

**BEFORE THE FLORIDA
PUBLIC SERVICE COMMISSION**

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

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

TESTIMONY & EXHIBITS OF:

ARMANDO PIMENTEL

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1 **BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**

2 **FLORIDA POWER & LIGHT COMPANY**

3 **DIRECT TESTIMONY OF ARMANDO PIMENTEL**

4 **DOCKET NO. 080677-EI**

5

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

7 A. My name is Armando Pimentel. My business address is Florida Power & Light
8 Company, 700 Universe Boulevard, Juno Beach, Florida 33408-0420.

9 **Q. By whom are you employed and what is your position?**

10 A. I am employed by Florida Power & Light Company (“FPL” or the “Company”) as
11 Chief Financial Officer. I am also FPL Group’s Executive Vice President
12 Finance and Chief Financial Officer.

13 **Q. Please describe your duties and responsibilities in that position.**

14 A. I am responsible for the major financial areas of the Company, including the
15 accounting and control functions, tax, treasury, and risk management. I oversee
16 the establishment and maintenance of the financial plans, controls and policies for
17 FPL. I am also responsible for establishing and maintaining effective working
18 relations with the investment and banking communities, and for communicating
19 the results of our operations to investors.

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

21 A. I hold a Bachelor of Science degree in accounting from Florida State University.
22 Prior to joining FPL Group, I was a senior partner in the regulatory and public
23 policy group at Deloitte & Touche. Previously, I held audit partner positions for

1 clients in the financial services and energy industries. I was appointed to my
2 present position in May 2008.

3 **Q. Are you sponsoring or co-sponsoring any Minimum Filing Requirements**
4 **(MFRs) in this case?**

5 A. Yes. I am sponsoring the following MFRs:

- 6 • D-2, Cost of Capital – 5-Year History
- 7 • D-3, Short-Term Debt
- 8 • D-4a, Long-Term Debt Outstanding (Test, Subsequent and Prior Years)
- 9 • D-5, Preferred Stock Outstanding
- 10 • D-7, Common Stock Data
- 11 • D-8, Financing Plans - Stock and Bond Issues
- 12 • D-9, Financial Indicators – Summary

13 I am co-sponsoring the following MFRs:

- 14 • A-1, Full Revenue Requirements Increase Requested
- 15 • D-1a, Cost of Capital – 13-Month Average
- 16 • D-4b, Reacquired Bonds

17 In addition, I am sponsoring the following 2009 supplemental MFR schedule(s)
18 that FPL has agreed with the Florida Public Service Commission (“FPSC” or the
19 “Commission”) Staff and the Office of Public Counsel to file:

- 20 • D-7, Common Stock Data
- 21 • D-8, Financing Plans - Stock and Bond Issues

1 **Q. Are you sponsoring any exhibits in this case?**

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

- 3 • AP-1, Historical Credit Spreads
- 4 • AP-2, Capital Investment and Generation Capacity Additions
- 5 • AP-3, Market Capitalization
- 6 • AP-4, U.S. High Grade Credit Facilities
- 7 • AP-5, Credit Spreads Since 2005
- 8 • AP-6, Historical Capital Expenditures
- 9 • AP-7, FPL Capital Structure

10 **Q. What is the purpose of your testimony?**

11 A. My testimony supports and supplements the testimony of FPL witness Avera on
12 the appropriate Return on Equity (ROE) that should be established in this
13 proceeding; it supports the appropriate capital structure for the Company; and it
14 also describes the current financial crisis and why it is even more important today
15 for FPL to maintain its current financial position. Additionally, I discuss the need
16 to reestablish an annual accrual for the Company's reserve established pursuant to
17 Account 228.1 – Accumulated Provision for Property Insurance (Reserve) and
18 describe why FPL's proposed accrual is in the best interest of customers.

19 **Q. Please summarize your testimony.**

20 A. It is critical in today's environment for FPL to maintain its financial strength as
21 we confront the challenge of meeting significant infrastructure investment
22 requirements at a time when cost of capital has significantly increased due to

1 historically high volatility and dislocation in the global financial markets and
2 economy.

3
4 A series of events in the economic, housing and financial markets have sparked a
5 global economic recession. Since September 2008, financial markets have
6 exhibited unprecedented volatility and decreased liquidity. This volatility has led
7 investors to demand substantial increases in the risk premiums for debt and equity
8 for all utilities, but especially for those without high quality credit ratings. These
9 increased risk premiums can be seen in the spread investors require over
10 treasuries to invest in fixed income securities. As Exhibit AP-1 illustrates, while
11 credit spreads have increased for all companies, the spread to treasuries for lower
12 investment grade rated companies (BBB categories) is now significantly higher
13 than companies with stronger ratings (AAA/AA categories). This significant cost
14 difference illustrated in Exhibit AP-1 has not been seen since the Great
15 Depression and demonstrates the importance of maintaining strong credit ratings
16 during periods of market volatility.

17
18 As one of the nation's most capital intensive industries, utilities have invested and
19 must continue to invest billions of dollars to maintain reliability, replace aging
20 infrastructure and meet load growth requirements even before the unknown costs
21 of potential climate change legislation and state or federal renewable portfolio
22 requirements are taken into account. Capital expenditure projections for the
23 industry for the period of 2010 to 2030 are approximately \$1.5 trillion with the

1 southern portions of the country having a disproportionate share of projected
2 expenditures (see Exhibit AP-2). FPL alone has projected capital expenditure
3 requirements of approximately \$16 billion just over the next five years.
4 Maintaining access to the capital markets for both debt and equity financing will
5 be paramount for FPL and its customers.

6
7 FPL, along with the utility industry as a whole, relies heavily on financial
8 institutions to provide credit lines to back up commercial paper programs that
9 support daily liquidity, seasonal cash flows and ongoing construction projects.
10 FPL and the industry as a whole have benefited from several years of favorable
11 credit market conditions and a competitive banking environment providing ready
12 access to credit lines at historically low rates. However, as Moody's noted in a
13 recent publication, the current financial crisis has "materially changed the banking
14 environment for utilities going forward." (January 2009 Special Comment:
15 Moody's Global Infrastructure – Near Term Bank Credit Facility Renewals to Be
16 More Challenging for U.S. Electric and Gas Utilities.) Exhibit AP-3 provides a
17 snapshot of the magnitude of change occurring for several leading financial
18 institutions, many of whom are significant credit providers for FPL. As the
19 exhibit indicates, these institutions alone have lost more than a trillion dollars of
20 market capitalization since January 1, 2007. Remarkably, this loss has occurred
21 after nearly \$500 billion of equity infusion from outside sources.

1 The impact of this reduced capacity in the banking environment on new credit
2 lines being offered by the banking industry has been significant. As can be seen
3 in Exhibit AP-4, new credit lines provided in 2008 declined by over 50% with the
4 most significant reduction in multi-year facilities. Today, new facilities have
5 been shortened from up to five years to almost exclusively less than one year.
6 The access to capital and the availability of credit will be constrained for some
7 time to come. Maintaining FPL's financial strength will put the Company in the
8 best position to compete for what will likely be a substantially reduced pool of
9 available liquidity.

10
11 For FPL to maintain the necessary financial strength to support our obligation to
12 serve our customers, the Company asks the Commission to: (1) maintain FPL's
13 current 55.8% adjusted equity ratio; (2) set rates with an allowed rate of return of
14 12.5%, which is the mid-point of FPL witness Avera's recommended rate of
15 return on equity range of 12.0% to 13.0%; and (3) reestablish the annual accrual
16 to the Reserve at a level of \$150 million.

17
18 Today's environment clearly illustrates the need for FPL to maintain a strong
19 financial position to benefit customers. FPL's recommendations would keep FPL
20 in a strong financial position - able to protect its credit rating, attract new capital
21 in both the debt and equity markets on reasonable terms, finance future system
22 expansion at a reasonable cost, and respond with the flexibility needed to manage
23 unforeseen events. Finally, FPL's recommendation on the annual Reserve accrual

1 will allow FPL to achieve and maintain a reasonable plan for responding to
2 storms in our service territory. In the long run, all of these things add up to
3 delivering reliable electric service at the lowest reasonable costs to our customers.
4

5 STATUS OF CURRENT FINANCIAL MARKETS

6
7 **Q. Is it appropriate for the Commission to consider the status of the current**
8 **financial markets?**

9 A. It is more than just appropriate; it is imperative that the Commission do so. These
10 issues have a real and direct impact on FPL's cost of capital, and must be
11 considered in order to determine a fair and reasonable rate of return on common
12 equity for FPL. The United States Supreme Court has explained the factors a
13 Commission must consider in reaching a determination on a particular utility's
14 rate of return. Specifically, an appropriate ROE is one that is commensurate with
15 the returns being earned on investments in businesses with similar risks and
16 uncertainties. Additionally, the return should be reasonably sufficient to assure
17 confidence in the financial soundness of the utility, to maintain and support its
18 credit, and to enable it to raise the money necessary to serve its customers. These
19 considerations are significantly affected by current market conditions and those of
20 the foreseeable future.

21 **Q. Please describe the current status of the financial markets.**

22 A. The second half of 2008 marked a period of unprecedented volatility and
23 decreased liquidity in the financial markets. During this time, financial
24 institutions experienced significant liquidity issues caused by the depressed

1 housing market and their exposure to sub prime mortgage losses. On September
2 7, 2008, the U.S. government took over operations of Fannie Mae and Freddie
3 Mac via conservatorship. The liquidity/credit crisis became even more acute with
4 Lehman Brothers declaration of bankruptcy, the announcement of Bank of
5 America's purchase of Merrill Lynch and the required bailout of AIG all within a
6 short period of time last Fall. The market experienced an extreme "flight to
7 quality" as investors withdrew several hundred billion dollars from mutual funds
8 over a two-to three-day period moving into treasuries, repurchase agreements
9 (backed by treasuries) and treasury funds. Mutual funds were forced to sell off
10 significant portions of their portfolios to meet redemption requests.

11
12 This massive movement of cash out of prime mutual funds ultimately caused the
13 Reserve Primary Fund, with assets prior to the market disruption of approximately
14 \$65 billion to suspend distributions on September 15, 2008 and announce that the
15 fund's net asset value had dipped below \$1.00 per share. This was only the
16 second time in history that a prime mutual fund had its value drop below \$1.00
17 per share. Several other mutual funds subsequently suspended withdrawals.

18
19 Since that time, the short-term and long-term debt markets have been extremely
20 volatile and at times have lacked the liquidity necessary for an efficient market
21 structure. Mutual funds are some of the largest investors in corporate commercial
22 paper. The unprecedented shrinkage of these funds essentially dried up a major
23 source of short-term funding for many companies. Although several government

1 programs have been put in place to improve market liquidity, they have not yet
2 had a significant impact as investor confidence has not been restored. Treasury
3 rates have fallen significantly due to investors' current lack of tolerance for risk,
4 while credit spreads (the return investors require over and above treasuries to
5 compensate for the difference in credit quality between a particular corporate
6 security and a U.S. government-backed security) have increased dramatically.

7 **Q. How is FPL weathering the current liquidity crisis?**

8 A. FPL's strong balance sheet, liquidity position and credit ratings have enabled the
9 company to weather the significant events in the financial markets as we have
10 seen over the past year without compromising our ability to continue to provide
11 reliable, cost-effective service to our customers. In fact, those strengths have
12 enabled the Company to maintain access to capital throughout the current
13 financial crisis.

14 **Q. How does FPL's access to the capital markets compare to others in the
15 industry?**

16 A. There has been a significant difference in the market access afforded to corporate
17 issuers in the short-term markets during this financial crisis. Our strong short-
18 term credit ratings ("A-1/P-1/F-1") supported by \$2.75 billion in back-up credit
19 facilities which I will detail later in my testimony, have enabled us to maintain
20 continued access to the commercial paper markets.

