BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for rate increase by Tampa Electric Company.	DOCKET NO. 080317-EI FILED: January 7, 2009

FLORIDA INDUSTRIAL POWER USERS GROUP'S MOTION TO STRIKE PREFILED TESTIMONY AND EXHIBITS OF SUSAN D. ABBOTT AND GORDON L GILLETTE

The Florida Industrial Power Users Group (FIPUG), pursuant to rule 28-106-204, Florida Administrative Code, by and through its undersigned attorneys, moves to strike portions of the prefiled direct and rebuttal testimony (and associated exhibits) of Susan D. Abbott and Gordon L. Gillette submitted by Tampa Electric Company's (TECO) in the above-captioned matter. Specifically, FIPUG moves to strike those portions of the testimony and exhibits that are hearsay and do not supplement or explain admissible evidence. Counsel has conferred with all other parties of record, pursuant to rule 28-106-204, Florida Administrative Code, and is authorized to represent that this motion is supported by the Florida Retail Federation, AARP, Public Counsel, and the Florida Attorney General. TECO opposes this motion.

Introduction

1. In this rate case, TECO, among other things, is seeking to increase its base rates by more than $228 million to become effective May 1, 2009.

2. On August 11, 2008, TECO filed the direct testimony and exhibits of Susan D. Abbott and Gordon L. Gillette.

3. On December 17, 2008, TECO filed the rebuttal testimony of Susan D. Abbott and Gordon L. Gillette.

4. Portions of this testimony, as detailed below, contain impermissible hearsay, must be stricken, and must not be used as a basis for a finding.

Hearsay

5. Section 90.801(1)(c), Florida Statutes, defines hearsay evidence as a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted. In many portions of both their direct and rebuttal testimony, Ms. Abbott and Mr. Gillette make statements that meet this definition.

6. With certain exceptions not applicable here, hearsay is generally inadmissible. Section 90.802, Florida Statutes.

7. Section 120.57(1)(c), Florida Statutes, addresses the use of hearsay in administrative hearings. It provides that hearsay evidence may only be used "for the purpose of supplementing or explaining other evidence, but it shall not be sufficient in itself to support a finding unless it would be admissible over objections in civil actions." None of the hearsay exceptions applicable in civil actions as set out in sections 90.803 and 90.804, Florida Statutes, are applicable in this case. *See also*, rule 28-106.213(3), Florida Administrative Code. ("hearsay evidence … may be used to supplement or explain other evidence, but shall not be sufficient in itself to support a finding unless the evidence falls within an exception to the hearsay rule as found in chapter 90, Florida Statutes."); *BAPCO v. Unemployment Appeals Commission*, 654 So.2d 292, 296 (Fla. 5th

DCA 1995) (until evidence exists in the record for hearsay to supplement or explain, hearsay evidence is “useless” and should be excluded.).

8. The portions of Ms. Abbott’s and Mr. Gillette’s testimony indicated in the attached Exhibits A – E do not supplement or explain other evidence. Rather, they are offered to singularly establish the truth of the matter asserted. As such, they are impermissible hearsay and should be stricken. Examples of inadmissible hearsay within Ms. Abbott’s and Mr. Gillette’s testimony are:

- Ms. Abbott’s assertion in her Direct Testimony, beginning on page 17, line 24, that “S&P calls “cash-flow analysis the single most critical aspect of all credit rating decisions.”” Ms. Abbott quotes from the 2006 Standard & Poor’s Corporate Ratings Criteria. The S&P publication is a declaration made out of court, not capable of being tested by cross examination, and is classic hearsay that is not admissible to establish the truth of the matter asserted.
- Ms. Abbott’s assertion in her Direct Testimony, beginning on page 18, line 1, that “[a]lthough they do not publish a ratings grid, Moody’s and Fitch use similar financial metrics and emphasize cash flow strongly.” Ms. Abbott provides no basis for this assertion, and her statement undoubtedly is information secured from an out of court declarant or source. As such, it is a declaration made out of court, not capable of being tested by cross examination, and is classic hearsay that is not admissible to establish the truth of the matter asserted.

- Mr. Gillette's assertions in his Direct Testimony beginning on page 17, line 4, that "[t]he processes used by the rating agencies to determine credit ratings are complex and consider many qualitative and quantitative factors." Further, beginning on page 18, line 16, he states that "[a]s part of their quantitative analyses, rating agencies focus on cash coverage ratios to determine a company's ability to meet its interest payments and debt obligations." Mr. Gillette provides no basis for these assertions, and his statements undoubtedly are information secured from an out of court declarant or source. As such, they are declarations made out of court, not capable of being tested by cross examination, and are classic hearsay statements that are not admissible to establish the truth of the matter asserted.

The above examples are illustrations of two types of hearsay statements that are being offered for the truth of the matter asserted and are not admissible under Florida law. Additional passages which must be stricken on this basis are included in Exhibits A – E.

Conclusion

WHEREFORE, for the reasons explained above, the portions of Susan D. Abbott's and Gordon L. Gillette's prefiled direct and rebuttal testimony (and associated exhibits) as specifically identified in attached Exhibits A – E are inadmissible hearsay, should be stricken, and should not be used as a basis for a finding.

s/ Vicki Gordon Kaufman

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the Florida Industrial Power User's Group's Motion to Strike Prefiled Testimony And Exhibits of Susan D. Abbott and Gordon L. Gillette has been furnished by electronic mail and U.S. Mail this 7th day of January, 2009, to the following:

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DOCKET NO. 080317-EI
FILED: January 7, 2009

FLORIDA INDUSTRIAL POWER USERS GROUP'S MOTION TO STRIKE PREFILED TESTIMONY AND EXHIBITS OF SUSAN D. ABBOTT AND GORDON L. GILLETTE

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MOTION TO STRIKE PREFILED TESTIMONY AND EXHIBITS
OF SUSAN D. ABBOTT AND GORDON L. GILLETTE

EXHIBIT B
Direct Testimony and Exhibit of Susan D. Abbott
(with hearsay testimony underlined)

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 080317-EI

IN RE: TAMPA ELECTRIC COMPANY'S
PETITION FOR AN INCREASE IN BASE RATES
AND MISCELLANEOUS SERVICE CHARGES

DIRECT TESTIMONY AND EXHIBIT

OF

SUSAN D. ABBOTT

ON BEHALF OF TAMPA ELECTRIC COMPANY

A. There are three principal U.S. rating agencies: Moody's Investors Service ("Moody's"), Fitch Ratings ("Fitch"), and Standard and Poor's ("S&P"). They have been in business since the turn of the 20th century or shortly thereafter, and they function as gatekeepers to financial marketplaces. Their primary function is to evaluate the creditworthiness of companies wishing to access capital in the public debt markets.

Their ratings, expressed as a series of letters and numbers, are used to indicate to investors the likelihood that a company issuing debt will pay principal and interest on time, and in amounts expected. <u>S&P, one of the largest rating agencies in the world, defines its ratings as an "evaluation of default risk over the life of a debt issue, incorporating an assessment of all future events to the extent they are known or can be anticipated"</u>[i].

The "rating symbols" are English alphabet letters used by all three major U.S. rating agencies and are recognizable regardless of an investor's native language. The rating scales of each major U.S. rating agency are shown in Document No. 2 of my exhibit. Each rating level represents the probability of default. The lower the rating, the higher the probability of default. When ratings fall from investment grade to non-investment grade, the probability of default rises rapidly to levels that are often double those of the lowest investment grade rating.

