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ORIGINAL

June 19, 2008

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COMMISSION
CLERK
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Ms. Ann Cole
Commission Clerk and Administrative Services
Room 100, Easley Building
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: Docket No. 070052-EI

Dear Ms. Cole:

Enclosed for filing, on behalf of the Citizens of the State of Florida, are the original and 15 copies of the Direct Testimony of Patricia W. Merchant, C.P.A.

Please indicate the time and date of receipt on the enclosed duplicate of this letter and return it to our office.

Sincerely,

Joseph A. McGlothlin
Associate Public Counsel

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Enclosures

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DOCUMENT NUMBER-DATE

04937 JUN 19 08

FPSC-COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

**In re: Petition by Progress Energy)
to Recover Costs of Crystal River)
Unit 3 uprate through the fuel)
Clause.)
_____)**

**Docket No. 070052-EI
Filed: June 19, 2007**

DIRECT TESTIMONY

OF

PATRICIA W. MERCHANT, CPA

On Behalf of the Citizens of the State of Florida

**Charles J. Beck
Interim Public Counsel**

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**Attorneys for the Citizens
of the State of Florida**

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FPSC-COMMISSION CLERK

1 Water and Sewer as an analyst in the Bureau of Accounting. From May, 1989
2 to February, 2005 I was a regulatory supervisor in the Division of Water and
3 Wastewater which evolved into the Division of Economic Regulation.

4
5 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE FLORIDA**
6 **PUBLIC SERVICE COMMISSION?**

7 A. Yes, I have testified numerous times before the PSC. I have also testified
8 before the Division of Administrative Hearings as an expert witness.

9
10 **Q. ARE YOU SPONSORING AN EXHIBIT IN THIS CASE?**

11 A. Yes. I am sponsoring Exhibit PWM-1, a summary of my regulatory
12 experience and qualifications, which is attached to my testimony.

13
14 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

15 A. The purpose of my testimony is to discuss the proper regulatory treatment of
16 the Crystal River Unit 3 ("CR 3") nuclear Uprate costs that PEF seeks to
17 recover through the Fuel and Purchased Power Cost Recovery Clause ("fuel
18 clause").

19
20 **Q. HAVE YOU REVIEWED PEF's PETITION FOR APPROVAL OF THE**
21 **COSTS ASSOCIATED WITH THE CR 3 UPRATE IN THIS DOCKET?**

22 A. Yes. PEF's original petition was filed on September 22, 2006, in Docket No.
23 060642-EI. In the original petition, PEF combined a request for determination
24 of need with a request to recover the costs of the Uprate project through the
25 fuel clause. Subsequently, the Commission separated the cost recovery

1 component from the need determination and opened Docket No. 070052-EI
2 for the purpose of considering the cost recovery request. On May 4, 2007,
3 PEF filed amended testimony describing 3 phases of the Uprate project. The
4 estimated cost of the project at the time the amended testimony was filed was
5 \$381 million. In its response to Javier Portuondo's Late-filed Deposition
6 Exhibit 3, PEF has revised the total estimated costs to almost \$450 million, an
7 increase of \$68 million in just one month. Phase 1 relates to plant
8 instrumentation and associated calculations to allow measurement uncertainty
9 recovery ("MUR") and is scheduled to be constructed in 2007. PEF
10 anticipates the MUR phase will add 12 thermal megawatts ("MWe") at a cost
11 of \$6.5 million. Phase 2 involves replacement of the turbine line components
12 to take advantage of greater steam efficiencies in the turbines and electrical
13 generator, and is projected to be placed in service with the CR3 refueling
14 outage in 2009. PEF projects this phase will add 28 MWe, with a preliminary
15 cost estimate of \$88 million. The 3rd Phase will increase the power or thermal
16 MWe produced in the reactor core by making plant modifications to allow for
17 use of more highly enriched uranium. Phase 3 is expected to add 140 MWe in
18 2011 at an estimated cost of \$199 million. Associated with this phase are
19 Point of Discharge ("POD") and transmission projects necessary to
20 accommodate the increased capacity of CR3, with preliminary cost estimates
21 of \$51 million and \$104 million, respectively.