21

22 In contrast, some corporate issuers with "A-2/P-2/F-2" rated commercial paper
23 programs have seen significant increases in commercial paper rates and their

1 access to the market restricted to an overnight or very short-dated basis. As a
2 result, many in our industry drew down on their credit facilities, utilizing back-up
3 liquidity sources and leaving themselves more vulnerable to potential liquidity
4 problems.

5
6 Long-term credit markets have been similarly challenged. Debt issuances have
7 generally been available only for issuers with higher credit ratings and with credit
8 spreads (the additional cost paid in excess of U.S. Government securities) that are
9 substantially above historical amounts.

10 **Q. Can this financial crisis be considered a one time event?**

11 A. No. Economic recessions have occurred rather frequently over the past eighty
12 years. In fact, since 1925, the U.S. economy has experienced fifteen recessionary
13 periods as can be seen on Exhibit AP-1. While economic recessions are not
14 unusual events, the magnitude and the impact of the current economic recession is
15 unusual. As can be seen on Exhibit AP-1, we have not experienced a widening of
16 credit spreads (the risk premium investors require over U.S. Treasury securities)
17 like today since the Great Depression.

18 **Q. Can this financial crisis be considered a short-lived event?**

19 A. Not at all. While market liquidity has improved somewhat, there will be long-
20 lasting effects from the current crisis. The financial services industry is currently
21 undergoing an unprecedented consolidation of financial institutions. In addition,
22 the banking industry, weakened by substantial write-offs is reducing leverage to
23 meet regulatory capital requirements. These actions are resulting in a significant

1 reduction in the amount and tenor of new bank lines being provided. Very few
2 new bank credit lines are being made available, and the maturities have been
3 shortened from up to five years to almost exclusively less than one year. For
4 example, U.S. high grade credit extended by financial institutions declined by
5 52% in 2008 from \$987 billion in 2007 to \$471 billion in 2008. The decline was
6 most pronounced in multi-year credit facilities (similar to FPL's) which declined
7 by 72% from 2007 to 2008 (see Exhibit AP-4). As the availability of credit has
8 become more constrained, the cost to obtain new credit lines has increased
9 significantly.

10
11 The utility industry relies heavily on credit lines to back up commercial paper
12 programs that support daily liquidity, seasonal cash flows and ongoing
13 construction projects. As Moody's Investors Service noted in a January 2009
14 Special Comment: Moody's Global Infrastructure – Near Term Bank Credit
15 Facility Renewals to Be More Challenging for U.S. Electric and Gas Utilities:

16 Unsettled credit and financial market conditions in 2008 have
17 dramatically reshaped the banking environment for utilities going
18 forward, which will make upcoming credit facility renewals
19 significantly more challenging. The banking sector, both in the
20 U.S. and on global basis, is being largely reshaped through a
21 combination of bank failures, massive government intervention in
22 some institutions, and large scale mergers of banks and other
23 financial institutions. The result has been a significant contraction

1 in the bank market and a substantial decline in the number of banks
2 available to provide credit to the utility sector. Those that remain
3 will be constrained in both their ability and inclination to provide
4 credit, as most will be focused on restoring their own balance
5 sheets and are likely to be less willing to renew and extend existing
6 credit facilities, especially at their current low pricing levels and
7 liberal terms and conditions. As a result, a broad “repricing” of
8 bank credit has begun, which will lead to sharply higher pricing for
9 these credit facilities. Utilities may also have to downsize their
10 credit facilities from their current levels as a result of these
11 developments. The consequences of this transformation of the
12 bank credit environment are likely to be profound for the U.S.
13 electric and gas utility sector.

14
15 Current market conditions reinforce the need to maintain a strong financial
16 position to plan for the unforeseen events that may materialize in the future.
17 These events extend beyond the financial markets and include the Company’s
18 ability to absorb financial shocks such as those associated with extraordinary
19 hurricane activity and volatile fuel pricing. A combination of improbable and/or
20 unforeseen events could impact FPL’s ability to serve customers on favorable
21 terms if its current financial strength is not maintained.

FPL'S CURRENT FINANCIAL CONDITION

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Q. Please describe FPL's current financial position and credit profile.

A. Our current financial position is strong. FPL currently has high-quality investment grade ratings from the three major credit rating agencies. FPL's corporate credit rating is A/A1/A from Standard and Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch), respectively. All three agencies currently have a stable outlook on the company.

FPL's commercial paper program is rated "A-1/P-1/F-1," by S&P, Moody's and Fitch, respectively. These ratings have provided FPL access to commercial paper at reasonable rates.

FPL's strong liquidity position and short-term ratings are supported by \$2.75 billion of available liquidity from FPL's \$2.5 billion credit facility and a \$250 million available term loan. These facilities are in place to back up commercial paper issuance and support the credit requirements of the fuel hedging program. Approximately 38 different banks participate in FPL's credit facility. This large bank group relationship diminishes the impact of the failure of any particular institution on FPL's ability to maintain current liquidity.

Q. Why is it important to maintain a strong financial position?

A. The most important benefits of a strong financial position are flexibility and security. Flexibility is a crucial element of FPL's ability to manage risk. The

1 statutory obligation to serve all customers at their desired level of demand,
2 coupled with the uncertainty inherent in unforeseen events such as the current
3 financial crisis and active storm seasons experienced in 2004 and 2005, mean that
4 FPL must go to the capital markets as service needs dictate rather than at the point
5 in time that might be the most advantageous from a market perspective. The
6 inability to time market entry is somewhat offset by a strong financial position.
7 Balance sheet strength and flexibility are also important factors in our ability to
8 manage unexpected financial shocks.

9
10 With respect to the security that a strong financial position affords, it is helpful to
11 think of a strong financial position as an insurance policy. The owner of an
12 insurance policy incurs a relatively modest, regular cost to protect against the
13 occasional or unforeseen high-cost, highly negative event. Health insurance, for
14 example, requires regular payments but protects the insured against the high cost
15 of a serious illness or injury. Similarly, FPL's financial position, supported by the
16 opportunity to achieve an adequate ROE, helps to protect against financial market
17 volatility, capital scarcity, and the increased costs some entities realize as a result.
18 One could certainly argue that so long as the insured is healthy, the short-term
19 cost of health insurance outweighs the benefits received. However, that would be
20 a very short-sighted view, and fails to recognize that the value of insurance is in
21 its protection against uncertain events. A strong financial position will help
22 protect FPL and its customers from the adverse effects of current and future
23 financial market volatility.

1 **Q. Why is financial strength more important today?**

2 A. Two aspects of the current environment increase the importance of maintaining a
3 strong balance sheet. First, the electric industry is at the beginning of a significant
4 investment cycle. Capital expenditure requirements for the industry have
5 increased significantly over the past several years as shown on Exhibit AP-6.
6 This need for substantial amounts of capital is occurring simultaneously with a
7 significant contraction in the credit markets as a result of the current economic
8 crisis.

9 **Q. How does financial strength impact liquidity and access to capital markets?**

10 A. Utilities, like other large corporations, generally depend on commercial paper to
11 provide an inexpensive (relative to long-term debt) and fluid source of funds to
12 meet seasonal short-term cash needs. Investors in commercial paper generally
13 rely on short-term ratings provided by the credit rating agencies. Historically,
14 companies with “A-1/P-1/F-1” ratings and above have been able to access the
15 commercial paper market even during times of decreased liquidity. After the
16 Lehman bankruptcy announcement in September 2008, many companies with
17 lower short-term ratings experienced difficulties issuing commercial paper at rates
18 and terms they were historically able to obtain.

19
20 Companies with “A-2/P-2/F-2” ratings generally find a smaller pool of investors,
21 as many investors are restricted to purchase only “A-1/P-1/F-1” paper. A smaller
22 pool of investors typically indicates higher rates and reduced availability of funds.

1 Access to the commercial paper markets is crucial in order for FPL to meet its
2 obligation to serve its customers. It serves an important purpose at FPL to meet
3 short-term cash needs necessary to support daily operations. It is used to support
4 storm restoration activities, fuel under-recoveries and is a bridge for liquidity
5 needs until more permanent financing can be issued.

6
7 It is equally important for FPL to maintain access to long-term debt markets. FPL
8 has an obligation to serve its customers and invest in long-lived assets to support
9 that obligation. Access to long-term capital markets to finance those long-lived
10 assets is just as important and our strong financial position allows the Company
11 that access.

12 **Q. How do customers benefit from FPL's strong financial position?**

13 A. Our strong financial position gives FPL access to capital markets at reasonable
14 rates. For instance, FPL has issued \$2.2 billion of debt with coupon rates that
15 average 5.7% and maturities of thirty years since January 2005 to retire higher
16 cost debt and fund future capital requirements. Our credit spreads (the additional
17 cost FPL pays in excess of U.S. Government securities) are among the lowest in
18 the industry. Customers will continue to benefit from these attractive debt
19 financings for many years to come. In addition, we expect to issue nearly \$6
20 billion of new debt securities over the next five years to help finance capital
21 expenditure requirements of approximately \$16 billion as well as refinance
22 maturing debt. The ability to support our capital expenditure program requires
23 access to capital on reasonable terms. Customers benefit because our strong

1 financial position allows us access to capital on reasonable terms relative to others
2 in the industry. Maintaining FPL's financial strength translates into better access
3 and lower costs, benefiting customers in much the same way that a household
4 with good credit benefits from better and lower cost access to credit.

5
6 FPL maintains credit facilities to back-up its commercial paper program and
7 procurement obligations related to the fuel hedging program. This fuel hedging
8 program is key to reducing the volatility of customer bills by locking in fuel
9 prices for a portion of FPL's fuel requirements. The Company could not execute
10 such a large fuel hedging program without extensive credit support. FPL's strong
11 financial position enabled the Company to upsize its credit facility in 2007 by
12 \$500 million to \$2.5 billion, in order to accommodate our expanded fuel hedging
13 program. FPL's credit facility, combined with our current ratings and strong
14 financial position, allow us to support collateral calls related to our fuel hedging
15 program primarily with company guarantees and low-cost letters of credit instead
16 of cash collateral required of many companies whose financial positions are not as
17 strong. Additionally, FPL's strong financial position reduces the total amount of
18 collateral required to support the fuel hedging program. For example, FPL had
19 \$719 million in letters of credit outstanding as of January 31, 2009 for margin
20 requirements related to the fuel hedging program. If instead of being in a strong
21 credit position, FPL were rated two notches lower by one of the credit agencies,
22 that collateral requirement would increase to over \$1.1 billion to support FPL's
23 fuel purchases.

1 **Q. What conclusion should the Commission draw about FPL's current financial**
2 **position?**

3 A. Our current financial position provides the necessary financial strength and
4 flexibility to accommodate the inherent uncertainties of the industry, taking due
5 regard of the risk factors affecting the industry and the Company today, and is of
6 benefit to our customers. Given the current financial crisis, the benefits of this
7 strong financial position have never been more apparent and important. The
8 benefits of a strong financial position can be seen in the current difference in
9 credit spreads afforded higher rated issuers in today's market as illustrated on
10 Exhibit AP- 5. It is critical that a strong financial position be maintained through
11 the provision of an adequate allowed return on equity and an appropriate equity
12 ratio, as reflected in the recommendations made later in my testimony.
13 Weakening in any of these areas would clearly be perceived by investors as a
14 decline in our overall financial strength, thereby affecting our access to capital at
15 reasonable rates at a time when external financing requirements will be
16 substantial. It will also jeopardize the Company's ability to use its financial
17 strength to reduce volatility in customer bills through activities such as fuel
18 hedging and would ultimately undermine our ability to provide highly reliable
19 service at costs below industry averages. The increase in base rates requested will
20 ensure financial stability and continued financial viability.

