



Docket No. 041272
Witness: Javier Portuondo
Exhibit ___ (JP-6)
PEF Response to Jan. 31, 2005
Final Audit Report

February 11, 2005

Denise N. Vandiver, Chief, Bureau of Auditing
State of Florida, Public Service Commission
Capital Circle Office Center
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Docket No.: 041272-EI; Audit of storm recovery costs charged to Account 228.1
Storm Insurance Property Reserve, Audit Control No.: 04-343-2-1

Dear Denise:

I am filing on behalf of Florida Power Corporation d/b/a Progress Energy Florida, Inc. ("PEF" or the "Company"), this response to the final audit report of the Company's storm costs dated January 31, 2005 that was filed by Jocelyn Y. Stephens, Audit Manager, and Joseph W. Rohrbacher, Tampa District Supervisor. We welcome the opportunity to respond to the audit.

It is important to keep in mind that the audit was limited in scope. The auditors readily admit in the report that substantial additional work must be done by them to satisfy generally accepted auditing standards. The limited nature of the audit necessarily resulted in the auditors making assumptions about the nature of the estimates of storm costs that they might not have made if they had a more complete understanding of the historical background and bases for the storm damage reserve and the costs applied to the reserve. I explain below what these assumptions are and why they are inaccurate or unsupported by the auditors in our response to each finding.

It is also important to remember the audit is of our storm cost estimates. The fact that we are still working with estimates explains a number of the findings by the auditors regarding the lack of documentation for the allocations of actual costs. As noted below, we have not allocated costs yet precisely because we are still dealing with estimates and not actual costs. We are continuing to receive and process invoices for storm-related costs and have always made clear that our cost estimates must be trued-up as we review and process the invoices.

Progress Energy Service Company, LLC
P.O. Box 14042
St. Petersburg, FL 33733
TPA#1984902.1

Turning to each numbered audit disclosure and conclusion in the audit report, we have the following response:

Audit Disclosure No. 1
Subject: Capital Estimate

Audit Conclusion: The staff auditors claim that they were unable to verify an allocation of costs between operation and maintenance ("O&M") and capital in Account 1861900 because there is no such allocation in Account 1861900.

Response:

Currently, all actual costs are being booked to Account 1861900, which is a clearing account. After all of the actual costs have been booked and all costs analyzed, an appropriate entry will be made to clear out Account 1861900 and move the storm related O&M and Capital to the appropriate accounts. The auditors cannot verify the allocation of costs between O&M and capital items in Account 1861900 because Account 1861900 contains all costs, and an allocation of the costs to O&M and Capital has not yet occurred.

An adjustment will be made from Account 1861900 to Account 1071000 to book all actual capital expense that have been incurred as a result of the storms, and the O&M costs will be booked against the Storm Damage Reserve. Consistent with my testimony in Docket No. 041272-EI, only those capital expenditures above the level of what would have been incurred under normal operating conditions, whether related to labor or materials, will be classified as O&M and charged to the Storm Damage Reserve. All other storm-related capital expenditures will be included in ongoing surveillance reports to the Florida Public Service Commission ("Commission") and will be absorbed by the Company in current base rates until the next base rate adjustment. The classification of the costs above normal operating conditions to install plant as a result of the storms as O&M costs charged to the storm damage reserve benefits our customers because the Company is not booking the higher costs paid during the hurricanes, such as overtime and premium labor rates, as capital investment upon which the Company will earn a return. Rather, the classification of such costs as O&M means the Company will only recover its actual costs and not a return on an investment base that is larger simply because of the extraordinary storm conditions. Further, the book value of capital investments for capital expenditures that are not charged to storm-related O&M costs that have been retired due to storm damage will be charged against the accumulated depreciation reserve. Ultimately, we will make appropriate entries to retire assets damaged by the respective storms in accordance with the accounting rule approved by the Commission. This future allocation process for the storm-related costs to O&M and Capital costs was explained to the auditors but is not reported in the final audit.