22
23 **Q. HOW DOES YOUR TESTIMONY RELATE TO THAT OF MR.**
24 **LAWTON, WHO ALSO IS TESTIFYING FOR THE CITIZENS?**

25 **A.** Citizens' witness Dan Lawton addresses whether the costs are appropriate to

1 be recovered through the fuel clause. He and I both apply the results of his
2 analysis to the criteria for eligibility for recovery through the fuel clause. I
3 also testify on ratemaking theory and the principal tools available to the
4 Commission to ensure the design of fair and reasonable rates.

5
6 Ratemaking and Regulatory Theory

7 **Q. WHAT RATE RECOVERY MECHANISMS ARE AVAILABLE FOR**
8 **REGULATED ELECTRIC UTILITIES?**

9 A. The principal rate recovery mechanisms are base rates and special cost
10 recovery clauses. Each recovery method has its defined role, and they are
11 designed to work together to ensure that rates paid by customers are fair, just,
12 reasonable and not unduly discriminatory.

13
14 **Q. PLEASE DESCRIBE THE BASE RATE RECOVERY MECHANISM.**

15 A. Base rates are those that result from an examination of a utility's overall
16 revenue requirements in a setting that considers the entire operation. Base
17 rates are designed to allow the utility the opportunity to recover all of its
18 prudent operating costs, subject only to exceptions noted below, and a
19 reasonable rate of return on its investment in utility plant. In a base rate case,
20 a test year is used to examine the levels of plant investment and operating
21 costs that represent the levels that will be incurred when the rates go into
22 effect. Adjustments are made to remove any unreasonable amounts and to
23 normalize nonrecurring or extraordinary amounts in the test year. By
24 analyzing the data included in the utility's rate request, the Commission

1 determines the total amount of revenues the utility should be allowed to
2 collect and then designs rates that will generate that revenue figure.

3

4 **Q. HOW DOES THE COMMISSION ALLOW THE UTILITY THE**
5 **OPPORTUNITY TO RECOVER A REASONABLE RATE OF**
6 **RETURN ON ITS INVESTMENT?**

7 A. In setting rates, the Commission determines the overall rate of return on the
8 utility's investment in its utility plant. This overall cost of capital is based on
9 the weighted average cost of debt, equity and other sources of capital. The
10 cost of debt and other sources of capital are determined based on actual cost
11 rates. The cost of equity reflects the Commission's assessment of the fair
12 return on investment to which the investors are provided an opportunity to
13 earn. Mr. Lawton discusses the concept of return on equity further in his
14 testimony.

15

16 **Q. HOW DOES REGULATORY THEORY ADDRESS DESIGNING**
17 **RATES TO BE SUFFICIENT FOR FUTURE PERIODS?**

18 A. Ratemaking principles recognize that after rates are set, the future
19 relationships between costs and revenues will change from those levels used
20 in setting the rates. The level of a particular cost may increase, decrease, or
21 the cost may go away altogether. Costs that were non-existent during the test
22 period may arise after the rates take effect. Projected revenue levels will also
23 vary based on customer growth, changes in consumption, or a combination of
24 both. An increase in a particular expense level does not automatically cause a
25 utility to earn less than its fair rate of return on its investment or to not recover

1 the expense. In order to determine whether an increase in a single cost is
2 affecting a utility adversely, it is necessary to consider the overall relationship
3 of total revenues and total costs.

4

5 **Q. HOW DOES ONE GAUGE WHETHER THE RETURN ON**
6 **INVESTMENT IS REASONABLE AT A GIVEN POINT IN TIME?**

7 A. The Commission sets rates using the mid-point of the authorized rate of return
8 on equity (ROE) and then establishes a range for the ROE that it deems to be
9 reasonable. If the utility earns within the range, generally set at 100 basis
10 points on either side of the mid-point, then by definition the utility is
11 recovering its prudent operating costs and earning a fair return on its
12 investment. If the utility is earning above or below the approved range on its
13 ROE, then it is over- or under-earning, respectively.