From 1982 through 2006, the average cumulative credit loss as the result of a default was 13.4 percent by year 20 in the life of a Baa bond, according to Moody's. In the same report, they calculated that 30.8 percent of Ba- rated issuers default, a rate more than twice as high as Baa-rated securities.[ii] Conversely, an investor in an A rated issuer will experience 6.4 percent loss over 20 years, less than half that of a Baa rated investment and a quarter of the loss that can be expected for a Ba rated investment.[iii] Any company that loses its investment grade status, in addition to paying more for the money it borrows to reflect the higher probability of default, has the added challenge of trying to regain its investment grade rating. According to Moody's, fewer than 35 percent of such companies regain their investment grade rating within five years.[iv]

Q. How are ratings used?

completion of critical infrastructure construction in jeopardy and undermine reliability of service.

Q. What has happened in the electric industry in the past few years?

A. Two things of importance. Most utilities have gone "back to basics", meaning they have adjusted their business strategies to refocus on regulated electric and gas services. The other important issue is capital spending. The last construction cycle was completed almost 20 years ago. The infrastructure of the industry needs to be renewed, and growth has necessitated additional spending for new generation equipment as well as new distribution and transmission lines in addition to the extension of those already in place. A report published on March 24, 2008 by S&P reflects its current concerns, and is titled Credit Perspective: Regulatory Risk Remains for U.S. Utilities. In it, S&P states that for "utilities….entering a multiyear capital expansion phase for growth and to accommodate mandatory environmental standards and replace aging infrastructure, borrowing needs will rise…" Therefore, "regulatory risk remains key to credit quality". I believe Tampa Electric's challenges mirror those of the

A. Regulators should be concerned about the views held by rating agencies because electric utilities are capital intensive entities that must obtain capital from the markets to provide service. The California Public Employee Retirement System estimates that $20 trillion needs to be invested in the U.S. infrastructure over the next 25 years. This includes investments in electric utility transmission and distribution equipment, generation, water facilities, bridges, tunnels, and toll roads among other things. The need for capital in the electric utility industry alone will more than double from 2004 levels to approximately $60 billion annually by 2010 according to Lehman Brothers' estimates.[v]

Utilities throughout the U.S. are faced with large capital programs needed to upgrade aging equipment, provide for growth in their service territories, make environmentally conscious investments and maintain service quality. Utilities must rely on either debt or equity capital provided from external sources and the funds a company can generate internally to finance these capital programs. There are no other options. A company's creditworthiness, as expressed through its ratings, will dictate its ability to attract capital in an increasingly competitive capital market.

Q. What impact does regulatory action have on a utility's ratings?

A. Quite a lot. Capital-intensive companies like utilities need to maintain access to capital markets on reasonable and sustainable terms. Regulated utilities are unique, because they are not free to set their own prices for service. Their financial integrity is a function of the way the company is managed and the price levels set by regulators in a rate case. Rates are established by regulators to permit recovery of operating expenses and to provide a fair return on the capital invested. It follows that rate decisions by utility commissions have a major impact on the financial health of utilities.

Indeed, it is fair to say that the investment community perceives that utility commissions have a significant impact on the financial health of the utilities they regulate. <u>For example, Moody's states that "the supportiveness of the regulatory framework under which a utility operates is a critical rating factor"[vi]. Moody's states further, that "the most significant risk [for utilities] might be future disallowances of investments that were made with an understanding that those investments were prudent and necessary at the time</u>

they were made"[vii]. And, in its 2008 Industry Outlook, Moody's cites as a key risk, "an increasing likelihood that utility cash outflows could materially outpace authorized cash inflows – thereby potentially creating an acute deferral/recovery overhang risk"[viii]. S&P expressed its view on the subject even more explicitly by naming an article written in 2004, "Utility Regulation Determines its Ratings". The article is a tutorial on how S&P analyzes regulation in light of the "renewed and increasing influence that regulators are asserting on the creditworthiness of utilities…".

Q. What are rating agencies looking for relative to regulation going forward?

A. Rating agencies are keenly aware of the capital spending cycle utilities have just entered. They have opined that while the "fundamental credit outlook for the U.S. electric utility sector currently remains stable, material negative bias appears to be developing over the intermediate and longer term due to rapidly rising business and operating risks"[ix]. The rising business and operating risks referred to are associated with the current building cycle. Therefore, rating agencies are looking to see whether regulators are taking sufficient action to preserve the financial integrity of the utilities they regulate.

Q. How are ratings established?

A. Ratings analysis is a complex exercise that strives to balance financial results against qualitative risks. That result is then viewed in the context of the corporate structure and industry in which the company operates. While there are dozens of metrics calculated to determine a rating, S&P publishes a grid in which it overlays ranges of financial results for the three most important financial metrics with risk levels determined by examining a company's operating risks, political environment, and competitive position. S&P emphasizes, however, that "it is critical to realize that ratings analysis starts with the assessment of the business and competitive profile of the company. Two companies with identical financial metrics are rated very differently, to the extent that their business challenges and prospects differ"[x]. S&P describes its ratings grid as one that shows how "the company's business-risk profile determines the level of financial risk appropriate for any rating category"[xi]. The primary business risk the agencies focus on for utilities is regulation.

The rating agencies have their own views of the regulatory climate in which a company operates, but also pay attention to knowledgeable Wall Street and other financial firms who express views on state regulatory climates. Florida is presently regarded by a number of equity analysts as having a constructive regulatory environment because of innovative and forward looking regulatory practices, including the timely recovery of storm restoration costs as a result of hurricanes in 2004 and 2005, and timely recovery of changes in fuel, purchased power, conservation, and environmental compliance costs. Regulatory Research Associates ("RRA"), a firm that focuses entirely on regulation of utilities, ranks the FPSC as "Above Average 2"[xii] on a scale that runs from Above Average 1 (in which there are no entries currently) to Below Average 3. The entire RRA rankings are presented in Document No. 3 of my exhibit.

Constructive regulatory policies and practices that support the creditworthiness of the utilities a regulatory body oversees is one of the most important issues rating agencies consider when deliberating ratings. Regulation in Florida is considered among the best in the country, and that has benefited customers by allowing utilities to provide for their customers' needs at a lower cost than they might otherwise. This has been one of the factors that have helped Florida utilities maintain pace with the growth in the state, which is essential to economic development.

Q. What does S&P emphasize in its ratings grid?

A. <u>S&P emphasizes three metrics: 1) funds from operations as a percentage of debt outstanding ("FFO/Debt"), 2) funds from operations coverage of interest ("FFO/Int"), and 3) debt to total capitalization ("Debt/Cap"). All three metrics measure cash flow or the obligations that need to be covered by that cash. The first two are cash measurements that describe how well a company's cash flow from operations supports its debt and interest burden. The third metric, Debt/Cap, describes how heavy that burden is. Numerous other financial metrics are calculated when a rating is assigned, but cash flow metrics are the most important.</u> After all, cash obligations can only be paid by cash. Therefore, how well a company generates cash relative to its cash obligations is critical to an analysis of creditworthiness. <u>S&P calls "cash-flow analysis the single most critical aspect of all credit rating</u>

decisions"[xiii]. Although they do not publish a ratings grid, Moody's and Fitch use similar financial metrics and emphasize cash flow strongly.

Q. Do the agencies overlay qualitative measures on the financial metrics in assigning ratings?

A. Absolutely. There are a number of qualitative issues that affect a company's rating, but the single most important qualitative risk factor analyzed by the rating agencies for electric utilities is the quality of regulation. Strategy, capital programs, customer base, and basic business profile (*i.e.*, whether a utility is a low risk transmission and distribution company or a higher risk vertically integrated one) are all important, but a company's financial integrity is significantly impacted by the rates regulators allow a company to charge. Regulators authorize the level of return on equity, the amount of equity on which a company is allowed to earn, and rate design, and these factors help determine cash flow. Since cash flow is of resounding importance, rating agencies are keenly focused on rates and whether they create cash flow that adequately covers fixed obligations.