Audit Disclosure No. 2
Subject: Payroll

Audit Finding No. 1: The Company included base/regular labor costs in its storm damage estimate.

Response:

This finding is accurate but the inclusion of all labor costs incurred for the storms in our storm cost estimate is consistent with Commission orders, policy, and utility practice, as I explain below. The auditor's recommendation that PEF's payroll charges should be adjusted to remove base/regular costs incorrectly assumes that PEF's budgets include costs to address catastrophic storms like the series of back-to-back hurricanes in 2004. The only costs budgeted by PEF for major storm restoration in the current year was the \$6 million charged to the storm reserve account. The annual accrual to the reserve represents the expected cost of major storm restoration and is the aggregate representation of the types of costs the Company indicated would be charged to the reserve and which the Commission approved. The annual accrual, then, necessarily covers all types of direct storm costs, including labor costs, to some extent. PEF agrees that the budgeted storm costs represented by the annual accrual to the storm reserve should be deducted from the Company's request for recovery of its extraordinary storm costs. The annual accrual for the current period and the cumulative balance in the reserve have been deducted from our request for recovery of the deficiency in the reserve.

PEF seeks to recover only those storm-related expenses that exceed the reserve in accordance with the Commission's policy for accounting for such expenses under which the Company includes all actual repair activities and those activities directly associated with storm damage and restoration activities in expenses charged to the Storm Damage Reserve, as explained on page 10 of my testimony in Docket No. 041272-EI and as approved by the Commission in Docket 930867-EI.

Direct costs typically are payroll, transportation, materials and supplies, and other services necessary to locate and repair or replace damaged property. Payroll includes labor charges for those employees involved in actual repair activities as well as those in support roles such as customer service, engineering, storeroom, and transportation personnel. A more detailed list of examples of the type of costs the Company charges to the storm damage reserve can be found in my testimony in Docket No. 041272-EI. But labor costs include overtime or premium pay for employees dedicated to repair activities such as line crews, storeroom, engineering, and transportation personnel, payroll loading for associated taxes, administrative costs, and employee benefits.

These direct costs represent the replacement cost method that was the basis for the Company's all risk coverage when transmission and distribution ("T&D") coverage was available, as explained in the testimony of John Scardino in Docket No. 930867-EI at pages 4 and 5. Mr. Scardino further explained at page 13 of his testimony in that Docket that the self insurance program proposed by the Company and accepted by the Commission was a replacement of its current insurance program with the cost of the self insurance program to be borne by all customers. The Storm Damage Reserve under the Company's self insurance plan covered, according to Mr. Scardino at page 9, all losses incurred not otherwise covered by insurance for any destructive acts of nature. The Commission agreed in PSC Order No. PSC-93-1522-FOF-EI, at page 3, ruling that the Storm Damage Reserve would be used to cover storm damage experience for all losses not covered by insurance, including Transmission and Distribution lines and deductibles associated with other property insurance.

In Order No. PSC-93-1522-FOF-EI, at page 5, the Commission further required the Company to file a study to determine the appropriate storm damage expense to be accrued to the reserve. PEF filed its Study for Storm Damage Accrual, and at page 9, the Company made clear that it proposed to use a replacement cost methodology consistent with its prior coverage under traditional T&D all risk insurance. The Company explained, also at page 9, that the "replacement cost approach assumes that the total cost of restoration and related activities will be charged against the storm damage reserve." Only indirect costs would not be charged to the reserve but all direct costs, typically payroll, transportation, materials and supplies, and other services necessary to locate and repair or replace damaged property, would be charged to the reserve. At Exhibit 3 to its Study, the Company provided a detailed list of the types of costs the Company believed would be directly associated with storm damage and restoration activities. This list mirrors the list of costs identified above and in my testimony in Docket 041272-EI. PEF's Study was filed with the Commission on March 17, 1994, in accordance with the Commission's Order in Docket No. 930867-EI.