14

15 **Q. WHAT ARE THE EXCEPTIONS TO THE ITEMS RECOVERED**
16 **THROUGH BASE RATES THAT YOU MENTIONED?**

17 A. The exceptions to base rate recovery are special cost recovery clauses. The
18 cost recovery clauses available to electric companies are the fuel clause, the
19 Environmental Cost Recovery Clause ("ECRC"), and the Energy
20 Conservation Cost Recovery Clause ("ECCR"). Base rates are designed to
21 generate revenues that reflect a variety of costs, and are intended to function
22 between revenue requirement cases without changing whereas cost recovery
23 clauses focus on specific costs and design a rate element or rate factor to track
24 changes in those costs outside the revenue requirements environment. In
25 Florida, the special cost recovery mechanisms feature a true-up mechanism.

1 Clauses provide dollar-for-dollar rate recovery of the specific eligible costs
2 identified for inclusion through the true-up process as long as those costs are
3 deemed to be prudently incurred. The cost recovery clauses are a departure
4 from the traditional base rate mechanism, under which the rates are designed
5 to provide the utility an opportunity, not a guarantee, to recover its prudent
6 costs and to earn a fair return. Base rate revenues and base rate earnings may
7 increase or decrease as relationships between costs and revenues change over
8 time. There is no true-up provision.

9
10 **Q WHAT RATIONALES SUPPORT THESE EXCEPTIONS TO THE**
11 **BASE RATE MECHANISM?**

12 A. The fuel clause provides recovery to the utility for the day to day fluctuations
13 in the cost of fuel that, because of volatility, cannot be treated adequately in
14 base rates. Without clause recovery of these volatile fuel costs, utilities could
15 be placed in the position of incurring and passing on the cost of expensive
16 base rate proceedings to its customers. In the case of environmental costs,
17 Section 366.8255, Florida Statutes, mandates the use of a cost recovery clause
18 for qualifying expenditures. Pursuant to Section 366.82, Florida Statutes, the
19 conservation clause allows utilities to recover costs to implement cost-
20 effective demand side conservation programs. Thus, each cost recovery
21 clause has a defined and legitimate function within the rate setting philosophy.
22 However, to meet the goal of overall fairness of rates, it is important to limit
23 the mechanisms to the costs that satisfy the eligibility criteria applicable to
24 each.

1 Q. WHY IS IT IMPORTANT TO LIMIT THE COSTS THAT ARE
2 COLLECTED THROUGH A COST RECOVERY CLAUSE TO THOSE
3 THAT ARE ELIGIBLE?

4 A. The reason is simple. If a cost does not legitimately meet the definition of
5 costs that qualify for a recovery clause, it should be borne through base rates.
6 To allow the cost to instead flow through the clause will result in an
7 unwarranted increase in overall charges borne by customers, resulting in a bill
8 for services that is unfair and unreasonable.

9
10 Q. CAN YOU GIVE AN EXAMPLE TO MAKE THIS POINT?

11 A. Yes. Assume a utility has a rate base (a utility's net investment in utility plant)
12 of \$1 billion, a Commission-authorized fair rate of return with a range of 9%
13 to 11%, and net income of \$100 million. Assume that the Commission must
14 consider the following: a) allow the utility to collect an additional \$1 million
15 expense normally recovered in base rates through the fuel clause or b) require
16 the utility to absorb the expense in earnings achieved from base rates.
17 Assume the achieved rate of return before the additional expense will be 10%,
18 which is in the middle of the authorized range.