RETURN ON EQUITY

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Q. What is your recommendation for a return on equity?

A. I have reviewed the analysis performed by FPL witness Avera and concur with his recommendation that the cost of equity for FPL is between 12.0% and 13.0%. I recommend that rates be set at the mid-point of 12.5%.

Q. What should the Commission consider in determining the Company's ROE?

A. A Company's ROE is an important indicator of both the economic return that the Company can provide to its equity holders and the overall financial strength of the enterprise. It is self-evident that any company must provide a prospective return to shareholders that is at least as good as the return that the shareholders could expect to earn on an investment of equal risk characteristics. Failure to do so will result in a loss of equity value and the inability to access capital markets at a reasonable cost. As I understand the Commission's task, it is, among other things, to look at risk through the eyes of current and potential equity investors and to set an allowed ROE that, if achieved by the Company, will induce the needed level of investment at the lowest reasonable cost and fairly compensate equity holders for the utilization of their assets. This level of ROE, if achieved by the Company, coupled with prudent management of the capital structure, will also satisfy investors' requirements for financial strength.

Investors' requirements at any particular point in time are set both by general conditions and risks and by company-specific conditions and risks. Virtually all

1 conditions affect both debt holders and equity holders; however, they may affect
2 these classes of investors differently. Therefore, the Commission should look to
3 all the risk factors affecting a company when setting an allowed ROE, and
4 emphasize those that have the greatest impact on equity holders.

5 **Q. What general risk factors should the Commission consider in determining**
6 **the Company's ROE?**

7 A. As a regulated utility, FPL is not exempt from risk. FPL operates under a
8 regulatory compact that mitigates some risks, but at the same time augments
9 others. For example, unlike an unregulated business, FPL is obligated to invest in
10 expanding its system to serve new load, even if the timing is not opportune for
11 such investments. Moreover, unregulated firms have the flexibility to raise prices
12 on their own when necessary to address inflationary cost increases. Finally,
13 regulated utilities have limitations on their allowed returns that have no
14 counterpart for unregulated firms. All of these risk factors should be considered
15 by the Commission in determining FPL's ROE.

16 **Q. Can you please specify these general risk factors?**

17 A. Yes, there are two broad categories of risk that I will discuss: economic risks and
18 utility operating risks. The financial success of all companies, including FPL, is
19 influenced by the growth rate of the economy, the inflation rate, and general
20 unemployment levels. Unfortunately, these conditions have significantly
21 deteriorated since our last filing in 2005. Economic events have worsened
22 nationally and are having a disproportionate effect here in Florida. The housing
23 crisis has severely affected economic conditions in Florida and we have seen a

1 slowdown in growth in the state. Additionally, Florida is a tourist-dependent state
2 that relies greatly on intangibles like consumer confidence as a driver of economic
3 activity. I discuss the slowdown in FPL's customer growth later on in my
4 testimony when I address company-specific risk factors.

5 **Q. What are the general operating risks that affect all utilities, including FPL?**

6 A. There are numerous operating risks affecting all utilities. One of the most
7 significant of these is the capital intensiveness of providing utility services. Other
8 operating risks include: changes in technology; uncertainty of long-term fuel
9 supply; increased fuel price volatility; stricter environmental control regulations
10 for items such as carbon dioxide and mercury; and strained transmission grids.

11

12 All of these operating risks create an expectation that substantial investment will
13 be required of regulated utilities for the foreseeable future. In a Fitch Ratings
14 report titled "U.S. Utilities, Power and Gas 2009 Outlook" dated December 22,
15 2008, the Agency notes:

16 "The regulatory compact is especially important in view of the
17 sector's need for capital to support its projected, large post-2008,
18 mostly non-discretionary capital spending programs. Recent
19 changes in the political landscape articulated above enhance the
20 prospects of higher environmental spending, including carbon
21 controls."

1 **Q. What is the level of the anticipated capital spending programs?**

2 A. The electric industry is at the beginning of a significant investment cycle. Capital
3 expenditure requirements for the industry have increased significantly over the
4 past several years as shown on Exhibit AP-6. It is projected that through the year
5 2030 over \$1.4 trillion in capital spending by utilities will be needed. Over \$500
6 billion is projected for generation investment with over half of that being in the
7 southern region of the country. These projections are shown on my Exhibit AP-2.

8 **Q. Why is the regulatory compact an important consideration?**

9 A. One of the essential components of the regulatory compact is the obligation to
10 serve. A regulated utility, like FPL, must make the required investment when it is
11 needed, not when it is convenient or economically advantageous to do so. This is
12 particularly critical in times of economic challenges, when unregulated companies
13 may defer capital expenditures or even constrict their current operations. A
14 regulated utility does not have these choices, a fact which is part of its overall risk
15 profile. Compounding this risk factor is the high level of future capital
16 expenditures required for the utility industry generally and the southern region
17 specifically.

18 **Q. Please identify and describe some of the company-specific risk factors that**
19 **are important in determining FPL's ROE.**

20 A. There are several Company-specific risk factors that must be addressed in
21 determining FPL's ROE:

1 **Growth**

2 The interaction of general economic uncertainty and the housing meltdown in our
3 service territory creates a particular set of risks for FPL. We have experienced a
4 slowdown in customer growth and our customer count is down to a level last seen
5 in July 2007. As FPL witness Morley indicates in her testimony, FPL's retail
6 sales are projected to decline at an average annual rate of 0.6% between 2006 and
7 2010. The extent of the slowdown in customer growth has been extremely
8 difficult to predict as evidenced by the fact that the Bureau of Economic and
9 Business Research within the University of Florida has made multiple downward
10 revisions to their projections in recent months for population growth in the state,
11 each one lower than the previous forecast. This slowdown in revenue growth
12 coupled with the uncertainty over future growth and continued need to make
13 incremental investments in infrastructure, increases risk for FPL.

14

15 **Customer Base**

16 The majority of our revenues come from our residential and commercial
17 customers. Compared to utilities across the country, Florida has a low industrial
18 load. From an investor perspective, a significant industrial load generally
19 indicates greater risk due to concentration of load within a single customer group.
20 However, the current economic recession and housing crisis are having
21 widespread negative impacts on load across FPL's entire customer base creating
22 load loss concerns on a much larger scale.

1 **Florida Economy**

2 As indicated earlier, the economic downturn is severe and the country is now
3 officially in a recession. As described in FPL witness Barrett’s testimony, the
4 Florida economy has been particularly affected by the housing and economic
5 crisis with disposable income per household declining at a much greater pace than
6 the U.S. as a whole resulting in personal bankruptcies and home foreclosures
7 more than doubling in the past two years. All of these factors have combined to
8 plunge Florida into an economic deterioration not seen since the early 1970s.

9 As a service provider to all segments of the Florida economy, we logically absorb
10 the consequences of this uncertainty, which from an investor perspective
11 represents additional company-specific risk. In a Fitch Ratings report entitled
12 “Credit Opinion: Florida Power & Light Company” dated February 12, 2008, the
13 agency notes:

14 FP&L’s service territory was one of the ‘overheated’ housing
15 markets in 2006–2007, and housing prices have declined in the
16 area. Currently, there are reported vacancies of unsold housing
17 units. These conditions in the real estate market could result in
18 slower payments and/or higher delinquencies of accounts
19 receivables, which would be made up in a subsequent tariff
20 adjustment.

1 **Capital Expenditures**

2 As I stated earlier, the utility industry as a whole is entering into a significant
3 capital expenditure cycle. FPL alone projects approximately \$16 billion of capital
4 requirements over the next five years. A significant amount of new capital is
5 being spent on large construction projects to build new generation facilities,
6 modernize existing facilities and expand the transmission system in the State.
7 These facilities will provide additional generating capacity, at lower emission
8 levels with lower costs for many years to come for FPL's customers. The
9 addition of a third West County unit in 2011 and modernizations of the Cape
10 Canaveral and Riviera plants in 2013 and 2014 will generate large fuel savings
11 over the life of the projects. However, investors view the potential for cost
12 overruns as an incremental risk for companies with significant construction
13 projects.

14
15 **Nuclear Generation**

16 FPL has four nuclear generating units: Turkey Point Units 3 and 4 and St. Lucie
17 Units 1 and 2. Together, these contribute 12% of available capacity and
18 approximately 22% of actual supply, owing to their high reliability and their low-
19 cost position in terms of economic dispatch. FPL has the highest percentage of
20 generation from nuclear resources of any utility in the state. While our customers
21 enjoy large fuel cost savings from these units, the investment community assigns
22 a higher level of risk to a utility that has nuclear units in its generating portfolio.

1 Additionally, FPL has received a need determination for two new nuclear units at
2 FPL's Turkey Point site. In general, the investment community and rating
3 agencies view new nuclear construction as a higher risk than other technologies.
4 This view is primarily driven by the long approval and construction process
5 associated with new nuclear construction as well as the size of the capital
6 requirements in relation to the utility as compared to capital requirements for
7 other generation technologies. The United States is just now resuming its pursuit
8 of nuclear power with the licensing and potential construction of new nuclear
9 plants, after a hiatus of over 30 years. In theory, this incremental risk is partly
10 offset by the regulatory rules that have been established in Florida to ensure
11 interim recovery of prudently incurred pre-construction and carrying costs on
12 construction work-in-process. However, investors remain cautious and will need
13 more time and experience with the legislation and the application of the nuclear
14 cost recovery rule to become fully committed to the development of new nuclear
15 capacity. In particular, they will closely monitor the regulatory and political
16 climate with respect to the development of new nuclear capacity in Florida. In
17 other words, we are still very early in the process.

18

19 On a total cost basis (i.e., including depreciation and a fair allowance for capital
20 recovery and assuming a risk premium for nuclear) our cost per kWh for nuclear-
21 produced power is significantly less than the equivalent cost for fossil-fueled
22 plants. It would be an inconsistent and unfair use of the rate setting process to

1 take advantage of the very large customer savings in variable cost without also
2 compensating equity holders for the risk premium associated with nuclear power.

3
4 **Fuel Supply**

5 Florida's geographic location, combined with an increasing reliance on natural
6 gas, exposes the Company to certain additional risk factors related to gas supply.
7 Currently, FPL obtains gas supply via two pipelines, Florida Gas Transmission
8 and Gulfstream pipeline, both of which are sourced primarily from the Gulf of
9 Mexico. The potential for disruptions of gas supply in the Gulf of Mexico due to
10 a hurricane or other unforeseen events creates additional risk in the eyes of
11 investors and the rating agencies. In a Moody's Investor Services report titled
12 "Credit Opinion: Florida Power & Light Company" dated July 10, 2007, the
13 Agency notes:

14 This will further expose the company to potentially higher and
15 more volatile fuel costs and risks possible service interruptions
16 should the supply of natural gas to Florida be disrupted as was
17 the case in 2005 following hurricane damage to the Gulf Coast.

18
19 This risk is partially mitigated through the use of fuel-switching capability, which
20 has had the additional benefit of keeping fuel costs lower than they otherwise
21 would have been. However, our dependence on natural gas has increased in
22 recent years and will continue to increase as most of our near-term generation
23 expansions are natural gas facilities.

1 **Fuel Mix**

2 FPL's growing dependence on natural gas creates another company-specific risk
3 factor. FPL is the largest utility purchaser of natural gas in the country and in
4 2008 natural gas accounted for 53% of the electric energy provided by FPL.
5 Additional capacity additions will further increase FPL's dependence on natural
6 gas. Although natural gas is environmentally appealing, it has historically had
7 more price volatility than other fuel sources. This increase in dependence on
8 natural gas combined with the price volatility creates greater cash flow volatility
9 and increases FPL's liquidity requirements when compared to other companies in
10 the utility industry.