PEF's Study for Storm Damage Accrual was received without objection by the Commission and, in Order No. PSC-94-0852-FOF-EI in Docket No. 94061-EI dated July 13, 1994, the Commission approved an increase in the annual accrual to the Storm Damage Reserve based on PEF's Study. Consistent with Commission policy in Orders No. PSC-93-1522-FOF-EI and No. PSC-94-0852-FOF-EI regarding what costs can be charged against the Storm Damage Reserve, the Company has charged all direct costs associated with Hurricanes Erin (1995), Floyd (1999), and Gabrielle (2001) against the Storm Damage Reserve.

The nature of the direct costs incurred by the Company as a result of Hurricanes Charley, Frances, Ivan, and Jeanne are no different from the direct costs identified in the testimony of John Scardino in Docket No. 930867-EI, the Company's Study filed with the Commission in accordance with the Commission's Order in Docket No. 930867-EI, and the costs incurred by the Company in Hurricanes Erin, Floyd, and Gabrielle and charged against the Storm Damage Reserve without question. Consistent with prior Commission policy, all costs directly associated

with the Company's storm damage restoration and related activities for Hurricanes Charley, Frances, Ivan, and Jeanne, including labor costs for Company employees working on the storms, have been and should be charged to the Storm Damage Reserve and recovered from the customers who benefited from the activities related to the Company's storm restoration efforts.

Moreover, the work of the Company does not end when a catastrophic storm event occurs like the 2004 hurricanes. Employees re-assigned from their daily responsibilities to storm preparation, restoration, and/or recovery work must return to those responsibilities when the work to prepare for, respond to, and recover from the hurricanes is over. For example, customer reconnects and new customer connections postponed due to the hurricanes must be performed at the same time as currently scheduled reconnects or new customer connections requiring the investment of regular, overtime hours, and extra contract labor, and the use of materials and supplies, to complete the work. Company employees, therefore, will continue to perform all work required of them prior to and after the hurricanes as part of their job responsibilities for the Company.

Audit Finding No. 2: Exempt employees (those not subject to overtime) in certain instances received overtime pay.

Response:

This finding is inaccurate because 'Exempt' employees receive extended pay, not overtime pay. The Company has an Extended Policy provision that has been in place since the early 1990's, which is used for special projects, including storms and outages where employees are required to work long hours for extended periods of time. It is only used for exempt employees that meet the requirements of a certain job value. Also, the Policy provides for extended pay only for time worked in excess of 40 hours per week with a maximum of 72 hours of extended pay. Extended pay is paid at a straight hourly rate under the Policy.

The Extended Policy was implemented for the 2004 hurricanes in Florida. The auditors recommend that this charge should be removed from payroll charges for the storm damage. However, this is another direct cost incurred by the Company as a result of Hurricanes Charley, Frances, Ivan, and Jeanne and is properly charged as a storm-related cost against the Storm Damage Reserve for all of the reasons that I explained in response to Audit Finding No. 1 above.

Audit Finding No. 3: The Company could not provide a schedule that accurately segregated total hours worked between regular and overtime charges.

Response:

The PSC audit staff requested (#29) a report containing payroll costs by total hours worked, by department and job title, by project, and by resource type, which further segregated the payroll type (e.g. bargaining unit, non-bargaining unit, etc.) into either Regular or Overtime hours and rates by cost category (e.g., materials, advertising, contract labor, etc.).

The requested segregation of payroll by resource type providing Regular and Overtime was provided but not understood by Audit. This could be because bargaining unit employees receive double-time pay. This occurs when employees are working shifts where they get less than eight hours rest between shifts. Based on the nature of the storms this occurred frequently during and following most of the hurricanes as our employees worked around the clock to restore power to customers. Given that the hours are compensated at a rate greater than their straight time, PEF considers this to be overtime.