19
20 If the utility is allowed to collect the additional expense through the fuel
21 clause, base rates will not change; but the customers will pay additional fuel
22 revenues of \$1 million. However, if the Commission denies the request to
23 recover the expense through the clause, the utility will recover the expense
24 through revenues generated by base rates. In this later scenario, the
25 customers' overall bill will not go up — both fuel revenues and base rate

1 revenues will be unchanged. The income for the period becomes \$99 million
2 instead of \$100 million and the return falls from 10% to 9.9%. The return is
3 still well within the range of the return that the Commission established as fair
4 and reasonable.

5
6 Because cost recovery clause treatment enables the utility to avoid absorbing
7 the expense through base rate earnings, the utility has a powerful financial
8 incentive to steer as many increased costs as possible through recovery
9 clauses. Another side effect of allowing base rate incremental expenses or
10 capital costs in a clause is that offsetting decreases in expenses might not be
11 disclosed by the utility. So at the very time that a company is requesting
12 recovery of a new expense through the fuel clause, there can easily be
13 expenses that might be decreasing or going away which could substantially
14 offset or eliminate any need of the requested increase in its entirety. This
15 illustrates the danger of reviewing a cost in isolation of the bigger picture.
16 Special cost recovery mechanisms have their places, but are not intended to
17 replace the base rate process, in which the Commission reviews the utility's
18 overall operation. For this reason, the Commission should be ever vigilant for
19 claims that new or unusual costs belong in a cost recovery clause as opposed
20 to being absorbed in base rates.

21

22 Commission Policy on Fuel Cost Recovery

23 **Q. PLEASE ADDRESS THE COMMISSION'S POLICY THAT**
24 **OUTLINES THE TYPES OF COSTS UTILITIES SHOULD BE**
25 **ALLOWED TO RECOVER THROUGH THE FUEL CLAUSE.**

1 A. While there are many orders that have been issued that address fuel recovery
2 issues, the primary order that outlines the basis for fuel cost recovery is Order
3 No. 14546. As part of the 1985 fuel clause docket, the Commission wanted to
4 delineate a policy by order to prescribe the proper means of recovery of fossil
5 fuel-related expenses – an instruction manual, if you will.

6
7 In the very first paragraph of the Order, the Commission expressed its goal for
8 the proceeding, which was to ascertain whether the utilities were passing
9 through the appropriate fixed and variable costs associated with fuel receipts
10 through each company's fuel factor. As a result of a stipulation, the parties to
11 the docket agreed on two essential points that reflect the Commission's
12 practical application of the fuel clause. First, the Commission should attempt
13 to treat cost recovery for fossil-fuel related expenses in a uniform manner,
14 recognizing that there may be times for dissimilar treatment. Second, and
15 most importantly, the parties agreed that prudently incurred fossil fuel-related
16 expenses which are subject to volatility should be recovered through the fuel
17 clause. The parties elaborated on the second point and agreed that:

18
19 The volatility of fossil fuel-related costs may be due to a
20 number of factors including, but not necessarily limited to:
21 price, quantity, number of deliveries, and distance. Except as
22 noted below, these volatile fossil fuel-related charges are
23 incurred by the utility for goods obtained or services provided
24 prior to the delivery of fuel to the electric utility's dedicated

1 storage facilities.... All other fossil fuel-related costs should be
2 recovered through base rates.

3
4 Thus, it is clear from the outset of this Order that the topic being discussed
5 was cost recovery for volatile fossil fuel-related expenses. The Order also
6 provided in detail a list of items that qualified and others that did not qualify
7 for fuel clause recovery. However, in item 10, the parties agreed, and the
8 Commission accepted, a provision for an exception to the normal fuel-type
9 cost as follows:

10
11 10. Fossil fuel-related costs normally recovered through base
12 rates but which were not recognized or anticipated in the cost
13 levels used to determine current base rates and which, if
14 expended, will result in fuel savings to customers. Recovery of
15 such costs should be made on a case by case basis after
16 commission approval.