11
12 **Geographic Position**

13 Florida's geographic location also exposes our electrical systems to a higher
14 likelihood of adverse weather events. In particular, FPL's service territory
15 includes much of the areas of Florida most at risk for damage from tropical storm
16 activity. In 2004 and 2005, FPL's service territory experienced an unprecedented
17 amount of storm activity, receiving damage from seven hurricanes and incurring
18 more than \$1.8 billion to restore the electric transmission and distribution system.
19 While the recovery of prudently incurred storm costs provides substantial
20 mitigation of this risk, investors are still at risk for loss of revenues and other
21 impacts during adverse weather conditions. All other factors being equal,
22 Florida's greater likelihood of adverse weather events increases risk. This risk is
23 further exacerbated by the very minimal electrical interconnection capacity

1 serving peninsular Florida, meaning that the ability to supply purchased power
2 from outside of Florida in the event that there is a significant need, for example
3 due to storm conditions, is severely constrained.

4 **Q. What conclusion should the Commission draw from these qualitative risk**
5 **factors?**

6 A. I believe it is important for the Commission to be aware of these risk factors as it
7 considers both the appropriate level of ROE and the capital structure that we have
8 maintained at FPL. Clearly, an analysis of the risk factors indicates that FPL
9 operates in a riskier environment today than in 1999, 2002 and 2005, the years of
10 prior rate proceedings. In my judgment, FPL witness Avera has appropriately
11 evaluated the impact of these uncertainties on investors' willingness to supply
12 capital and considered the implications for FPL's financial integrity. A 12.5%
13 ROE would fairly account for the exposures that investors attribute to FPL, while
14 ensuring the Company's ability to attract capital even under adverse
15 circumstances.

16 **Q. Should the Commission consider performance in setting a Company's ROE?**

17 A. Yes. There is little doubt that the Commission can influence a company's
18 performance by taking that performance into account when establishing the ROE
19 upon which rates are set. While 12.5% is an appropriate ROE, taking into
20 account the company's risk profile, market conditions, its need for access to large
21 amounts of capital, it is also an appropriate ROE considering the Company's
22 strong performance as detailed by various other FPL witnesses. I agree with FPL
23 witness Avera and Olivera in this regard.

1 **CAPITAL STRUCTURE**

2

3 **Q. What is FPL's current equity ratio?**

4 A. Since the 1999 Revenue Sharing Agreement took effect we have maintained our
5 equity position over time, on an adjusted basis, at approximately 55.8%, though
6 the pattern of seasonal cash flows may drive the ratio slightly up or down on a
7 short-term basis. As provided in all of the past agreements, the adjusted equity
8 ratio equals common equity divided by the sum of common equity, preferred
9 equity, debt, and off-balance sheet obligations.

10 **Q. What is your recommendation for an equity ratio for FPL for regulatory**
11 **purposes?**

12 A. I recommend use of FPL's actual adjusted equity ratio of 55.8%. The
13 Commission on several occasions has stated that the capital structure used for
14 ratemaking purposes should bear an appropriate relationship to the utility's actual
15 sources of capital. (See e.g., Order No. 850246-EI, Petition of Tampa Electric
16 Company for Authority to Increase its Rates and Charges.) FPL's equity ratio
17 was sustained in FPL's 2002 Stipulation and Settlement and FPL's 2005
18 Stipulation and Settlement. FPL's strong balance sheet has provided continuous
19 access to both short-term liquidity and the capital markets throughout extreme
20 events such as the 2004 through 2005 storm seasons as well as the current
21 financial market crisis. Nothing has happened in the interim that would suggest
22 that the ratio should be reduced, and in fact the current market conditions would
23 support consideration of a higher equity ratio. FPL's current equity ratio

1 recognizes the additional liquidity requirements and financial flexibility necessary
2 to be in a position to hedge fuel price volatility for our customers, fund storm
3 restoration activities and fund substantial construction activities. It would
4 certainly be inconsistent for the Commission to seek to reduce the financial
5 strength of the Company at a time when many key risk drivers point to a period of
6 increased risk. Moreover, reducing the Company's equity ratio in current market
7 conditions would send a very poor message to the investment community.

8 **Q. Why are you not recommending an increase in FPL's equity ratio?**

9 A. FPL's reasonable and consistently managed equity ratio has provided financial
10 stability and benefits to customers. Thus, I believe that maintaining FPL's current
11 equity ratio will provide sufficient confidence to the investment community in
12 this market, when viewed in conjunction with FPL's trade record and the
13 historically constructive regulatory support of this Commission. Thus, even
14 though an increase in the equity ratio may be justified in these challenging
15 economic times, FPL is not proposing it at this time.

16 **Q. Why has FPL so carefully managed and maintained its equity ratio and
17 capital structure consistent with prior Commission decisions?**

18 A. A reasonable and stable equity ratio is a key requisite for maintaining financial
19 integrity and the many benefits it provides customers. FPL is keenly aware of this
20 relationship and has accordingly maintained its equity ratio in a narrow band
21 consistent with regulatory directives. It should be noted that FPL has taken
22 measures to maintain its equity ratio even though a decline in the equity ratio

1 would have enhanced returns between rate cases. This exemplifies the
2 importance FPL places on its equity ratio.

3 **Q. How does the 55.8% adjusted equity ratio correlate to FPL's test year**
4 **regulatory capital structure provided on MFR D-1a?**

5 A. FPL's regulatory capital structure includes components for deferred taxes,
6 investment tax credits and customer deposits, which lower the equity ratio to
7 47.9% in the test year. These items are generally excluded by rating agencies
8 and investors in evaluating FPL's capital structure. Exhibit AP-7 provides a
9 reconciliation of FPL's regulatory capital structure to its adjusted capital structure
10 for the 2010 test year.

11 **Q. How would a decrease in the adjusted equity ratio be viewed by the credit**
12 **rating agencies?**

13 A. A decrease in the adjusted equity ratio as a result of a regulatory decision would
14 be negatively viewed by the credit rating agencies. All three credit rating
15 agencies often mention the constructive regulatory environment in Florida as an
16 important influence on their assessment of business risk for FPL. One agency
17 goes further to mention that an adverse change to FPL's debt to total capital ratio
18 as a factor that could cause the credit rating at FPL to be downgraded.

19 **Q. Please explain why it is important to evaluate a company's capital structure**
20 **on an adjusted basis.**

21 A. In evaluating the adequacy of the capital structure of any company, investors will
22 make adjustments to the capital structure to take into account major financial
23 commitments that are not reflected on the balance sheet as well as to remove all

1 or a portion of obligations that are included on the balance sheet but are generally
2 considered off credit or non recourse to the company. For FPL, two principal
3 adjustments are made: 1) to remove the outstanding balance of Storm Recovery
4 Bonds that are generally considered off-credit or non-recourse to FPL, and 2) to
5 impute debt associated with long term commitments for purchased power
6 agreements (PPAs).

7 **Q. Why is it appropriate to make an adjustment for FPL's Storm Recovery**
8 **Bonds?**

9 A. In 2007 FPL issued Storm Recovery Bonds (Bonds) to finance, on a long-term
10 basis, a portion of the restoration costs associated with the 2004 and 2005 storms.
11 The bonds were issued pursuant to a statute passed by the Florida legislature
12 which gives the FPSC the authority to approve the issuance of what is commonly
13 referred to as securitized bonds. The Bonds were issued by FPL Recovery
14 Funding LLC, a subsidiary of FPL. The sole source of repayment for the Bonds
15 is customer receipts from a separate charge on customer bills called the Storm
16 Recovery Charge. This charge is adjusted semi-annually to ensure sufficient
17 funds to make principle and interest payments. Because FPL has no ongoing
18 performance risk associated with the storm restoration activities, these Bonds are
19 generally considered off-credit or non-recourse to FPL and, as such, are removed
20 when evaluating the adequacy of FPL's capital structure.

21 **Q. Why is it appropriate to make an adjustment for commitments associated**
22 **with purchased power obligations?**

1 A. In the case of a utility, the financial community commonly takes into account
2 obligations associated with purchased power agreements (PPAs). This fairly
3 acknowledges the fact that a long-term contractual commitment to purchase firm
4 capacity behaves economically much like debt, imposing fixed charges
5 independent of a company's revenues and, thus, should be taken into account in
6 evaluating the financial strength of the company.

7
8 In the case of FPL, we have several long-term purchase contracts that supply
9 about 14% of the energy we provide to our retail customers. These obligations
10 significantly increase the fixed charge leverage of the Company and are generally
11 understood by the investment community. They are explicitly evaluated by the
12 rating agencies, who examine each contract and assign it a rating that dictates how
13 much of the nominal total value of the contract will be added to FPL's debt
14 obligations for rating purposes. The net effect is to increase the relative share of
15 debt and debt-like instruments in the capital structure. Accordingly, FPL needs to
16 maintain a higher unadjusted equity ratio to attain the same level of financial
17 security with PPAs than without.

18 **Q. Please describe the basic methodology employed to determine the amount of**
19 **imputed debt.**

20 A. While all of the rating agencies take off-balance sheet obligations into account
21 when evaluating credit quality, S&P uses an approach that has both quantitative
22 and qualitative aspects to value the debt component of off-balance sheet
23 obligations. It involves first computing the net present value of the remaining

1 capacity payments under the contract. A risk factor is then determined based
2 primarily on the method of recovery of capacity payments. Once the risk factor
3 is determined, it is then multiplied by the net present value of the remaining
4 capacity payments to determine the amount of off-balance sheet obligation to
5 include as debt in the capital structure of the company for purposes of analyzing
6 credit quality.

7 **Q. Do you believe an adjustment of this type is appropriate?**

8 A. Yes. In general I agree with the judgment of the financial community that an
9 adjustment for off-balance sheet obligations should be made in assessing the
10 financial condition of a utility. In addition, while our own calculation of the
11 appropriate amount to include might be different, I believe that the rating
12 agencies' overall assessment fairly represents the general investor viewpoint that
13 all other things equal, a company with an ongoing obligation to buy power should
14 be evaluated as having more risk than a company without the obligation and is
15 thus directly relevant. It is therefore reasonable for the Commission to make a
16 comparable adjustment when it evaluates the financial strength of FPL.

17 **Q. Does the adjustment for imputed debt made by S&P take into account the
18 regulatory certainty provided by the Capacity Clause?**

19 A. Yes. S&P assigns a risk factor to the capacity payment stream based on the
20 method of recovery, ranging from 100% to 15%. For example, for an unregulated
21 entity, 100% of the future minimum capacity payments would be imputed as debt.
22 The risk factor used for a company that recovers purchased power costs through
23 base rates is 50%. S&P reduces this risk factor to 25% for utilities that recover

1 purchase power costs through a clause mechanism. In other words, if FPL were
2 recovering these capacity payments through base rates, S&P's methodology
3 would result in an imputed debt adjustment of \$1,899 million versus the current
4 adjustment of \$949 million.

5 **Q. Why is it important that regulatory policy be consistent with the perspective**
6 **of the financial community on this issue?**

7 A. There are two reasons. First, as I understand the goals of regulatory policy, one of
8 the Commission's tasks is to set rates such that investors have the prospect,
9 though not the guarantee, of earning a reasonable rate of return. In doing so, the
10 Commission must look to capital markets for evidence of investor requirements.
11 Rating agencies, acting as independent risk assessors on behalf of investors
12 generally are an important source of evidence in this regard. The fact that they
13 include off-balance sheet obligations should be strong evidence of the relevance
14 of these obligations to financial risk.