S&P recently changed their descriptive ratings grid relative to utilities to normalize their expression with that used for all other corporate entities. They rank companies for business risk using the following appellations: "excellent", "strong", "satisfactory", "weak", and "vulnerable". Financial risk is described as "minimal", "modest", "intermediate", "aggressive", or "highly leveraged". All utilities have been judged to have "excellent" or "strong" business risk profiles. This reflects the quality of regulation and the continued need for supportive regulation to maintain credit ratings that allow free access to capital markets. The entire S&P grid is shown in Document No. 4 of my exhibit.

Q. Once ratings analysts have all of this information, how is a rating determined?

A. Ratings are determined through an extensive process that involves a detailed examination of all the information available to the analyst, and the application of a significant amount of judgment based on experience. It is always difficult to accurately predict what a rating agency will do. However, rating agencies provide investors and rated companies some guidelines as to their methodologies. S&P is the most transparent about their rating practices, although their matrix that compares business risk and financial risk is very broad, so understanding when they might move a rating is extremely difficult. Nevertheless, the process rating agencies use to determine a rating is fairly straightforward. Once the financial metrics are calculated and an analyst has determined the business risk level of a company, he or she compares the results to those of comparable companies in the industry as well as against internal standards that have been developed at each rating agency.

Q. In your opinion, what should Tampa Electric be targeting as its credit rating?

A. Tampa Electric needs to access the capital markets in order to make capital investments for the benefit of its customers. Because it is in competition for capital with other utilities and infrastructure entities, it is essential that Tampa Electric have credit quality sufficient to ensure access to capital under all market conditions. In my opinion, that desired rating level is in the A range. To achieve this rating, regulation must support the financial integrity of the company to a spending period and potential hurricane damage.

Q. How does S&P view Tampa Electric under its descriptive ratings grid?

A. Tampa Electric is considered to have an "excellent" business risk profile in part because it is a regulated electric utility serving a growing customer population in Florida. However, it is considered to have an "aggressive" financial risk profile, indicating that the financial metrics are relatively modest.

S&P's business risk level of "excellent", and financial risk profile of "aggressive", qualifies the company for a BBB rating, which is the rating Tampa Electric currently has. For Tampa Electric to achieve a better rating to carry it through its construction program, during which financial stress may degrade its metrics, the company should have stronger financial metrics. Document No. 5 of my exhibit contains a comparison of Tampa Electric's financial metrics to the range needed for both the current BBB rating, assuming an "excellent" business risk ranking, as well as what is necessary to move the financial risk indication to a more reasonable "intermediate" level, which would qualify for an A rating.

As can be seen, Tampa Electric's metrics, especially the important cash flow metrics of FFO/Debt and FFO/Interest, currently fall in, or near, the guidelines for the BBB rating category. More importantly, however, they are deteriorating. With a heavy capital program and persistent need to access the capital markets, Tampa Electric requires healthier financial metrics to ensure capital market access on a sustainable basis. As mentioned previously, Moody's is concerned about the overall industry's financial indicators, which "have been relatively stable over the past few years … a *credit negative* since stronger metrics would be needed to offset the pace of rising business and operating ~~risk~~"[xiv].

Q. Document No. 5 of your exhibit shows that some of Tampa Electric's credit metrics in 2007 and in projected 2009 fall within the A range of the S&P matrix. Doesn't that indicate that Tampa Electric already has credit metrics that should qualify it for an A rating?

A. Clearly not. All three of the rating agencies affirmed Tampa Electric's ratings in the BBB category. The rating reports state either that Tampa Electric's credit metrics are consistent with the current rating, or that improvements in the company's credit metrics could lead to ratings improvements. The S&P matrix that compares business risk and financial risk is, as I noted, very broad and does not represent the only factors affecting a rating. For example, a utility with the same credit metrics as Tampa Electric but with modest capital needs that are expected to be met entirely with internal cash flows might be rated A. But, it is very clear that Tampa Electric has significant capital spending requirements that will require external funding, and this is a continuation of a trend that has resulted in the deterioration of the company's credit metrics over time, as Document No. 5 of my exhibit illustrates.

Q. What are the most recent pronouncements of the rating agencies that you believe are relevant to Tampa Electric's financial standing?

A. Most recently, Fitch affirmed Tampa Electric's rating, citing credit concerns related to construction expenditures, environmental requirements, and the need for base rate relief to maintain current metrics. At the same time, recognizing the distinction between Tampa

Electric and TECO Energy, Fitch upgraded TECO Energy, Tampa Electric's parent company, to BBB- (investment grade) from BB+ (non-investment grade). Similarly, Moody's affirmed Tampa Electric's ratings in December of 2007 but upgraded TECO Energy's ratings. In its press release, Moody's stated that a "rating upgrade of the utility (Tampa Electric) could be considered if there is additional clarity on the size and timing of its capital expenditure program and the magnitude and regulatory response to potential rate increases related to these capital expenditures"[xv]. Finally, in June 2008, S&P changed its outlook on TECO Energy and Tampa Electric to positive from stable stating that the company "should be able to achieve better credit metrics as it focuses on achieving greater cash realization through the regulatory process". They go on to say that, "the company's ability to manage regulatory risk during the construction program will be an important factor in resolving the positive outlook"[xvi].

Q. In your opinion, what are the implications of those pronouncements for Tampa Electric?

A. First, all three of the rating agencies cite the same capital program and necessary rate relief as issues of concern. Moody's stated, in its Credit Opinion on Tampa Electric published in December of 2007, that "the rating is constrained by expected high capital expenditure requirements for the system reliability and environmental compliance…".[xvii] All three rating agencies have clearly expressed their opinion that Tampa Electric's financial position results from the need to recover significant expenditures on its system and the uncertainty regarding future rate decisions. As a result, they are keeping Tampa Electric's ratings at the BBB/Baa level in anticipation of continued financial strain and uncertainty about regulatory outcomes.

Q. If the Commission approves the rate increase as requested by Tampa Electric in this proceeding, will this be sufficient to improve its credit rating?

A. Yes, it should be sufficient. Looking at the S&P grid for the 2009 test year and assuming the requested rate increase is approved, the credit metrics appear to be in the range of "intermediate", and should support credit ratings in the A range. More importantly, the credit metrics would improve measurably from their current levels and reverse the declining trend, something the rating agencies have cited as a catalyst for future upgrades of Tampa Electric's credit ratings.

Q. Please summarize your direct testimony.

A. My direct testimony supports the conclusion that Tampa Electric's current ratings are primarily the result of 1) changes in the risk level and general nature of the regulated electric utility sector since the company's last rate filing, and 2) an unrelenting need to fund capital expenditures in order to provide service to a constantly growing customer base. I also conclude that in order for Tampa Electric to access the capital markets to continue to fund a robust and necessary capital program at costs that limit rate impacts on customers, it needs to improve its ratings to the A level. Approval of the company's requested rate increase should improve its credit metrics and result in an A level profile.