17
18 Order No. 14546 provided an example of what type of expense to which item
19 10 referred. The given example is a utility that leases an additional oil storage
20 tank for a short period to enable it to purchase a shipment of oil on favorable
21 terms: the rent paid to lease the oil tank makes possible the fuel savings, and
22 would qualify for inclusion in the fuel clause. In the illustration in the Order,
23 the expenditure is directly related to the delivered cost of fossil fuel to be
24 burned in the boilers to generate electricity.

25

1 While it is the Commission's intent in this Order to establish
2 comprehensive guidelines for the treatment of fossil fuel-
3 related costs, it is recognized that certain unanticipated costs
4 may have been overlooked. If any utility incurs or will incur a
5 fossil fuel-related cost which is not addressed in this order and
6 the utility seeks to recover such costs through its fuel
7 adjustment clause, the utility should present testimony
8 justifying such recovery in an appropriate fuel adjustment
9 hearing. (at page 5) (Emphasis added)

10
11 It is clear that Item 10 was designed to address a situation in which a utility
12 that initiated a cost-saving measure would have no ability to have the costs of
13 the activity reflected in base rates timely.

14
15 **Q. WHAT DOES ORDER NO. 14546 SAY ABOUT THE TYPES OF**
16 **COSTS THAT ARE NOT APPROPRIATE TO BE RECOVERED**
17 **THROUGH THE FUEL CLAUSE?**

18 A. On page 3 of the Order, it states that operation and maintenance ("O&M")
19 expenses at plants, storage facilities and terminals are relatively fixed and do
20 not tend to fluctuate significantly, are closely akin to other O&M expenses
21 and more properly recovered through base rates. On page 4 of the Order, the
22 Commission also addressed expenses that had previously been recovered
23 through the fuel clause that were inappropriate on a going-forward basis.
24 These related to non-fuel costs that were not volatile or costs that were
25 incurred after fuel was burned. These items demonstrate that the Commission

1 wanted to provide recovery through the fuel clause of volatile fuel costs and
2 delineate that non-volatile, non-fuel related costs belong in base rates.

3

4 Costs Not Anticipated or Included in the Company's Last Rate Case

5 **Q. WHAT ASPECT OF ORDER 14546 IS SIGNIFICANT TO PEF'S**
6 **REQUEST?**

7 A. PEF has the time and the ability to file a base rate request and have it decided
8 prior to the point in time at which the material costs of the Uprate project will
9 affect its financial situation. PEF's current settlement agreement expires at
10 the end of 2009. The Phase 2 and Phase 3 investments will not be placed into
11 service until the end of 2009 and 2011, respectively. PEF can submit a base
12 rate request in 2009, and rates reflecting its overall situation – including the
13 costs of the Uprate project – can be in place at the time it places the project
14 into service. Item 10 simply is not applicable to this situation, in which the
15 utility is not exposed to any lag in recovering the costs of a worthwhile
16 project.

17

18 **Q. YOU MENTIONED PHASES 2 AND 3. WHAT ABOUT THE MUR**
19 **PHASE, WHICH PEF HOPES TO PLACE INTO SERVICE IN 2008?**

20 A. This is where the concept of materiality must be given effect. The full cost of
21 the MUR is estimated to be \$6.5 million. If PEF places it in rate base in 2008,
22 the estimated annual costs of MUR (depreciation; taxes) will amount to \$1.05
23 million. This would have a de minimus impact on earnings. This is precisely
24 the type of fluctuation in investments, expenses, and revenues that base rates
25 are designed and intended to accommodate in-between base rate cases.

1 Q. GIVEN THE ABILITY OF PEF TO SUBMIT A BASE RATE
2 REQUEST PRIOR TO THE IN-SERVICE DATE OF THE
3 SIGNIFICANT CAPITAL IMPROVEMENTS, IS THERE A
4 PARTICULAR DANGER TO RATE PAYERS OF ALLOWING PEF
5 TO PASS THE COSTS THROUGH THE FUEL CLAUSE?