15
16 In addition, there are sound fundamental economic reasons for viewing PPAs as
17 part of the financial profile. These obligations are similar to debt from a financial
18 perspective. Moreover, they represent avoided capacity – capital expenditures
19 and rate base that would otherwise have been included like other assets – but with
20 a fixed obligation. Whereas all other assets are supported by a cushion in the
21 form of the most junior financial claim (common equity), which bears the
22 ultimate risk of financial fluctuations, these PPAs have no such support. The
23 company is required to meet these obligations and cannot, in a weak year, pay its

1 power suppliers less than the contractual commitment. From the company's
2 perspective, it is as though the capacity represented by these contracts were 100%
3 financed by debt. The major bond rating agencies include a portion of the present
4 value of these contracts as debt in their analysis. Logically, this effect should be
5 incorporated into the overall assessment of financial structure.

6 **Q. Has the Commission previously recognized the financial market's imputation
7 of debt in assessing the impact of PPAs on a utility's capital structure?**

8 A. Yes. In several past power plant need determination cases, the Commission has
9 acknowledged that imputed debt associated with PPAs is taken into consideration
10 by credit rating agencies, and that its effect on a company's cost of capital should
11 be considered. (See, e.g., Order No. PSC-02-1743-FOF-EI and Order No. PSC-
12 01-0029-FOF-EI.) The Commission also continues to recognize the financial
13 leverage implicit in PPAs in the approach used for surveillance reporting
14 requirements. The 2005 Stipulation and Settlement Agreement currently in effect
15 for FPL states:

16 For surveillance reporting requirements and all regulatory
17 purposes, FPL's ROE will be calculated based upon an adjusted
18 equity ratio as follows. FPL's adjusted equity ratio will be capped
19 at 55.8% as included in FPL's projected 1998 Rate of Return
20 Report for surveillance purposes. The adjusted equity ratio equals
21 common equity divided by the sum of common equity, preferred
22 equity, debt and off-balance sheet obligations. The amount used

1 for off-balance sheet obligations will be calculated per the
2 Standard & Poor's methodology.

3

4 **Q. What can you conclude about FPL's current adjusted equity ratio?**

5 A. Our 55.8% equity ratio has been and continues to be viewed as adequate and
6 appropriate by the investment community. Maintaining this adjusted equity ratio
7 will indicate to the Capital Markets the Commission's continued commitment to
8 support the financial integrity of the service providers subject to its jurisdiction.
9 Maintaining our current equity ratio will help to ensure continuous access to the
10 capital markets at reasonable rates even during turbulent credit markets.
11 Furthermore, a strong capital structure is appropriate under current circumstances
12 and offers flexibility and security, which in turn enables us to serve our customers
13 well.

14

15 **ACCRUAL FOR THE ACCOUNT 228.1 RESERVE**

16

17 **Q. What has FPL proposed as the annual accrual to the Reserve to be reflected**
18 **in base rates?**

19 A. FPL has proposed that the Commission establish the annual accrual in base rates
20 to be \$150 million and a target reserve level of \$650 million. The annual accrual
21 approximates the expected amount of annual storm losses. As discussed in the
22 testimony of FPL witness Harris, assuming an annual accrual of \$150 million, a
23 two-year surcharge recovery of any deficit storm damage reserve balances that

1 may occur during this period, and an initial Reserve balance of \$215 million
2 (Reserve replenishment amount per Financing Order No. PSC-06-0464-FOF-EI,
3 adjusted for earnings and securitization-related activities), the expected balance of
4 the Reserve would be approximately \$382 million after five years.

5 **Q. What are the key policy considerations underlying any storm cost recovery**
6 **framework?**

7 A. The key policy considerations underlying any storm cost recovery framework
8 have been clearly acknowledged in past Commission treatment of storm
9 restoration costs, as articulated in Orders Nos. PSC-93-0918-FOF-EI, PSC-95-
10 0264-FOF-EI and PSC-95-1588-FOF-EI. The key principles are as follows:

11

12 First, storm restoration is a cost of providing electric service in Florida and is
13 therefore, properly recoverable through the rates and charges of the Company.
14 While we cannot predict with certainty when storms will occur, we can predict
15 with virtual certainty that tropical storms and hurricanes will affect our service
16 territory and we will incur costs for restoring power. However, those costs are not
17 reflected in the Company's base rates.

18

19 Second, each "generation" of customers should contribute to the cost of storm
20 restoration, even if no storm strikes in a particular year. Since storms will occur
21 and only their timing is uncertain, the true cost of providing electric service
22 should include an allowance for a level of restoration activity that approximates
23 the expected annual storm costs.

1 Third, “pre-funding” restoration costs sufficient to cover an extreme sub-period of
2 storm activity (i.e., building up a Reserve sufficient to cover virtually all storm
3 restoration) is likely to be economically inefficient. Thus, some mechanism for
4 recovery of the prudently incurred costs that exceed the Reserve is required.

5

6 Each of these principles has been reflected, expressly or implicitly, in prior
7 Commission decisions relative to the establishment of the Reserve and the
8 recovery of storm restoration costs.

9 **Q. Please describe the history of the Reserve and the principal components of**
10 **the Commission’s approach to storm cost recovery.**

11 A. Prior to Hurricane Andrew, FPL had a small Reserve and maintained commercial
12 insurance coverage for its Transmission and Distribution (T&D) network. The
13 cost of carrying this insurance was recovered through base rates. The cost of
14 storm restoration, therefore, was spread out to customers over time largely
15 through the cost of insurance included in the Company’s base rate charge.

16

17 Following Andrew, commercial insurers withdrew from the market. In Order No.
18 PSC-93-0918-FOF-EI, the Commission approved the implementation of a self-
19 insurance mechanism for damage to FPL’s T&D system and to resume and
20 increase the annual contribution to the Reserve. In the absence of commercial
21 coverage, the Company established and the Commission consistently endorsed an
22 overall framework which acknowledges that the costs associated with restoring
23 service after storms are a necessary cost of providing electric service in Florida

1 and as such, are properly recoverable from customers. The framework consists of
2 three main parts: (1) an annual storm accrual, adjusted over time as circumstances
3 change; (2) a Reserve adequate to accommodate most but not all storm years; and
4 (3) a provision for utilities to seek recovery of costs that go beyond the Reserve.
5 The regulatory framework is designed to provide the flexibility to prevent
6 unbounded growth of the storm fund during extended periods of extremely low
7 storm activity as well as provide for supplemental recovery of deficits in the
8 Reserve during periods of high storm activity.

9
10 These three parts act together to allow FPL over time to recover the costs of storm
11 restoration, while at the same time balancing competing customer interests,
12 namely: holding the ongoing impact to reasonable levels; minimizing the
13 volatility of “rate shock” in customer bills which occurs when the Reserve is
14 insufficient, (the timing of which could adversely impact customers when they are
15 experiencing repair costs of their own); and promoting intergenerational equity.
16 This balance requires periodic adjustment to the amount of the main components
17 of the framework, the annual accrual and the target Reserve balance, in light of
18 changing storm experience and the growth of FPL’s T&D network.

19 **Q. Please summarize your understanding of the Commission’s policy on the**
20 **appropriate level of the Reserve balance.**

21 A. The Commission’s policy, as articulated in Order Nos. PSC-95-0264-FOF-EI,
22 PSC-95-1588-FOF-EI and PSC-98-0953-FOF-EI, is to determine a Reserve
23 balance sufficient to protect against most years’ storm restoration costs, but not

1 the most extreme years. Such a level should reduce dependence on a relief
2 mechanism such as a special customer assessment, providing for more stability in
3 customer bills. Obviously, the lower the Reserve balance, the higher the risk that
4 storm losses will exceed the funds available in the Reserve, and therefore the
5 greater the need for special assessments. The higher the Reserve balance, the
6 lower the risk windstorm losses will exceed the funds available in the Reserve.

7 **Q. Did the passage of Section 366.8260, Florida Statutes, which provides for the**
8 **issuance of Bonds, alter the current framework for storm cost recovery?**

9 A. No. Section 366.8260 simply provides the Commission with an additional
10 alternative for recovery of storm restoration costs that have exceeded the Reserve
11 and replenishment of the Reserve. Under Section 366.8260, recovery of deficits
12 and replenishment of the Reserve would be achieved through the issuance of
13 Bonds which are repaid by customers through a non-bypassable charge. Prior to
14 the 2004 hurricane season, FPL had not experienced a deficit balance in the
15 Reserve.

16 **Q. Why should customers pay for storm restoration costs?**

17 A. These costs are an integral part of the cost of providing electric service in Florida,
18 a region susceptible to storms. As such, they are legitimately recoverable from
19 customers under basic principles of cost-based rate regulation.

20 **Q. How is this different than, for example, an accident at one of FPL's**
21 **generating plants?**

22 A. In many respects it is not. It is true that even an organization such as FPL, with a
23 good track record, will from time to time incur losses from accidents. These

1 losses are a part of the cost of providing electric service and as such a fair average
2 level of costs is reasonably recoverable from customers. The fundamental
3 difference, however, is that extraordinary losses from plant outages are covered
4 by insurance, the cost of which is recovered through base rates. So, the costs of
5 such extraordinary losses, effectively, are borne by customers.

6 **Q. Why doesn't FPL purchase insurance for storm losses?**

7 A. The substantial losses associated with Hurricane Andrew in 1992 essentially
8 eliminated the commercial market for T&D insurance at the levels or amounts
9 needed to provide adequate protection to FPL's extensive network of assets and
10 its ability to quickly restore reliable service. Though FPL continues to explore the
11 market for insurance for storm damage losses, it has been forced to seek other
12 methods to ensure that it would have adequate available resources for the costs of
13 repairing and restoring its T&D system in the event of a hurricane, storm damage,
14 or other natural disaster.

15 **Q. Please briefly describe the circumstances that led to the adoption of the 2004**
16 **Storm Restoration Surcharge.**

17 A. The 2004 storm season inflicted severe damage on FPL's service territory and the
18 electric infrastructure. As a result, costs incurred to restore electric service
19 following Hurricanes Charley, Frances, and Jeanne, in the aggregate totaled \$890
20 million (net of insurance proceeds), depleting in its entirety FPL's Reserve, and
21 leaving the Reserve with a substantial deficit. In Order No. PSC-05-0937-FOF-
22 EI, the Commission affirmed the surcharge it had approved on a provisional basis
23 in Docket No. 041291-EI (the Storm Restoration Surcharge). The approved

1 surcharge of \$1.65 (per 1,000 kWh residential bill) was intended to eliminate the
2 deficit in the Reserve caused by the 2004 storm season.

3 **Q. What effect did the 2005 storm season have on the Reserve?**

4 A. In 2005, another very active storm season, four Hurricanes inflicted damage on
5 FPL's system. Restoration costs associated with Hurricanes Dennis, Katrina, Rita
6 and Wilma increased the Reserve deficiency by approximately \$816 million,
7 leaving a deficit balance in the Reserve in excess of \$1.1 billion. The Storm
8 Restoration Surcharge was designed to recover approximately \$300 million of
9 that amount by February 2008, leaving approximately \$800 million to be
10 recovered through another means, as well as the question of how best to restore
11 the Reserve to a reasonable level going forward.

12 **Q. How did the 2005 Stipulation and Settlement Agreement signed by parties to
13 FPL's base rate proceeding address the issues of storm cost recovery and the
14 replenishment of the Reserve?**

15 A. The Settlement Agreement: (1) suspended the then current base rate accrual of
16 \$20.3 million; (2) provided that FPL will be entitled to recover prudently incurred
17 storm restoration costs and replenish the Reserve to a level approved by the
18 Commission; and (3) allowed recovery of prudently incurred storm restoration
19 costs and replenishment of the Reserve through charges that are incremental to
20 base rates, either through a charge established through Section 366.8260, Florida
21 Statutes or another form of surcharge.

1 Q. How did Financing Order No. PSC-06-0464-FOF-EI issued May 30, 2006
2 address the issues of storm cost recovery and the replenishment of the
3 Reserve?