Q. Does that conclude your direct testimony?

A. Yes it does.

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EXHIBIT NO. ____ (SDA-1)
WITNESS: ABBOTT
DOCUMENT NO. 2
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Rating Agencies' Rating Symbols[1]

Investment Grade	Non-Investment Grade
AAA/Aaa	BB+/Ba1
AA+/Aa1	BB/Ba2
AA/Aa2	BB-/Ba3
AA-/Aa3	B+/B1
A+/A1	B/B2
A/A2	B-/B3
A-/A3	CCC+/Caa1
BBB+/Baa1	CCC/Caa2
BBB/Baa2	CCC-/Caa3
BBB-/Baa3	CC/Ca
	C/C
	D/na

The definition for the lowest investment grade category, BBB/Baa (including the +, -, 1, 2, and 3 gradations) means they are "subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics."[2]

BB/Ba rated, or non-investment grade companies, however, "are judged to have speculative elements and are subject to substantial credit risk" while B/B rated paper is "considered speculative and … subject to high credit risk".[3] The differences between investment grade and non-investment grade can be quite stark in terms of access to, and cost of funds in the marketplace, and at times, even the difference between interest rates required for A and BBB rated issuers can be quite striking.

1 S&P and Fitch, who use the same rating symbols, appear first, with Moody's symbols after the slash

2 Moody's ratings definitions, Moody's Sourcebook, Power and Energy Company, October 2004; S&P's definitions, while using different words, are essentially the same in concept.

3 *IBID*

Public Utility Commission Rankings

Compiled by Regulatory Research Associates

As Of April 30, 2008

Jurisdiction	RRA Ranking
Alabama	Above Average / 2
Arkansas	Below Average / 1
Arizona	Average / 3
California	Average / 1
Colorado	Average / 2
Connecticut	Average / 3
District of Columbia	Average / 2
Delaware	Average / 1
Florida	Above Average / 2
Georgia	Average / 1
Hawaii	Average / 2
Iowa	Above Average / 3
Idaho	Average / 3
Illinois	Below Average / 2
Indiana	Above Average / 2
Kansas	Average / 3
Kentucky	Average / 2
Louisiana	Average / 3
Massachusetts	Average / 1
Maryland	Average / 2
Maine	Average / 2
Michigan	Average / 2
Minnesota	Average / 2
Missouri	Average / 3
Mississippi	Above Average / 3
Montana	Below Average / 1
North Carolina	Above Average / 2
North Dakota	Average / 2
Nebraska	Average / 2

Jurisdiction	RRA Ranking
New Hampshire	Average / 3
New Jersey	Average / 2
New Mexico	Average / 3
Nevada	Average / 2
New York	Average / 2
Ohio	Average / 2
Oklahoma	Average / 2
Oregon	Average / 3
Pennsylvania	Average / 3
Rhode Island	Average / 2
South Carolina	Average / 1
South Dakota	Average / 2
Tennessee	Average / 1
Texas	Below Average / 1
Texas	Below Average / 1
Utah	Average / 3
Virginia	Above Average / 3
Vermont	Average / 3
Washington	Average / 1
Wisconsin	Above Average / 2
West Virginia	Below Average / 1
Wyoming	Average / 2

Standard & Poor's Corporate Ratings Matrix

Business Risk / Financial Risk

	Financial Risk Profile				
Business Risk Profile	**Minimal**	**Modest**	**Intermediate**	**Aggressive**	**Highly Leveraged**
Excellent	AAA	AA	A	BBB	BB
Strong	AA	A	A-	BBB-	BB-
Satisfactory	A	BBB+	BBB	BB+	B+
Weak	BBB	BBB-	BB+	BB-	B
Vulnerable	BB	B+	B+	B	B-

Financial Risk Indicative Ratios - U.S. Utilities

(Fully adjusted, historically demonstrated, and expected to consistently continue)

	Cash Flow		Debt Leverage
	(FFO/debt)(%)	(FFO/interest)(x)	(Tot debt/cap)(%)
Modest	40 - 60	4.0 - 6.0	25 - 40
Intermediate	25 - 45	3.0 - 4.5	35 - 50
Aggressive	10 - 30	2.0 - 3.5	45 - 60
Highly Leveraged	Below 15	2.5 or less	over 50

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EXHIBIT NO. ___ (SDA-1)
WITNESS: ABBOTT
DOCUMENT NO. 4
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Tampa Electric's Credit Metrics
versus
Standard & Poor's Metrics Matrix
2004 - 2009 Test Year

	S&P Ratings Level (Business Risk "Excellent") — Financial Risk		Actual				Proforma Adjusted Test Year	
	aggressive	intermediate					wo/rates	w/rates (1)
	BBB	A	2004	2005	2006	2007	2009	2009
FFO/Debt	10%-30%	25%-45%	36%	34%	30%	30%	30%	39%
FFO/Interest	2.0x-3.5x	3.0x-4.5x	4.8x	4.3x	3.8x	3.7x	3.4x	4.5x
Debt/Capital	45%-60%	35%-50%	51%	51%	54%	54%	45%	45%

1) Reflects full year of requested revenue increase of $228,167,000.

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EXHIBIT NO. ___ (SDA-1)
WITNESS: ABBOTT
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FILED: January 7, 2009

FLORIDA INDUSTRIAL POWER USERS GROUP'S
MOTION TO STRIKE PREFILED TESTIMONY AND EXHIBITS
OF SUSAN D. ABBOTT AND GORDON L. GILLETTE

EXHIBIT C
Rebuttal Testimony and Exhibit of Susan D. Abbott
(with hearsay testimony underlined)

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 080317-EI

IN RE: TAMPA ELECTRIC COMPANY'S
PETITION FOR AN INCREASE IN BASE RATES
AND MISCELLANEOUS SERVICE CHARGES

REBUTTAL TESTIMONY

OF

SUSAN D. ABBOTT

ON BEHALF OF TAMPA ELECTRIC COMPANY

construction program and the need to purchase large amounts of fuel and purchased power on a regular basis. Solid creditworthiness is essential for both access to the financial markets, and to make capital expenditures and to purchase fuel, materials, and supplies necessary to produce electricity for ratepayers. My testimony is meant to help the Commissioners make a fully informed decision by providing insight into 1) how financial integrity is regarded by the rating agencies, 2) how rating agency actions affect a company's access to capital, and 3) what the financial metrics would be with and without the rates requested, both cases assuming a 55 percent equity level, as a way to gauge the effect on Tampa Electric's financial integrity of any decision the Commission makes. Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon make no attempt whatsoever to provide information on what their recommendations would do to the financial integrity of Tampa Electric.

Q. How do Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon reflect their interpretation of your testimony?

A. In his direct testimony, Dr. Woolridge states on pages 85, lines 19 through 21 and 86, lines 1 and 2, that I do "not perform any studies to evaluate the adequacy of Dr.

Q. But shouldn't Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon expect ratings analysis to include consideration of allowed returns on equity?

A. Yes. Any credit analysis includes an examination of allowed returns on equity. However, more important to creditworthiness than the level of returns allowed is how ROE, capital structure and rate design work together in light of the level of a company's business risk to generate cash flow that is adequate to support a company's credit ratings. Mr. Herndon fatuously states that I suggest that the company's ratings would "automatically" improve if it were granted its requested return on equity. After 20 years of working at a rating agency, and more than ten years working with them from the outside, I know that nothing is "automatic" about what they do, and the return on equity is far from the only thing the rating agencies look at. <u>What I did suggest was that approval of the requested rate increase and capital structure would improve the company's financial profile to the point where A ratings by the rating agencies would be warranted.</u>

Q. Why have you concluded that none of the three intervenor witnesses demonstrates an understanding of the rating

Q. Why is Dr. Woolridge mistaken in his approach to this issue?

A. The inclusion of PPAs as debt equivalents has been incorporated as a core part of utility credit analysis by the rating agencies since the early 1990s. S&P has always taken a more systematic approach to the issue than has Moody's. S&P has published numerous articles on the topic, and clearly stated in its May 7, 2007 update on the topic, "in cases where a regulator has established a power cost adjustment mechanism that recovers all prudent PPA costs, we employ a risk factor of 25 percent…" Florida has established such an adjustment mechanism, and therefore, Tampa Electric qualifies for S&P's 25 percent risk factor adjustment. In addition, as Tampa Electric witness Gordon Gillette discusses in his rebuttal testimony, S&P has told Tampa Electric that this is the risk factor they use when making adjustments to the company's balance sheet. Even though there is a purchased power cost pass-through mechanism in Florida, S&P apparently believes there is enough residual risk to reflect a 25 percent risk factor in its analysis, indicating that they do not believe the pass-through clause entirely mitigates the risk of the PPAs.