6 A. Yes. The danger, that I discuss generally above, is that customers will be
7 made to bear the costs of the Uprate project on an incremental basis as an
8 adder to the fuel factor, when a review of the utility's total circumstances may
9 demonstrate that base rate revenue growth may is adequate to absorb some
10 portion of the new costs without the necessity of a dollar-for-dollar increase.
11 Mr. Lawton describes in greater detail the consequences of allowing PEF to
12 avoid an examination of the Uprate costs in the full context of a revenue
13 requirements proceeding.

14
15 Q. PLEASE COMMENT ON MR. PORTUONDO'S STATEMENT THAT
16 THE COSTS OF THE CR3 UPRATE PROJECT WERE NOT
17 ANTICIPATED OR INCLUDED IN THE COMPANY'S LAST BASE
18 RATE TEST YEAR AND AS SUCH ARE NOT INCLUDED IN THE
19 COMPANY'S CURRENT BASE RATES.

20 A. Since the test year in the last base rate case was the projected year ended
21 December 31, 2006, the specific plant costs addressed in this petition were not
22 considered as a component in determining the rates that were ultimately
23 agreed to by the parties and approved by the Commission. However, I
24 disagree with the premise that only if a cost was reflected as a specific line
25 item in the last test year is it being recovered through base rates. As I testified

1 earlier, because base rates are designed and intended to recover all changing
2 base rate-related costs of whatever description, as long as the utility's base
3 rate revenues exceed its expenses including debt, then it is recovering all of
4 those expenses. The earnings above that level all inure to the shareholders.

5

6 **Q. WHAT POINTS DO YOU HAVE REGARDING MFR PROJECTION**
7 **LEVELS?**

8 A. First, just because a cost is not specifically reflected in the minimum filing
9 requirements (MFRs) that does not per se show that a certain cost was not
10 anticipated or included as a projection in the details supporting the plant and
11 operational costs in the company's last rate case. Second, basic ratemaking
12 theory recognizes that it is impossible to project exactly what levels will be
13 incurred after the rate case test year has concluded. This is precisely the basis
14 for allowing utility companies to earn within a range of reasonableness on its
15 rate of return on equity. Just because an item is not specifically spelled out in
16 the company's last MFRs certainly does not mean that it cannot recover the
17 costs and earn a fair return on its investment through base rates. That is the
18 nature of the rate setting process and the company is adequately compensated
19 for this risk through the approved rate of return.

20

21

22 CR3 Net Savings

23 **Q. PLEASE ADDRESS MR. PORTUONDO'S ASSERTION THAT THE**
24 **CR3 ESTIMATED COSTS PRODUCE NET SAVINGS.**

1 A. As addressed by Mr. Lawton, PEF has proposed that the plant costs be
2 recovered over the amount of time in which the cost of the investment would
3 be offset by the projected fuel savings. By accounting for the recovery in the
4 manner as requested by PEF, the customers will not see any measurable
5 savings for any of the phases until 2016, which is 9 years after the cost of the
6 MUR has been fully recovered and 5 years after the completion of the last
7 three projects placed in service in 2011. Important to note is that PEF's case
8 represents the best case scenario in cost estimates. If the actual construction
9 project incurs material cost-overruns, which is what happened with PEF's
10 projected steam generator replacement costs projected in PEF's last rate case,
11 then the net cost savings presented here could decrease dramatically.

12
13 **Q. PLEASE EXPLAIN THE IMPACT OF THE COMPANY'S PROPOSED**
14 **COST SAVINGS ANALYSIS.**

15 A. What the Company has requested in this docket is that these costs should be
16 recovered through the fuel docket because there will be net savings by the
17 year 2036. But what PEF is proposing is that before you give the customers
18 those savings, let the Company recover the costs associated with the project
19 over the same period that the savings would have been generated. The
20 recovery period that the Company is requesting negates the rationale that
21 supports the need for the costs to be flowed through the fuel clause.