4 A. The Commission found the issuance of Bonds and the imposition of related storm
5 restoration charges to finance the recovery of FPL's reasonable and prudently
6 incurred storm restoration costs, the replenishment of the Reserve, and related
7 financing costs were reasonably expected to significantly mitigate rate impacts to
8 customers as compared with alternative methods of recovery of storm restoration
9 costs and replenishment of the Reserve.

10

11 The Commission approved the issuance of Bonds in the amount of up to \$708
12 million, provided the initial average retail cents per kWh for the Bonds would not
13 exceed the average retail cents per kWh for the Storm Restoration Surcharge
14 which was then in effect. The proceeds from the issuance of Bonds authorized by
15 this Financing Order were required to be used by FPL to finance the after-tax
16 equivalent of the following amounts: (1) approximately \$199 million in
17 unrecovered 2004 storm-recovery costs as of July 31, 2006 (estimated); (2)
18 approximately \$736 million in 2005 unrecovered storm-recovery costs
19 (estimated); (3) replenishment of FPL's Reserve to the level of \$200 million; and
20 (4) \$11.4 million in financing costs (estimated) associated with the Bonds. To the
21 extent there were differences between the actual and estimated balances for
22 unrecovered 2004 and 2005 storm restoration costs and between the actual and

1 estimated financing costs, the differences were to be reflected through an
2 adjustment to the Reserve.

3 **Q. What are the fundamental regulatory objectives that should be considered in**
4 **reestablishing the annual storm accrual and target reserve balance?**

5 A. FPL believes that the regulatory objectives should be the following: (1) achieve
6 low long-term customer costs; balanced with (2) dampening volatility of the
7 Reserve (i.e., reduce reliance on special assessments/rate increases providing
8 stability of customer bills); and (3) cover the costs of most storms, but not those
9 from the most catastrophic events.

10 **Q. How should the Commission determine the appropriate level of annual**
11 **accrual?**

12 A. The Commission's policy, as articulated in Order No. 95-0264-FOF-EI, is to
13 determine a target reserve balance that is sufficient to protect against most years'
14 storm restoration costs but not the most extreme years. Assuming the regulatory
15 framework continues to provide for the recovery of prudently incurred storm costs
16 in excess of storm reserves in periods of high storm activity, the goal of the
17 accrual over the next several years should be to cover the expected value of
18 annual windstorm losses and make some progress in reestablishing the Reserve to
19 a level adequate to fund most but not all windstorm losses. Such a level should
20 reduce FPL's dependence on a relief mechanism such as a special customer
21 assessment, proving more efficient and effective for our customers. The annual
22 accrual should be set large enough to allow the reserve to build modestly in years
23 of "normal" hurricane activity, yet low enough to prevent unbounded storm fund

1 growth. An accrual and reserve approach is the most cost effective means by
2 which we can ensure that critical funds are available when needed while at the
3 same time providing stability of customer bills and thereby minimizing the overall
4 impact of hurricanes in our service territory. One advantage to funding the
5 Reserve with an annual accrual is that in a year where no or low storm activity
6 occurs, the Reserve has the opportunity to grow for future benefit and stability.
7 This is in direct contrast to insurance premiums where, even during periods of no
8 or low losses, the insurer retains the premiums paid. The Reserve primarily exists
9 due to the unavailability of cost effective insurance for FPL's T&D system.

10 **Q. Has FPL performed a study to determine the annual amount of expected**
11 **losses from windstorms?**

12 A. Yes. FPL commissioned studies to calculate the annual amount of expected
13 windstorm losses, as well as the expected value of the Reserve given various
14 funding levels. The studies were prepared by and are being sponsored by FPL
15 witness Harris of ABS Consulting.

16 **Q. What direction was provided by FPL to ABS Consulting in the preparation**
17 **of the studies?**

18 A. FPL requested that ABS Consulting determine the levels of losses to which the
19 Company and its customers are statistically exposed and to develop average
20 annual cost estimates associated with repair of storm damage and service
21 restoration over a long period of time. Additionally, FPL requested ABS
22 Consulting to provide a probabilistic analysis of expected results for the Reserve
23 balance over five years at various levels of annual accrual. The current storm

1 accrual established under the 2005 settlement agreement is zero. The Settlement
2 Agreement addressed recovery of future storm costs via surcharge or
3 securitization.

4 **Q. What does the analysis conclude regarding the expected annual long-term**
5 **cost for service restoration and repair of storm damage to FPL's assets?**

6 A. The ABS Consulting analysis concludes that the expected annual cost for
7 windstorm losses is approximately \$153.3 million. Windstorm losses include
8 costs associated with service restoration and system repair of FPL's T&D system
9 from hurricane, tropical and winter storm losses. Also included are storm staging
10 costs, windstorm insurance deductibles attributable to non-T&D assets, and
11 payments of nuclear retrospective premiums. The \$153.3 million expected annual
12 loss has increased significantly since the 2005 Loss Analysis. This increase is
13 predominantly the result of an increase in replacement values for FPL's T&D
14 assets, as well as the incorporation of the hurricane storm data for the 2004
15 through 2007 hurricane seasons, which increases the modeled storm hazard. The
16 expected annual loss estimate becomes a range of \$146.6 million to \$153.3
17 million when taking into consideration the potential reduction in storm restoration
18 costs due to FPL's storm hardening activities.

19 **Q. Are there other circumstances that could increase FPL's expected annual**
20 **losses?**

21 A. Yes. Changes in the insurance markets affecting the availability and affordability
22 of insurance coverage would impact expected annual losses. FPL witness Harris'
23 analysis assumes no T&D insurance is available and that non-T&D insurance

1 deductibles remain stable. After the very active storm seasons of 2004 and 2005,
2 the insurance markets continue to decline to offer T&D insurance at reasonable
3 cost. In addition, non-T&D windstorm insurance availability remains volatile
4 based on insurers' loss experience and available capacity, and could require
5 higher deductibles in the future. If this were to happen, any deductible increase or
6 any diminution in non-T&D windstorm insurance would increase the storm
7 damage costs to be charged to the Reserve.

8 **Q. Does the analysis recommend a target reserve level?**

9 A. No. There is no single correct Reserve balance. The appropriate Reserve level
10 depends largely on the regulatory framework for storm cost restoration and the
11 point at which the Commission decides to balance the customer interests referred
12 to earlier. Obviously, the lower the Reserve balance, the more likely that storm
13 losses will exceed the funds available in the Reserve and, therefore, the greater
14 the reliance on special assessments. The higher the Reserve Balance, the less
15 likely windstorm losses will exceed the funds available in the Reserve. If the
16 regulatory framework were to be changed such that FPL could not recover
17 prudently incurred restoration costs in excess of the Reserve, then the balance in
18 the Reserve would have to be maintained at substantially higher levels to ensure
19 that FPL could recover the full cost of providing electric service over the long-
20 term taking into consideration the condition of the financial markets at any given
21 point in time.

1 **Q. What target Reserve level does FPL recommend?**

2 A. Consistent with past Commission Orders, a reserve level should be large enough
3 to withstand the storm damage from most but not all storm seasons. FPL
4 recommends a \$650 million target reserve level. According to the aggregate
5 damage exceedance probabilities presented in Table 5-2 on page 5-6 of FPL
6 witness Harris' Storm Loss Analysis, Exhibit SPH-1, the chance that losses will
7 exceed \$650 million in any one season is approximately 5%.

8
9 Although a Reserve of \$650 million is not necessarily what FPL would project as
10 the ideal Reserve level going forward, weighing a number of factors including (i)
11 an expected annual cost for windstorm losses, taking into consideration the storm
12 hardening activities, of approximately \$146.6 million to \$153.3 million as
13 determined by FPL's outside expert FPL witness Harris, (ii) the possibility that
14 Florida is in the midst of a much more active hurricane period relative to average
15 levels of activity over the much longer term, (iii) the impact of the recent severe
16 and unprecedented storm seasons on customer bills in the near term, and (iv) the
17 opportunity to revisit this issue in future proceedings, establishing a target
18 Reserve level of \$650 million is reasonable at this time.

19 **Q. Does this recommendation eliminate the possibility of special assessments for**
20 **future storm damage?**

21 A. No. Without an additional annual surcharge or accrual to fund ongoing storm
22 restoration costs, the Reserve naturally will decline over time as costs are charged
23 against the Reserve. If we are fortunate enough to experience a few years of

1 below average storm losses, the Reserve may be sufficient to avoid an additional
2 surcharge or securitization during that period of time. However, FPL witness
3 Harris' analysis concludes that the expected value of the Reserve under the
4 Company's recommendation would be approximately \$382 million after five
5 years and that there would be a 33% chance that the Reserve would be insufficient
6 at some point over the next five years to fund required storm restoration costs. Of
7 course, future storm activity will dictate the necessity for any type of special
8 assessments or additional issuances of storm-recovery bonds.

9 **Q. How will the Company ensure that the requested annual accrual of \$150**
10 **million will not result in unbounded growth?**

11 A. FPL proposes to file updated studies at least every five years for review by the
12 Commission. Based on the ABS Consulting analysis, at an annual accrual level of
13 \$150 million, the probability that the storm fund will exceed \$650 million in five
14 years is approximately 42%, and there is a 5% chance that the reserve would
15 reach approximately \$930 million after five years, at which time the annual
16 accrual and appropriate reserve level could be reevaluated.

17 **Q. Has the Commission allowed for a 5-year review of other funded reserves?**

18 A. Yes. For example, the Commission currently requires FPL to file a study that
19 allows the Commission to review its nuclear decommissioning costs at least every
20 five years.

21 **Q. Can FPL change its storm fund accrual without Commission authorization?**

22 A. No.

1 **Q. Can funds collected from customers for storm restoration be used for**
2 **any other purpose?**

3 A. No. FPL follows FPSC Rule 25-6.0143 – Use of Accumulated Provision
4 Accounts 228.1, 228.2 and 228.4, to charge amounts to the Reserve. Funds
5 collected can be used for any allowed purpose of the fund including costs
6 associated with service restoration and repair of FPL’s T&D system as a result of
7 hurricanes, tropical storms and winter storms, storm staging costs, windstorm
8 insurance deductibles attributable to non-T&D assets, and payments of nuclear
9 retrospective premiums. The Commission established the inclusion of nuclear
10 retroactive assessments as an allowed purpose of the fund in Docket No. 810002-
11 EU, Order No. 10306 issued September 23, 1981. The Commission provided
12 clarification in Order No. PSC-98-0953-FOF-EI as to the appropriate uses of the
13 Reserve, and articulated the Reserve is available to cover retrospective
14 assessments incident to FPL’s insurance for its nuclear facilities.

15

16 **NUCLEAR FUEL LEASE**

17

18 **Q. Can you please provide a brief history of FPL Fuels, LLC?**

19 A. FPL Fuels, LLC, initially called St. Lucie Fuel Company, was established in 1979
20 for the purpose of financing the acquisition of nuclear fuel and then leasing the
21 fuel to FPL. Under the terms of the lease, FPL Fuels owns finances and leases the
22 fuel to FPL.

1 **Q. How did the establishment of the nuclear fuel lease benefit FPL's customers?**

2 A. At the time FPL entered into the lease, the accounting rules did not require
3 consolidation of FPL Fuels. This allowed the lessor to finance the fuel at a lower
4 overall cost than would be obtained if FPL were to acquire the fuel through its
5 conventional purchasing and financing activities at its weighted average cost of
6 capital.

7 **Q. Does FPL Fuels still provide a benefit to customers?**

8 A. No, it does not. Changes in accounting rules now require FPL to consolidate FPL
9 Fuels in its financial statements filed with the Securities Exchange Commission.
10 Consequently, the commercial paper issued by FPL Fuels is now included as
11 short-term debt on FPL's balance sheet and is included in rating agency and
12 investor evaluations of the adequacy of FPL's capital structure.