Q. How do you respond to the claim that Moody's does not adjust for PPAs, and, therefore, those adjustments should be ignored?

A. The truth is that Moody's does calculate a debt equivalent for PPAs. They just do not put as much weight on them as does S&P, and may not, under certain circumstances, reflect the adjustment in their metrics. Nevertheless, the concept that if rating agencies make different adjustments, those adjustments should somehow be negated makes no sense. That approach shows a lack of understanding of how investors view ratings and risk.

Q. Why is that?

A. If the inclusion of PPA obligations as debt equivalents results in pressure on either a rating that becomes visible to investors in the form of a negative outlook, or a lower rating than another agency has for that same company, the investors will default or give more weight to the lower outlook or rating. That negatively affects a company's ability to access the market and affects the interest rates for new debt.

Q. You cited two issues Dr. Woolridge is mistaken about.

What is the second?

A. Dr. Woolridge emphasizes that debt imputed by S&P relative to PPAs is not GAAP accounting, and therefore investors will not see the liability on the company's financial statements.

The rating agencies use GAAP statements as a starting point in their analyses. However, since they are interested only in cash flow measures of creditworthiness, they make routine adjustments to financial statements to include or exclude items. The rating agency believes those items represent a fixed obligation or change the level of cash flow. They make these adjustments regardless of what the GAAP treatment of those items may be. In addition, the rating agencies routinely publish reports on the adjustments they make, so investors are well aware of what they are. Investors do not blindly accept GAAP statements as the whole truth of a company's creditworthiness. If Dr. Woolridge understood that, he would never have made the odd statement that investors would never see the adjustments the rating agencies make.

Q. What statements did Mr. O'Donnell make that indicates he

A. Mr. O'Donnell is being provocative rather than helpful in his critique of my testimony. The "conflict of interest" that he refers to on page 42, lines 6 and 7, is grossly misunderstood by most and irrelevant to this case. <u>It involves the erroneous assumption on the part of some that the rating agencies cannot be objective because they are paid by the issuers they rate.</u> It is hard to see why, even if the assertion were true, it is relevant here. In addition, he suggests that I believe rates for electric service should be set by the rating agencies and that I do not understand the regulatory process. Further, the idea that a management concerned with its ratings is going to take risks it otherwise would not demonstrates a complete lack of understanding of rating agencies. Rating agencies do not like risk, and would, therefore downgrade or otherwise maintain a low rating on a company that increased its risk. Therefore, where is the incentive provided by a rating agency for company management to take risk? There simply is no incentive. Mr. O'Donnell's statements have nothing to do with the substance of my testimony, or Tampa Electric's financial integrity. He seems to have been unable to formulate a cogent argument as to why Tampa Electric's financial integrity is not important to the Commission, and has chosen instead to attack the recovery clauses the FPSC allows which do diminish risk to a certain degree, they have not demonstrated that they understand that the utility industry suffers from high levels of financial risk.

Q. What do you mean by "financial risk"?

A. Rating agencies construct ratings by examining both business risk and financial risk. Business risk includes such issues as regulatory practices, the growth rates for electric service in the service territory, fuel use, customer mix, etc. Financial risk relates to how much leverage a company has and how well its cash flow covers its obligations. As I explained in my direct testimony, S&P evaluates all companies for business risk on a scale of "Excellent" to "Vulnerable", and for financial risk on a scale of "Modest" to "Highly Leveraged". Although 133 of the 180 utilities S&P rates have "Excellent" business risk profiles, meaning their business risk is low, 106 are deemed to have "Aggressive", or high financial risk, while 65 have "Intermediate" financial risk. Only one is deemed to have "Modest" financial risk. As a result, even their "Excellent" business risk positions only generate an average industry rating of BBB. In today's markets, BBB utilities can not access the markets at all at times, or can do so, but only at very high cost.

Q. What indicates that Dr. Woolridge, Mr. O'Donnell, and Mr. Herndon are out of touch with market conditions?

A. Several things. First, Mr. Herndon illogically claims that a 7.5 percent return on equity would be attractive to investors. In the current market environment, if BBB utilities even have access to the markets, they are paying 9 percent and 10 percent for 10-year debt. No equity investor will accept an equity return that is less than the company's cost of debt, simply because the equity holder's risk is higher than the debt holder's. In fact, that subordinate position leads equity investors to demand a reasonable spread between the cost of debt and the return on equity. Mr. Herndon also compares his recommended return on equity to the risk free rate, which is quite low. In fact, the Treasury rate has been pushed down to stimulate economic growth, while the credit markets, when they are open, are requiring higher and higher spreads to that Treasury rate. The new issue bond market was closed entirely for two weeks in September. When it reopened, it opened to A and AA rated utilities and AAA corporations. Spreads, which had been in the 175 to 300 basis points range for A rated utilities at the low end, and split rated utilities in the BBB range at the high end, prior to the market closing increased to 350, then 400, and were recently at almost 700 basis points for unsecured 10 year debt of investment grade split rated companies. Dr. Woolridge claims that capital costs are at historic lows. This is the same misinformation provided by Mr. Herndon. Treasury rates may be at historic lows, but utilities do not borrow at Treasury rates. The evidence is clear that interest rates required by investors to lend money to utilities are higher than they have been since the recovery from the economic slump of the early 1990's. In addition, the difference in cost from one rating category to the next is higher than it has been in at least 20 years. More importantly, access is limited. Despite most utilities having aggressive construction spending needs, issuance of utility debt in the U.S. dropped in the third quarter of this year by half, from $20.1 billion to $9.7 billion, according to Dealogic.

Q. The absence of a study of the cost of an increase in Tampa Electric's ratings, assuming the requested return on equity is granted, has been criticized by both Mr.

the targeted 55.3 percent equity ratio, with and without the requested rate increase. However, Tampa Electric's witness Mr. Gillette provided a complementary exhibit to mine which included what the financial metrics would be without the proposed rate increase at Tampa Electric's 2007 equity ratio of 46 percent. <u>The resulting financial metrics indicate the company needs both rate relief and the proposed equity ratio to be more assured of achieving credit rating parameters within its targeted single A debt rating.</u>

Q. Please summarize your rebuttal testimony.

A. My rebuttal testimony explains my view that Dr. Woolridge, Mr. O'Donnell and Mr. Herndon either did not understand, or will not acknowledge that my direct testimony was in support of Tampa Electric's need for improved financial integrity in order to access the capital markets to successfully pursue an ambitious construction program undertaken for the benefit of ratepayers. None of them explored what their own recommendations meant to the financial integrity of the company, and they seem to have failed to understand the benefits to both consumers and financial partners of a financially healthy utility. I have demonstrated that, contrary to Dr. Woolridge, Mr. O'Donnell and Mr. Herndon's claims, <u>the financial markets are both difficult to access and are demanding higher rates of interest, even for what would be considered "creditworthy" entities.</u> I have also injected some balance into their views of how much risk the utility industry endures. My direct and rebuttal testimonies were written to illuminate the issue of financial integrity and how important it is to a company that needs to access the capital markets on a regular basis. Not one of the witnesses acknowledges my focus on cash flow and how a regulatory decision affects credit metrics. The Commissioners, while taking into consideration all of the relevant testimony provided them in this case, must understand that their decision, which is theirs alone to make, will have a profound impact on Tampa Electric's ability to access the capital markets, and at what price. Credit metrics combined with business risk factors dictate the level of a company's creditworthiness. Creditworthiness defines the ability of a company to access the capital markets. With a $3.5 billion construction program in progress, Tampa Electric needs to improve and then maintain its financial integrity in order to access the markets at will. This message was lost on Dr. Woolridge, Mr.

