troubling, especially
22 since the Office of Public Council who represents the citizens of Florida is not a
23 party to the settlement. If the corporate tax cut issue is not already addressed

1 elsewhere in regulations or policy, so it can be dealt with in a prompt and effective
2 way, the proposed settlement agreement should be modified to do so, or rejected in
3 its entirety.

4
5 **Q 2. Is the provision contained in paragraph 10(b) of the Stipulation and**
6 **Settlement, which allows the amortization of a portion of FPL's Fossil**
7 **Dismantlement Reserve during the Term, in the public interest?**

8 **A** No. See answer to #5.

9
10 **Q 3. Is the provision contained in paragraph 11 of the Stipulation and Settlement,**
11 **which relieves FPL of the requirement to file any depreciation or**
12 **dismantlement study during the Term, in the public interest?**

13 **A** No. See answer to #5.

14
15 **Q 4. Is the provision contained in paragraph 12 of the Stipulation and Settlement,**
16 **which creates the "Incentive Mechanism" including the gain sharing thresholds**
17 **established between customers and FPL, in the public interest?**

18 **A** Incentives are obviously key tools for motivating desired behavior of individuals and
19 organizations, and as an engineer and economist I appreciate their importance. Our
20 understanding of incentives in economic decision making has advanced in recent
21 years, particularly with respect to the role of asymmetric information. For example,
22 MIT's Paul Joskow describes his view of how our understanding of economic
23 incentive mechanisms in regulation has advanced:

1 The **major advances in the theory and practice of regulation have**
2 **relied on formalizing the information structure that characterizes the**
3 **real world** [emphasis added]. Regulators are imperfectly informed,
4 regulated firms have better information about the cost and demand attributes
5 they face, and regulated firms will use this information advantage to their
6 benefit (Incentive Regulation and Its Application to Electricity Networks,
7 Review of Network Economics, December 2008, p. 547).

8 Joskow is generally enthusiastic about deregulation, so the tone of his remarks can be
9 disregarded, but his observation about the importance of asymmetric information is
10 critical and applies to many situations where the parties have important “private”
11 information.

12
13 In this case, it suggests caution about accepting the specific details of the incentive
14 mechanism included in the proposed settlement because the utility almost certainly has
15 better information about the value potential of this opportunity. On the other hand, there
16 may be a substantial opportunity to manage fuel costs down to the benefit of all parties.
17 If more time were available, I would advocate considering the implications of some of
18 the more recent academic developments in mechanism design, including the work of
19 Roger Myerson and Alvine Roth (both recent Nobel laureates).

20
21 One relatively conservative way to seek this opportunity without taking the risk of
22 creating windfall profits might be to reduce the incentive share in the top tier from 50%
23 to 20% (as in the current mechanism), while accepting the other terms of the new

1 mechanism as proposed in the settlement offer, except perhaps the outsourcing option.
2 This would broaden the scope of the mechanism and provide a substantial incentive, but
3 also insure that gains derived from assets in the rate base are primarily received by the
4 ratepayers. It would provide a more measured transition from the current situation and
5 less risk.

6
7 As explained in my response to Staff's First Interrogatory, it is my opinion that the
8 proposed incentive mechanism be should be considered in this case, and not in a separate
9 generic proceeding. There is no reason to believe that an optimal incentive mechanism
10 for FPL would also be optimal for other electric utilities in Florida. A "one size fits all"
11 incentive would likely fit badly, and the size of FPL's customer base warrants an
12 efficient incentive mechanism.

13

14 **Q 5. Is the proposed Settlement Agreement in the public interest?**

15 **A** Not as it stands. All of the settlement issues discussed above individually provide
16 substantial new opportunities for FPL to increase its profits without providing a
17 reasonable balance of benefits to ratepayers. Taken together, they are mutually
18 reinforcing and exacerbate the imbalance, creating a risk of blowback in future years
19 when the results of the decisions in this case become obvious.

20

21 Issues two and three concern provisions that would allow FPL to manage earnings by
22 manipulating amortization of certain reserve accounts and shield the company from
23 any depreciation or dismantlement studies during the term of the agreement. They

1 are not separately discussed in this testimony, but they are undesirable as they create
2 a lack of transparency about how ROE is generated and could facilitate steering
3 reported earnings to maximize profits, while avoiding tripping the trigger at the top
4 of the allowed ROE range. When a reserve account is used for purposes other than
5 those for which it was established, it is sometimes referred to as a “slush fund.”

6
7 As proposed the GBRA would benefit FPL by eliminating the risk of regulatory lag,
8 bypassing rate cases and imposing financing at a very high 60.969% equity ratio for
9 incremental investor capital for three new combined cycle gas generation facilities
10 that should have a much lower risk profile than nuclear, coal or other alternative
11 technologies. This exposes ratepayers to forgoing regulatory lag benefits that could
12 amount to \$300 million, and paying for equity gross-up costs of about \$130 million
13 in the first year of operation and a slowly declining repeat cost each year the units
14 are in service. Reductions in the corporate income tax are being seriously proposed
15 that could cut some of this burden, but it unclear if the benefits would in fact flow
16 through to ratepayers if these taxes are reduced.

17
18 The Incentive Mechanism is an excellent concept, but the fixed threshold and the
19 outsourcing option are questionable. The above-threshold incentive fees appear very
20 rich and could lead to windfall profits.

21
22
23

1 **A Please summarize your testimony.**

2 **A** Overall, the settlement agreement is even less balanced than the original FPL
3 proposal. I suggest four concrete adjustments to improve the balance of the
4 proposed settlement.

5

6 1. Reduce the incremental investor capital equity ratio for the GBRA from 60.969%
7 to 50.00%.

8

9 2. Insert specific provisions to insure that any reductions in state or federal income
10 tax rates immediately and completely flow through to ratepayers by adjusting
11 the base rate.

12

13 3. Eliminate the provisions for adjustable amortization of reserve accounts.

14

15 4. Adjust the top incentive rate in the incentive mechanism down from 50% to 20%
16 and consider eliminating or putting some restrictions on the outsourcing option.

17

18 If the proposed settlement is not substantially improved it should be rejected.

19

20

21