13 **Q. How has FPL Fuels been treated in this filing?**

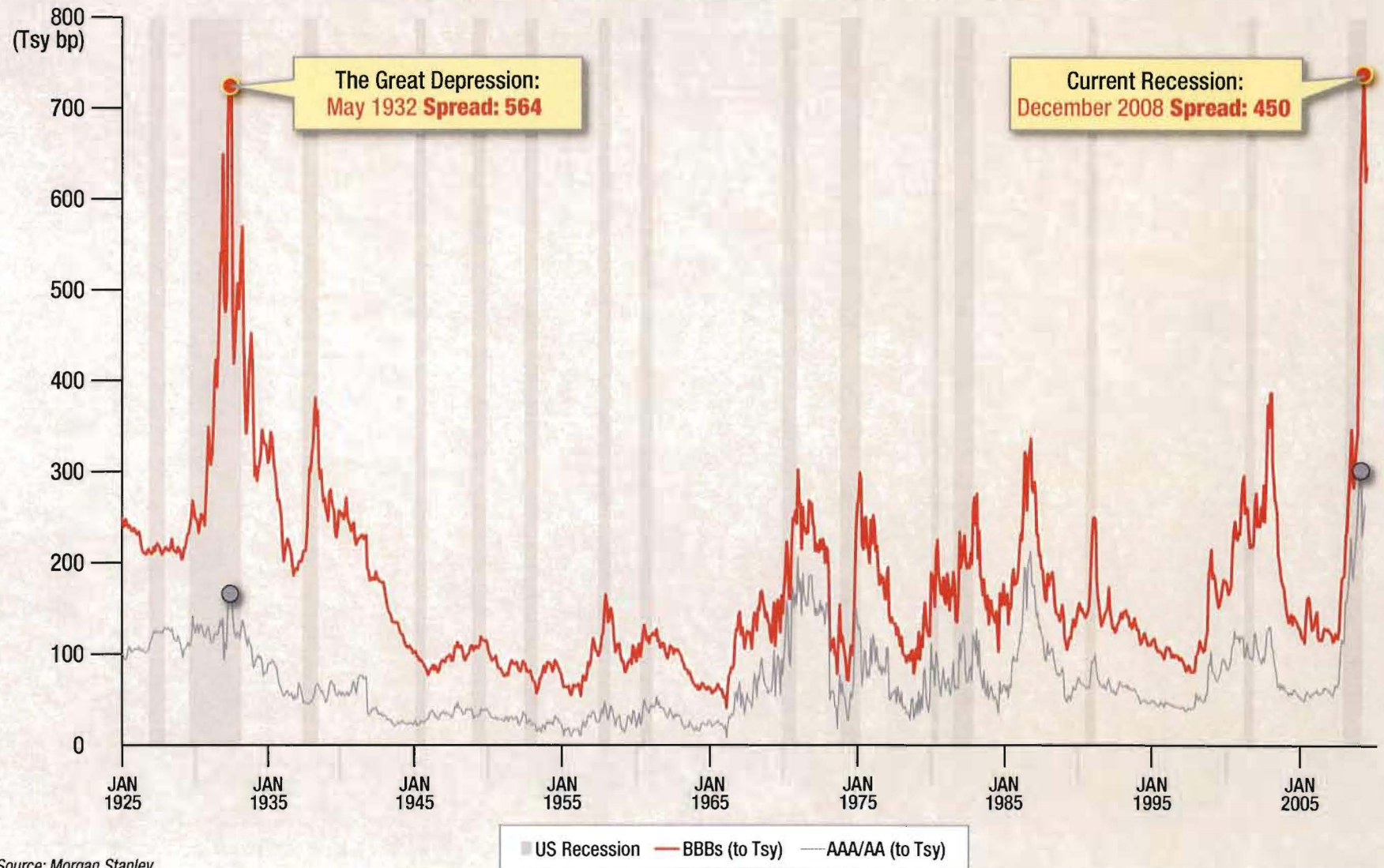
14 A. FPL's 2010 forecast reflects continuation of FPL Fuels, but FPL makes a
15 company adjustment that assumes the dissolution of FPL Fuels on January 1,
16 2010. FPL witness Ousdahl explains this company adjustment.

17 **Q. Does this conclude your direct testimony?**

18 A. Yes.

Credit Spreads Not This Wide Since Great Depression

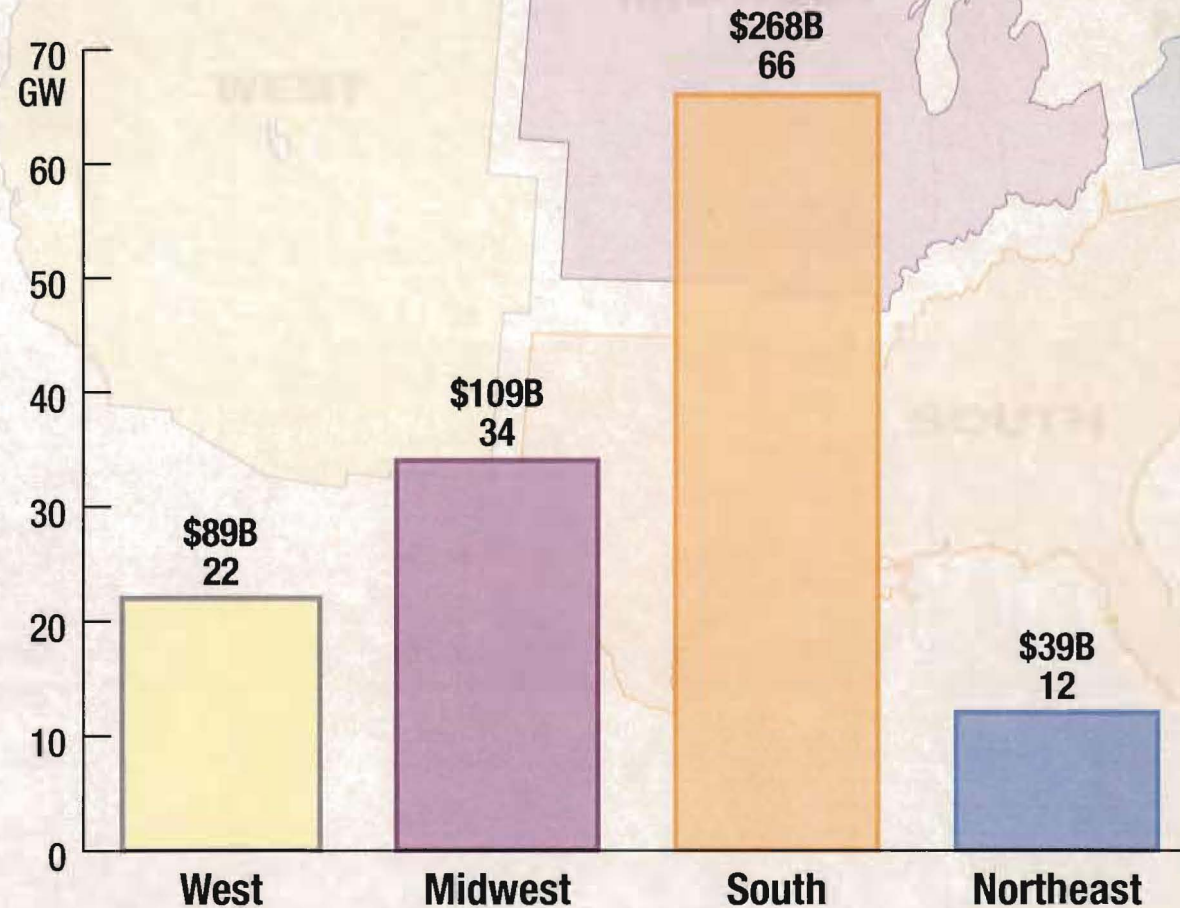
Comparison of AAA/AA to BBBs Rated Credit



Source: Morgan Stanley

Southern U.S. Projecting Largest Increase in Needs

Generation Capacity Increase By Region Through 2030

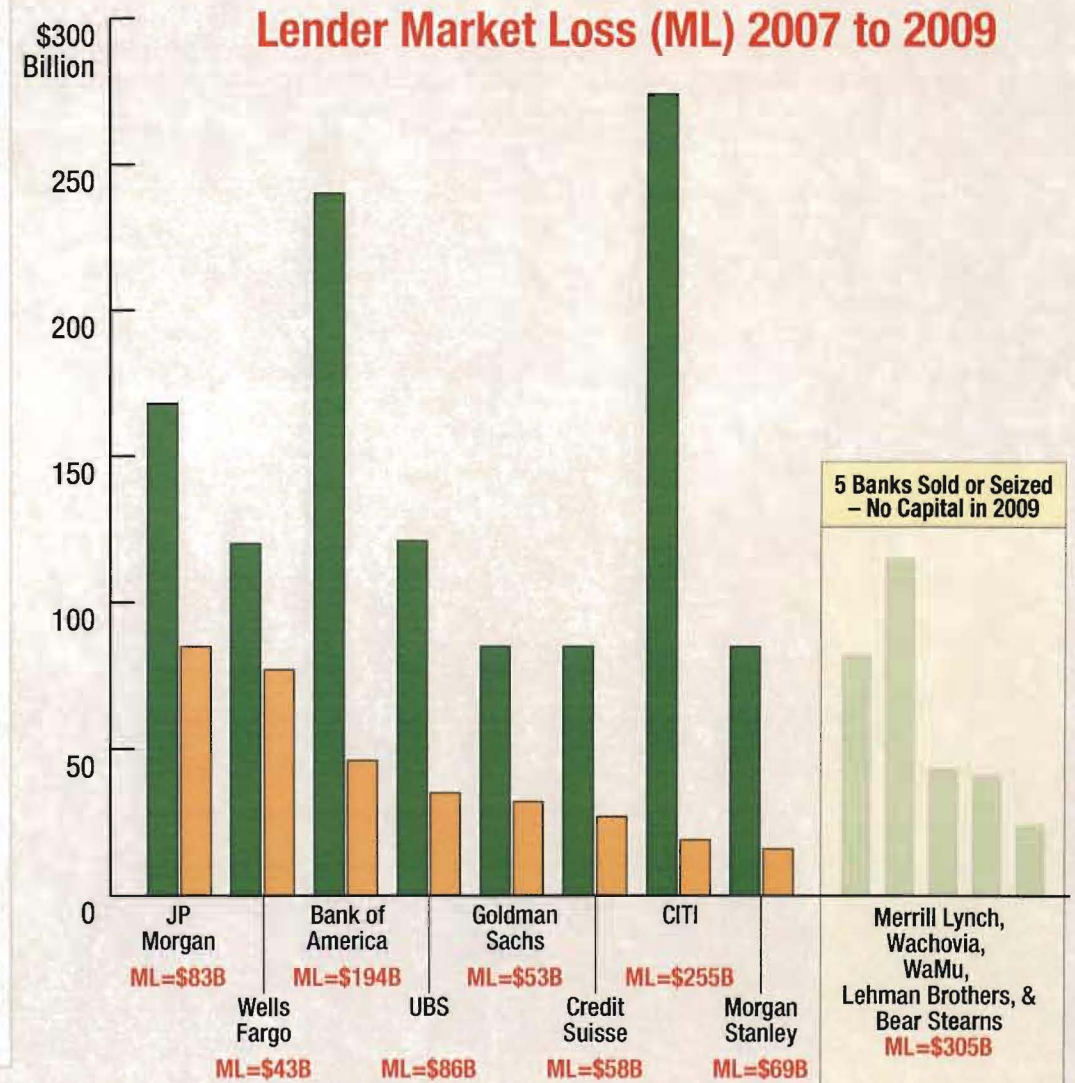
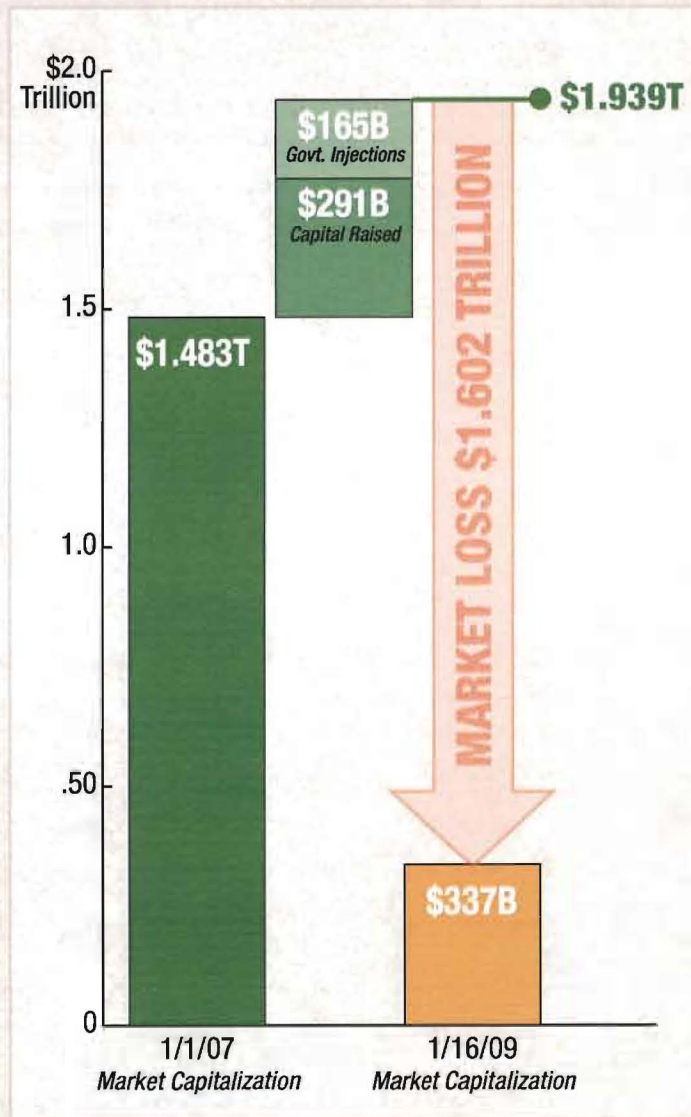