DOCKET NO. 080317-EI
FILED: January 7, 2009

FLORIDA INDUSTRIAL POWER USERS GROUP'S MOTION TO STRIKE PREFILED TESTIMONY AND EXHIBITS OF SUSAN D. ABBOTT AND GORDON L. GILLETTE

EXHIBIT D
Direct Testimony and Exhibit of Gordon L. Gillette
(with hearsay testimony underlined)

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 080317-EI

IN RE: TAMPA ELECTRIC COMPANY'S
PETITION FOR AN INCREASE IN BASE RATES
AND MISCELLANEOUS SERVICE CHARGES

TECO.
TAMPA ELECTRIC

DIRECT TESTIMONY AND EXHIBIT
OF
GORDON L. GILLETTE

Financial strength is often referred to in regulatory circles as "financial integrity". If the company and its regulators act in ways that maintain or enhance the company's financial integrity, customers will ultimately benefit. The Commission has a history of performing the delicate balancing act between rate increases and maintaining financial integrity very well. <u>The rating agencies and Wall Street alike have long recognized the Commission for its constructive regulatory decision making.</u> The Commission is viewed by Wall Street and the public as being tough but fair in reaching an appropriate balance between the interests of customers and investors.

CREDIT RATING OBJECTIVE

Q. What is Tampa Electric's current credit rating?

A. Tampa Electric is currently rated in the BBB range by the three major rating agencies: Standard & Poor's ("S&P"), Moody's Investor Service ("Moody's") and Fitch Ratings ("Fitch"). In her direct testimony, witness Abbott explains in more detail how the rating agencies currently view Tampa Electric and how they have derived their ratings for the company.

Q. What credit rating is the company targeting in the future

Q. Do the credit rating agencies publicly announce or publish what it takes to achieve certain credit ratings?

A. No. The processes used by the rating agencies to determine credit ratings are complex and consider many qualitative and quantitative factors. The ratings process typically provides little transparency, and the rating agencies publish no precise guidelines regarding how to achieve a certain rating. S&P is the only rating agency that has even attempted to provide some level of quantitative guidance. Some years ago, S&P published a matrix that identified ranges of credit parameters, such as coverage ratios, necessary to achieve certain credit ratings. However, S&P has recently modified this matrix, broadening the ranges for the ratings and leaving more room for judgment on their part, but creating greater uncertainty on the part of debt issuers, like Tampa Electric, on the exact quantitative targets needed to achieve certain credit ratings. In addition, since the rating agencies consider qualitative factors as well, achieving the quantitative parameters does not ensure that a particular rating will actually be achieved.

CAPITAL STRUCTURE

Q. What capital structure is Tampa Electric proposing in its test year?

A. Tampa Electric is projecting, for the 2009 test year, a jurisdictional adjusted 13-month average financial capital structure consisting of 44.7 percent debt, including off-balance sheet purchased power obligations, and 55.3 percent common equity. This 55.3 percent equity ratio is necessary since the company believes the combination of this capital structure and the resulting coverage ratios should enable the achievement of credit parameters commensurate with debt ratings in the single A range.

Q. What coverage ratios are important to rating agencies?

A. As part of their quantitative analyses, rating agencies focus on cash coverage ratios to determine a company's ability to meet its interest payments and debt obligations. Typical coverage ratios reviewed by the agencies are Funds from Operations to Interest (FFO/Interest) and Funds from Operations to Total Debt (FFO/Debt). Document No. 5 of my exhibit shows Tampa Electric's credit parameters on a historical and projected basis. It shows that there has been a significant deterioration in Tampa Electric's credit metrics as used by the credit rating agencies. If Tampa Electric's requested rate increase was not granted and the capital structure remained at the 2007 level, there would be another significant decline in the credit parameters. For Tampa Electric to improve its credit metrics, equity infusions from TECO Energy and base rate relief are needed. In her direct testimony, witness Abbott further addresses these credit parameters and the effect these factors have on Tampa Electric's credit ratings.

Q. Did you consider other credit parameters when targeting ratings in the single A range?

A. Yes. <u>Although the rating agencies tend to focus on cash coverage ratios, another commonly used parameter in the utility industry is an Earnings Before Interest and Taxes to Interest (EBIT/Interest) coverage ratio.</u> This coverage ratio is included in the company's MFR Schedule D-9 and is reported in Schedule 5 of the company's monthly Surveillance Report filings. Tampa Electric's coverage ratio for EBIT/Interest has been declining and is projected to be 2.1 times in 2009. This same coverage ratio averaged 4.6 times in 1992 through 2000 and 3.5 times in 2001 through 2007. The 2.1 times represents an

A. Yes. <u>Since the rating agencies consider portions of long-term fixed payments associated with purchased power agreements as debt and analyze company credit profiles with an adjustment to its credit parameters, the company's proposed capital structure reflects an adjustment for this imputation of additional debt.</u>

Q. Using the S&P methodology, please describe the calculation for the additional debt that reflects the associated risk of long-term purchased power agreements in Tampa Electric's capital structure.

A. S&P discounts future capacity payments using a discount rate based on the cost of debt, and then applies a "risk factor" to determine the amount of imputed debt to include in the adjusted debt to total capital. For similarly situated electric utilities as Tampa Electric, S&P uses a risk factor of 25 percent. S&P also imputes an annual amount for interest expense in cash coverage ratios for the imputed debt.

Q. Using S&P's methodology, how much debt and interest expense has been imputed to recognize the impact of purchased power agreements on Tampa Electric's capital structure for 2009?

Utility Credit Ratings*

	S&P	%	Moody's	%	Fitch	%
Nationwide number of utilities at ratings level of:						
AA	0	0.0%	0	0.0%	0	0.0%
A	24	25.0%	29	33.8%	19	24.0%
BBB	60	62.5%	50	58.1%	47	59.5%
BB	12	12.5%	7	8.1%	13	16.5%
B	0	0.0%	0	0.0%	0	0.0%
	96	100.0%	86	100.0%	79	100.0%
Southeast number of utilities at ratings level of:						
AA	0	0.0%	0	0.0%	0	0.0%
A	8	53.3%	9	60.0%	8	61.5%
BBB	7	46.7%	5	33.3%	4	30.8%
BB	0	0.0%	1	6.7%	1	7.7%
B	0	0.0%	0	0.0%	0	0.0%
	15	100.0%	15	100.0%	13	100.0%

*Derived from the Regulatory Research Associates Credit Rating Report as of May 30, 2008. Excludes Tampa Electric.