22
23 **Q. WHY SHOULD THE COMMISSION REFUSE TO ALLOW PEF TO**
24 **COLLECT THESE COSTS THROUGH THE FUEL CLAUSE?**

1 A. First, the costs associated with the CR3 Uprate are ineligible for the clause.
2 They are generation plant costs. They are not fossil-fuel related. They are not
3 volatile. When the plant is placed into service, the amounts will be constant
4 and will not vary from year to year except for any variation in the rate of
5 return allowed on the asset.

6
7 Secondly, Paragraph 10 in Order 14546 was meant to encourage utilities to
8 spend money that they might not spend to save fuel costs without the ability to
9 reflect those costs in rates. As I explained, that is not the case here. In
10 addition, PEF has included in its request \$89 million of transmission
11 upgrades, \$43 million of "POD" enhancements, and unspecified O&M costs
12 that would not qualify, for clause treatment even if the Commission
13 entertained PEF's rationale – which it should not.

14
15 **Q. HAS THE COMMISSION ALLOWED UTILITIES TO PASS BASE**
16 **RATE-RELATED COSTS THROUGH THE CLAUSE IN THE PAST?**

17 A. Yes, the Commission has allowed some non-fuel related costs to be recovered
18 through the fuel clause on a case-by-base basis. One example that PEF
19 mentioned in this docket is that the Commission allowed Florida Power and
20 Light to recover the cost of a very limited nuclear Uprate to be flowed through
21 the fuel clause. In that case FPL incurred a cost of \$10 million for a 6.1 MWe
22 thermal Uprate and was allowed to expense the project over two years. In that
23 case, however, the savings generated from the Uprate began in year one and
24 by year three the savings were 3 times the cost of the plant. Also, in that case
25 ratepayers saw lower bills immediately – not eight years after the first phase.

1 It was easy to see in that case that the costs were de minimus in relation to the
2 almost immediate savings generated in fuel costs, as was the absence of
3 intergenerational inequities.

4

5 Encouragement of Innovative, Cost-saving Projects

6 **Q. IS FUEL CLAUSE RECOVERY THE PROPER VEHICLE TO**
7 **REWARD UTILITIES FOR INNOVATIVE PROJECTS AND**
8 **PROGRAMS THAT REDUCE TOTAL CUSTOMER COSTS?**

9 A. No it is not. While the Commission has allowed cost saving mechanisms to be
10 recovered through the fuel clause, many more have been recovered properly
11 through base rates. Any incentive mechanism can occur equally through base
12 rates or a clause and still provide the company recovery of and a return on the
13 costs that it has invested to generate customer savings. The base rate
14 regulatory mechanism has always provided the proper incentive for rate
15 recovery. However, the trend in recent years has been for companies that have
16 entered into base rate settlements or in years between rate cases, to continually
17 request clause recovery of normal base rate type costs in order to increase
18 earnings to its shareholders at the expense of higher than necessary rates to
19 customers. For the reasons I have given, it is incumbent on the Commission
20 to deny those requests that involve ineligible costs or otherwise do not qualify
21 for recovery.

22

23 **Q. DOES DENYING COST RECOVERY THROUGH THE FUEL**
24 **CLAUSE FOR NORMAL BASE RATE PROJECTS THAT RESULT IN**

1 FUEL SAVINGS DISCOURAGE PRUDENT COST SAVING
2 INVESTMENTS?

3 A. No, it does not. First, this statement is so broad that if you follow this
4 language through, any cost could be considered appropriate to consider in the
5 fuel clause if it generates fuel savings. Next, the utility is obligated to provide
6 cost-effective service to its customers and should not need additional
7 incentives to do what it is already required to do. Third, as Mr. Lawton
8 develops in more detail, utilities are compensated for the risk they incur by the
9 opportunity to earn a fair rate of return. If the recovery of long-term
10 investments in generating or other plant is shifted to the fuel clause, the risk
11 incurred by the utility is correspondingly reduced, but the utility has not
12 proposed to reflect the lower risk in the return it expects to earn – another
13 reason why granting the request would result in overall rates that are unfairly
14 and unreasonable high.