Projected Industry Capital Expenditures Through 2030

● Generation	\$ 505 Billion
● Transmission	\$ 298 Billion
● AMI and EE/DR	\$ 85 Billion
● Distribution	\$ 582 Billion
Total	\$1.470 Trillion

Source: The Brattle Group "Transforming America's Power Industry: The Investment Challenge 2010-2030," November 2008

Market Capitalization \$1.6T Decrease From 2007 to 2009



Source: JP Morgan

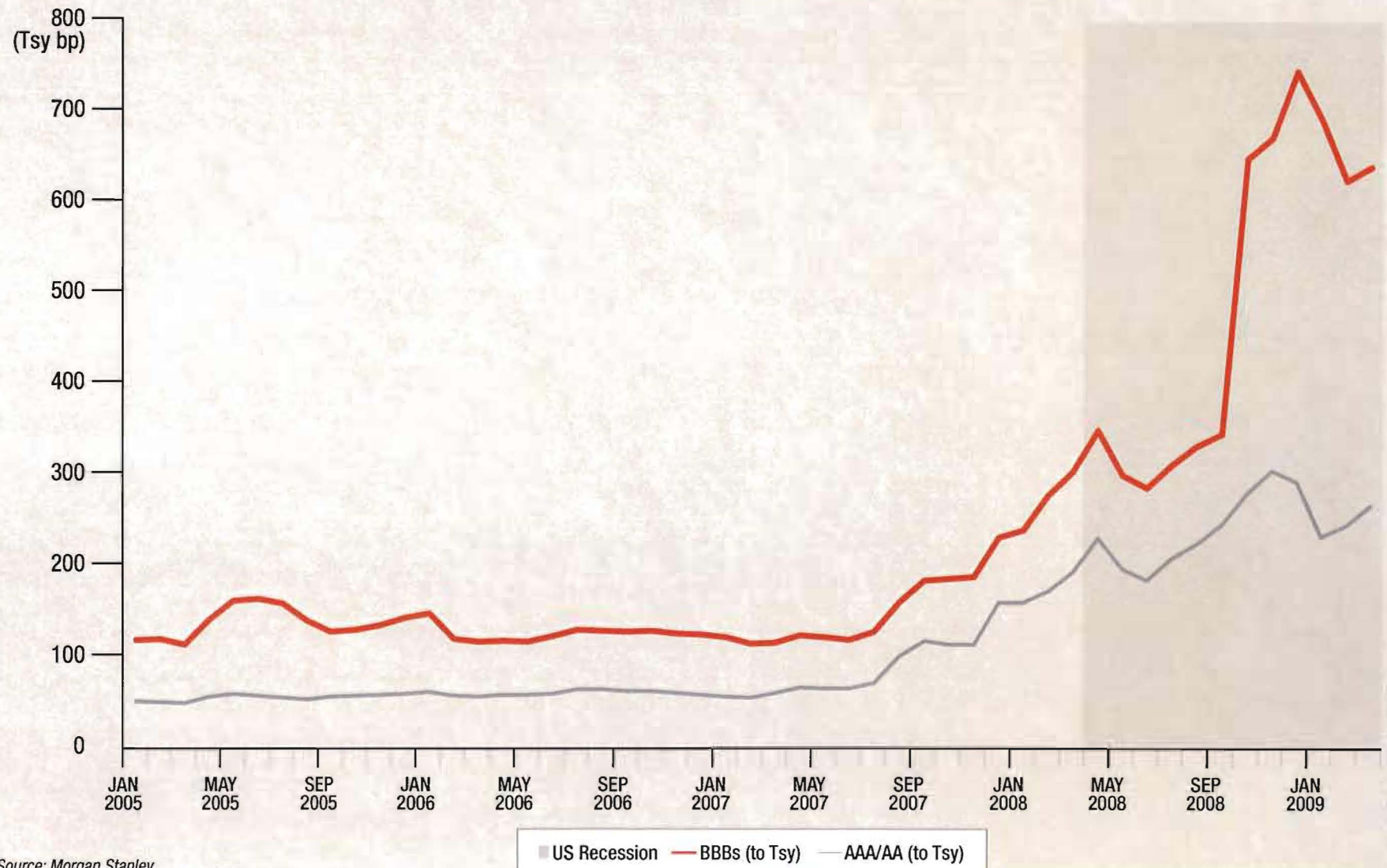
As Banks Reduce Leverage, Utilities Need New Sources of Liquidity

U.S. High Grade Credit Facilities



Credit Spreads Have Increased Dramatically Since 2005

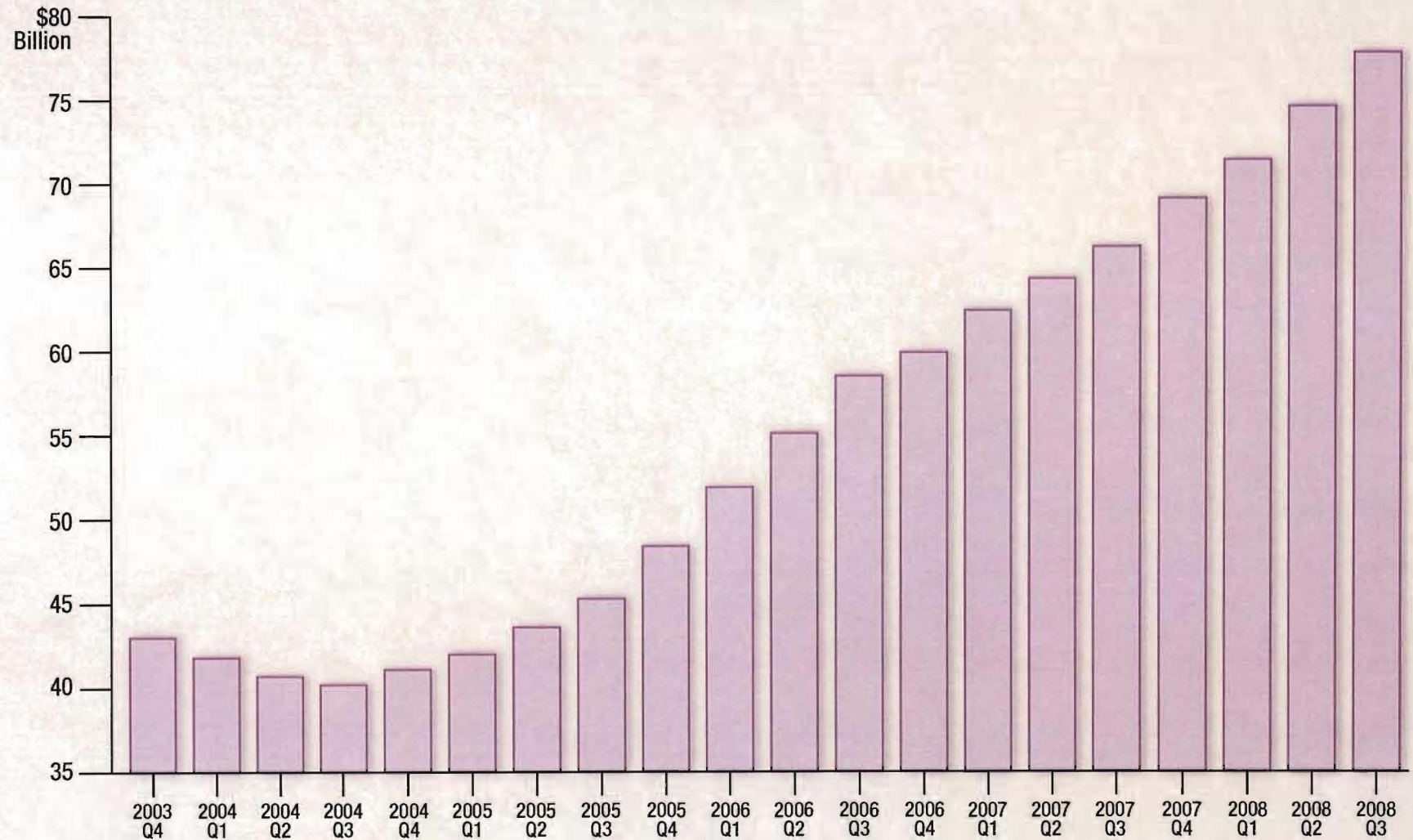
Comparison of AAA/AA to BBBs Rated Credit



Source: Morgan Stanley

Utility Industry Capital Expenditures

Trailing 12 Months



Source: Edison Electric Institute

FPL Test Year Capital Structure

13-Month Average

	Regulatory Capital Structure		Adjusted Capital Structure		
	Jurisdictional Adjusted	Ratio	Adjustments	Adjusted	Ratio
Long-Term Debt	\$ 5,377,787 ^[1]	31.5%	\$ 949,260 ^[2]	\$ 6,327,047	43.1%
Preferred Stock	—	0.00%			
Customer Deposits	564,652	3.3%			
Common Equity	8,178,980	47.9%		8,178,980	55.8%
Short-Term Debt	161,857	1.0%		161,857	1.1%
Deferred Income Taxes	2,723,327	16.0%			
Investment Tax Credits	56,983	0.3%			
TOTAL:	\$17,063,587	100%	\$ 949,260	\$14,667,884	100%

[1] Jurisdictional adjusted long-term debt excludes \$546 million Storm Recovery Bonds.

[2] Adjustment to reflect imputed debt for purchased power obligations.