TAMPA ELECTRIC COMPANY
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FILED: January 7, 2009

FLORIDA INDUSTRIAL POWER USERS GROUP'S
MOTION TO STRIKE PREFILED TESTIMONY AND EXHIBITS
OF SUSAN D. ABBOTT AND GORDON L. GILLETTE

EXHIBIT E
Rebuttal Testimony and Exhibit of Gordon L. Gillette
(with hearsay testimony underlined)

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 080317-EI

IN RE: TAMPA ELECTRIC COMPANY'S
PETITION FOR AN INCREASE IN BASE RATES
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TECO.
TAMPA ELECTRIC

REBUTTAL TESTIMONY AND EXHIBIT
OF
GORDON L. GILLETTE

is Tampa Electric's. <u>Additionally, recent discussions with the rating agencies suggest that Tampa Electric's current credit parameters, including its equity ratio, are not sufficient to justify a single A rating.</u> Hence, the more important factors for Tampa Electric to obtain stronger debt ratings are for the company to receive the rate relief requested, including the proposed equity ratio and return on equity.

CAPITAL STRUCTURE

Q. Messrs. Woolridge and O'Donnell suggest alternatives to the 55.32 percent equity ratio proposed by Tampa Electric. Why should the Commission reject their recommendations and use the company's proposed equity ratio?

A. In the interest of lowering the revenue requirement, the intervenor witnesses have recommended much lower equity ratios than the company has proposed. Although they derived their recommended equity ratios using different arguments or justifications which I will discuss later in my testimony, their recommendations were similar (48.9 percent and 49.6 percent) compared to the company's proposed 55.32 percent. While Mr. O'Donnell's 49.6 percent recommendation was not stated directly in his

A. Dr. Woolridge makes three basic points in support of his position that a PPA adjustment is not warranted; 1) the risk factor is not defined, 2) the adjustment is not in accordance with GAAP accounting, and 3) the PPA payments are unlike debt. While Ms. Abbott addresses some of these issues in her rebuttal testimony, I have a few additional comments regarding his first and third points.

In his first point, Dr. Woolridge questions the use of the 25 percent risk factor in calculating the imputed debt amount and he states that the "S&P risk factor for imputing debt is not well defined and cannot be assessed in this situation." <u>To the contrary, through direct discussions with S&P, the company is aware that S&P has been and continues to impute debt for PPAs in its credit rating analysis of Tampa Electric by applying a 25 percent factor to the present value of the PPA capacity payments.</u> This is exactly what Tampa Electric has done in preparing the projected adjustment in this proceeding. <u>This is further supported by Document No. 1 of my Rebuttal Exhibit No. __ (GLG-2) which is an article that suggests that S&P would use a 25 percent factor for companies with recovery clause mechanisms similar to Tampa Electric's.</u>

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The McGraw-Hill Companies
STANDARD & POOR'S RatingsDirect

RESEARCH

Criteria | Corporates | Utilities:

Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements

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For many years, Standard & Poor's Ratings Services has viewed power supply agreements (PPA) in the U.S. utility sector as creating fixed, debt-like, financial obligations that represent substitutes for debt-financed capital investments in generation capacity. In a sense, a utility that has entered into a PPA has contracted with a supplier to make the financial investment on its behalf. Consequently, PPA fixed obligations, in the form of capacity payments, merit inclusion in a utility's financial metrics as though they are part of a utility's permanent capital structure and are incorporated in our assessment of a utility's creditworthiness.

We adjust utilities' financial metrics, incorporating PPA fixed obligations, so that we can compare companies that finance and build generation capacity and those that purchase capacity to satisfy customer needs. The analytical goal of our financial adjustments for PPAs is to reflect fixed obligations in a way that depicts the credit exposure that is added by PPAs. That said, PPAs also benefit utilities that enter into contracts with suppliers because PPAs will typically shift various risks to the suppliers, such as construction risk and most of the operating risk. PPAs can also provide utilities with asset diversity that might not have been achievable through self-build. The principal risk borne by a utility that relies on PPAs is the recovery of the financial obligation in rates.

The Mechanics Of PPA Debt Imputation

A starting point for calculating the debt to be imputed for PPA-related fixed obligations can be found among the "commitments and contingencies" in the notes to a utility's financial statements. We calculate a net present value (NPV) of the stream of the outstanding contracts' capacity payments reported in the financial statements as the foundation of our financial adjustments.

The notes to the financial statements enumerate capacity payments for the five years succeeding the annual report and a "thereafter" period. While we have access to proprietary forecasts that show the detail underlying the costs that are amalgamated beyond the five-year horizon, others, for purposes of calculating an NPV, can divide the amount reported as "thereafter" by the average of the capacity payments in the preceding five years to derive an approximate tenor of the amounts combined as the sum of the obligations beyond the fifth year.

In calculating debt equivalents, we also include new contracts that will commence during the forecast period. Such contracts aren't reflected in the notes to the financial statements, but relevant information regarding these contracts are provided to us on a confidential basis. If a contract has been executed but the energy will not flow until some later period, we won't impute debt for that contract until the year that energy deliveries begin under the contract if the contract represents incremental capacity. However, to the extent that the contract will simply replace an expiring contract, we will impute debt as though the future contract is a continuation of the existing contract.

We calculate the NPV of capacity payments using a discount rate equivalent to the company's average cost of debt, net of securitization debt. Once we arrive at the NPV, we apply a risk factor, as is discussed below, to reflect the benefits of regulatory or legislative cost recovery mechanisms.

Balance sheet debt is increased by the risk-factor-adjusted NPV of the stream of capacity payments. We derive an adjusted debt-to-capitalization ratio by adding the adjusted NPV to both the numerator and the denominator of that ratio.

We calculate an implied interest expense for the imputed debt by multiplying the same utility average cost of debt used as the discount rate in the NPV calculation by the amount of imputed debt. The adjusted FFO-to-interest expense ratio is calculated by adding the implied interest expense to both the numerator and denominator of the equation. We also add implied depreciation to the equation's numerator. We calculate the adjusted FFO-to-total-debt ratio by adding imputed debt to the equation's denominator and an implied depreciation expense to its numerator.

Our adjusted cash flow credit metrics include a depreciation expense adjustment to FFO. This adjustment represents a vehicle for capturing the ownership-like attributes of the contracted asset and tempers the effects of imputation on the cash flow ratios. We derive the depreciation expense adjustment by multiplying the relevant year's capacity payment obligation by the risk factor and then subtracting the implied PPA-related interest expense for that year from the product of the risk factor times the scheduled capacity payment.

Risk Factors

The NPVs that Standard & Poor's calculates to adjust reported financial metrics to capture PPA capacity payments are multiplied by risk factors. These risk factors typically range between 0% to 50%, but can be as high as 100%. Risk factors are inversely related to the strength and availability of regulatory or legislative vehicles for the recovery of the capacity costs associated with power supply arrangements. The strongest recovery mechanisms translate into the smallest risk factors. A 100% risk factor would signify that all risk related to contractual obligations rests on the company with no mitigating regulatory or legislative support.

For example, an unregulated energy company that has entered into a tolling arrangement with a third-party supplier would be assigned a 100% risk factor. Conversely, a 0% risk factor indicates that the burden of the contractual payments rests solely with ratepayers. This type of arrangement is frequently found among regulated utilities that act as conduits for the delivery of a third party's electricity and essentially deliver power, collect charges, and remit revenues to the suppliers. These utilities have typically been directed to sell all their generation assets, are barred from developing new generation assets, and the power supplied to their customers is sourced through a state auction or third parties, leaving the utilities to act as intermediaries between retail customers and the electricity suppliers.