For our non-bargaining unit employees, double time is paid at straight pay (1 times the rate) and the double-time hours are included in the Regular (Resource Type: EBC) and Overtime (Resource Type: EBO) categories the staff auditors requested. The total hours are correct in our records, but you cannot assume, as the staff auditors did, that 80 hours is always Regular time in the resource type format they requested because of the double-time pay issue.

Audit Disclosure No. 3
Subject: Removal Labor Costs

Audit Conclusion: The staff auditors recommend an adjustment of \$1,677,449 for Company-identified costs of removal of damaged plant in the storms from O&M to Capital.

The revised capital estimate includes \$1.67 million for Capital Cost of removal. It was our intent all along to make sure that the cost of removal was removed from the total final storm costs as well as any other capital related expenditures. Given that we are still working with estimates, PEF believes it is unnecessary to make any adjustment at this time. This will all be addressed as we true up our estimate against actual invoices.

When the final cost of all hurricane replacement assets installed is calculated, PEF will record a charge for all calculated removal costs. To date this transaction has not been recorded as a final cost because all work has not been completed related to all fixed asset replacements, and all invoices for storm-related work have not been received. The removal costs will be treated similarly to the replacement of fixed assets and will not be applied to the storm damage fund.

Public Service Commission
Docket No. 041272
February 11, 2005
Page 7 of 8

Audit Disclosure No. 4
Subject: Monthly Comparison of Operations Expenses

Audit Conclusion: The staff auditors compare year-to-date actual costs to prior year-to-date actual costs and the month of September 2004 actual costs against the September 2004 budget and question the costs charged to the storm damage reserve, although they concede further analysis is required to determine if “normal, recurring” charges are included.

Response:

This comparison by Staff has no bearing on what we have actually incurred in storm-related costs. Any ascertainment or derivation of the budget is irrelevant and immaterial to any issue in this Docket because (1) the Company does not and cannot budget for catastrophic storms; (2) the Company’s annual budgets are just that, annual budgets, and therefore do not accurately reflect actual costs incurred for work performed on any particular day for the Company for a variety of reasons, for example, changes in the volume or nature of Company requests for service; and (3) the Company’s work is continuing such that Company employees will complete work they were diverted from due to the storms as well as their current work as part of the on-going work of the company in providing efficient, effective service to its customers.

Moreover, for all of the reasons that I explained in response to Audit Disclosure No. 2 above, we are entitled to the recovery of our direct storm-related costs of our employees, equipment, vehicles, materials, and supplies diverted to the monumental task of preparing for, responding to, and recovering from the catastrophic 2004 hurricane season under our self-insurance program approved by the Commission, Commission orders, policy, and practice.

Audit Disclosure No. 5
Subject: Damage Claims

Audit Conclusion: The staff auditors examine our accrual of \$1.5 million for potential damage claims from the four hurricanes and question whether the Company should pay one claim in the approximate amount of \$500,000 if the fire that resulted in the damage claim is found to be caused by the “undue” negligence of the Company.

Response:

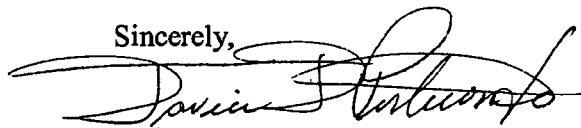
The damage claims included in our storm cost estimates represent potential payments in the future for damages arising out of the hurricanes. There has been no determination of negligence on behalf of the Company with respect to any damage claim including the one singled out by the staff auditors. For this reason alone it is improper for the auditors to assume

Public Service Commission
Docket No. 041272
February 11, 2005
Page 8 of 8

that these costs should not be included as a regular cost of doing business. It is further improper for the staff auditors, who are engaging in an audit of the Company's books and records, to draw conclusions on issues of negligence that will be determined as part of a legal, not an auditing, process.

I want to thank you for the opportunity to respond to the Final Audit Report dated January 31, 2005 in Docket No. 041272-EI.

Sincerely,

A handwritten signature in black ink, appearing to read "Javier Portuondo", written in a cursive style. The signature is positioned above the printed name.

Javier Portuondo