Intermediate degrees of recovery risk are presented by a number of regulatory and legislative mechanisms. For example, some regulators use a utility's rate case to establish base rates that provide for the recovery of the fixed costs created by PPAs. Although we see this type of mechanism as generally supportive of credit quality, the fact remains that the utility will need to litigate the right to recover costs and the prudence of PPA capacity payments in successive rate cases to ensure ongoing recovery of its fixed costs. For such a PPA, we employ a 50% risk factor. In cases where a regulator has established a power cost adjustment mechanism that recovers all prudent PPA costs, we employ a risk factor of 25% because the recovery hurdle is lower than it is for a utility that must litigate time and again its right to recover costs.

We recognize that there are certain jurisdictions that have true-up mechanisms that are more favorable and frequent than the review of base rates, but still don't amount to pure pass-through mechanisms. Some of these mechanisms are triggered when certain financial thresholds are met or after prescribed periods of time have passed. In these instances, in calculating adjusted ratios, we will employ a risk factor between the revised 25% risk factors for utilities with power cost adjustment mechanisms and 50%.

Finally, we view legislatively created cost recovery mechanisms as longer lasting and more resilient to change than regulatory cost recovery vehicles. Consequently, such mechanisms lead to risk factors between 0% and 15%, depending on the legislative provisions for cost recovery and the supply function borne by the utility. Legislative guarantees of complete and timely recovery of costs are particularly important to achieving the lowest risk factors.

Illustration Of The PPA Adjustment Methodology

The calculations of the debt equivalents, implied interest expense, depreciation expense, and adjusted financial metrics, using risk factors, are illustrated in the following example:

Example Of Power-Purchase Agreement Adjustment

($000s)	Assumption	Year 1	Year 2	Year 3	Year 4	Year 5	Thereafter
Cash from operations	2,000,000						
Funds from operations	1,500,000						
Interest expense	444,000						
Directly issued debt							

Short-term debt	600,000						
Long-term due within one year	300,000						
Long-term debt	6,500,000						
Shareholder's Equity	6,000,000						
Fixed capacity commitments	600,000	600,000	600,000	600,000	600,000	600,000	4,200,000*
NPV of fixed capacity commitments							
Using a 6.0% discount rate	5,030,306						
Application of an assumed 25% risk factor	1,257,577						
Implied interest expense¶	75,455						
Implied depreciation expense	74,545						
Unadjusted ratios							
FFO to interest (x)	4.4						
FFO to total Debt (%)	20.0						
Debt to capitalization (%)	55.0						
Ratios adjusted for debt imputation							
FFO to interest (x)§	4.0						
FFO to total debt (%)**	18.0						
Debt to capitalization (%)¶¶	59.0						

*Thereafter approximate years: 7. ¶The current year's implied interest is subtracted from the product of the risk factor multiplied by the current year's capacity payment. §Adds implied interest to the numerator and denominator and adds implied depreciation to FFO. **Adds implied depreciation expense to FFO and implied debt to reported debt. ¶¶Adds implied debt to both the numerator and the denominator. FFO--Funds from operations. NPV--Net present value.

Short-Term Contracts

Standard & Poor's has abandoned its historical practice of not imputing debt for contracts with terms of three years or less. However, we understand that there are some utilities that use short-term PPAs of approximately one year or less as gap fillers pending the construction of new capacity. To the extent that such short-term supply arrangements represent a nominal percentage of demand and serve the purposes described above, we will neither impute debt for such contracts nor provide evergreen treatment to such contracts.

Evergreen Treatment

The NPV of the fixed obligations associated with a portfolio of short-term or intermediate-term contracts can lead to distortions in a utility's financial profile relative to the NPV of the fixed obligations of a utility with a portfolio of PPAs that is made up of longer-term commitments. Where there is the potential for such distortions, rating committees will consider evergreen treatment of existing PPA obligations as a scenario for inclusion in the rating analysis. Evergreen treatment extends the tenor of short- and intermediate-term contracts to reflect the long-term obligation of electric utilities to meet their customers' demand for electricity.

While we have concluded that there is a limited pool of utilities whose portfolios of existing and projected PPAs don't meaningfully correspond to long-term load serving obligations, we will nevertheless apply evergreen treatment in those cases where the portfolio of existing and projected PPAs is inconsistent with long-term load-serving obligations. A blanket application of evergreen treatment is not warranted.

To provide evergreen treatment, Standard & Poor's starts by looking at the tenor of outstanding PPAs. Others can look to the "commitments and contingencies" in the notes to a utility's financial statements to derive an approximate tenor of the contracts. If we conclude that the duration of PPAs is short relative to our targeted tenor, we would then add capacity payments until the targeted tenor is achieved. Based on our analysis of several companies, we have determined that the evergreen extension of the tenor of existing contracts and anticipated contracts should extend contracts to a common length of about 12 years.

The price for the capacity that we add will be derived from new peaker entry economics. We use empirical data to establish the cost of developing new peaking capacity and reflect regional differences in our analysis. The cost of new capacity is translated into a dollars per kilowatt-year (kW-year) figure using a weighted average cost of capital for the utility and a proxy capital recovery period.

Analytical Treatment Of Contracts With All-In Energy Prices

The pricing for some PPA contracts is stated as a single, all-in energy price. Standard & Poor's considers an implied capacity price that funds the recovery of the supplier's capital investment to be subsumed within the all-in energy price. Consequently, we use a proxy capacity charge, stated in $/kW, to calculate an implied capacity payment associated with the PPA. The $/kW figure is multiplied by the number of kilowatts under contract. In cases of resources such as wind power that exhibit very low capacity factors, we will adjust the kilowatts under contract to reflect the anticipated capacity factor that the resource is expected to achieve.

We derive the proxy cost of capacity using empirical data evidencing the cost of developing new peaking capacity. We will reflect regional differences in our analysis. The cost of new capacity is translated into a $/kW figure using a weighted average cost of capital and a proxy capital recovery period. This number will be updated from time to time to reflect prevailing costs for the development and financing of the marginal unit, a combustion turbine.

Transmission Arrangements

In recent years, some utilities have entered into long-term transmission contracts in lieu of building generation. In some cases, these contracts provide access to specific power plants, while other transmission arrangements provide access to competitive wholesale electricity markets. We have concluded that these types of transmission arrangements represent extensions of the power plants to which they are connected or the markets that they serve. Irrespective of whether these transmission lines are integral to the delivery of power from a specific plant or are conduits to wholesale markets, we view these arrangements as exhibiting very strong parallels to PPAs as a substitute for investment in power plants. Consequently, we will impute debt for the fixed costs associated with long-term transmission contracts.

PPAs Treated As Leases

Several utilities have reported that their accountants dictate that certain PPAs need to be treated as leases for accounting purposes due to the tenor of the PPA or the residual value of the asset upon the PPA's expiration. We have consistently taken the position that companies should identify those capacity charges that are subject to operating lease treatment in the financial statements so that we can accord PPA treatment to those obligations, in lieu of lease treatment. That is, PPAs that receive operating lease treatment for accounting purposes won't be subject to a 100% risk factor for analytical purposes as though they were leases. Rather, the NPV of the stream of capacity payments associated with these PPAs will be reduced by the risk factor that is applied to the utility's other PPA commitments. PPAs that are treated as capital leases for accounting purposes will not receive PPA treatment because capital lease treatment indicates that the plant under contract economically "belongs" to the utility.

Evaluating The Effect Of PPAs

Though history is on the side of full cost recovery, PPAs nevertheless add financial obligations that heighten financial risk. Yet, we apply risk factors that reduce debt imputation to recognize that utilities that rely on PPAs transfer significant risks to ratepayers and suppliers.

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