15
16 CR3 Revenue Requirements and Savings Analysis

17 **Q. PEF HAS PROJECTED THAT BECAUSE THE SAVINGS EXCEED**
18 **THE COSTS ASSOCIATED WITH THESE PROJECTS, THE COSTS**
19 **ARE APPROPRIATE TO BE RECOVERED THROUGH THE FUEL**
20 **CLAUSE. HAS PEF INCLUDED IN ITS PETITION THE**
21 **SUPPORTING CALCULATIONS TO SHOW THE ANNUAL**
22 **SAVINGS AND COSTS?**

23 A. No, the petition and supporting testimony provide absolutely no showing of
24 the revenue requirement components that PEF is proposing for recovery
25 through the fuel clause or any of the assumptions used to calculate the

1 projected cost savings. Because of this, OPC requested and received through
2 discovery a breakdown of the revenue requirements and costs savings that
3 PEF projects will occur from 2007 out to 2036. I believe that it is important
4 for the Commission to consider several of the proposals that PEF used in
5 determining its revenue requirements that vary from the regulatory accounting
6 procedures that are normally employed for recovery of capital plant costs. I
7 also provide some comments about assumptions used to calculate PEF's
8 projected cost savings.

9
10 **Q. WHAT DEPRECIATION RATES DOES PEF PROPOSE FOR EACH**
11 **OF ITS PHASES?**

12 A. First, Mr. Portuondo stated in his deposition that PEF was proposing ten-year
13 depreciation recovery periods for all of the 5 phases of the Uprate. This life
14 was chosen "on the basis that over that period of time, there would be
15 sufficient savings to recover the costs." PEF estimated the recovery period for
16 the current projects to correspond with the time frame in which the savings
17 would be generated and would increase or decrease the amortization period
18 depending on the actual costs incurred. Essentially, PEF is requesting that the
19 recovery period be equal to the period of time that the fuel savings will exceed
20 the costs. Note that under this concept, customers will experience very
21 minimal, if any, savings until the utility has recovered 100% of the costs of
22 the project, including the return on its investment. The impact to customers
23 could even be greater if the actual construction costs materially exceed those
24 included in PEF's petition.

1 I also would note that in response to late-filed deposition exhibit 3, Mr.
2 Portuondo changed the recovery period of the \$6 million in plant costs
3 associated with the MUR Phase 1 project from 10 years to a full-year recovery
4 in year one. When asked in deposition, PEF witness Roderick stated that all
5 of the components that PEF will put into these 5 projects are designed to last
6 until 2036, or at least 25 years. Additionally, the tax depreciation lives that
7 PEF has used in its own analysis are 15 years for nuclear plant and 20 years
8 for the POD and transmission plant.

9
10 **Q. WHAT DOES THE UNIFORM SYSTEM OF ACCOUNTS (USOA)**
11 **STATE ABOUT RECOVERY OF DEPRECIATION EXPENSE?**

12 A. Rule 25-6.014 (1), Florida Administrative Code, requires that each investor-
13 owned electric utility shall maintain its accounts and records in conformity
14 with the Uniform System of Accounts (USOA) for Public Utilities and
15 Licensees as found in the Code of Federal Regulations, Title 18, Subchapter
16 C, Part 101, for Major Utilities as revised April 1, 2002, Uniform System of
17 Accounts Prescribed for Public Utilities and Licensees Subject to the
18 Provisions of the Federal Power Act. In Section 22A of the USOA for
19 electric utilities, the method of depreciation accounting is provided:

20
21 Utilities must use a method of depreciation that allocates in a
22 systematic and rational manner the service value of depreciable
23 property over the service life of the property.
24

1 Q. DID PEF PROVIDE THE ACCOUNT TITLES TO WHICH IT WOULD
2 RECORD THE AMORTIZATION OF THE ASSETS RELATED TO
3 THE PHASES OF THIS PROJECT?

4 A. Yes. In response to OPC's Interrogatory Nos. 4e, 8c and 11b, the utility has
5 indicated that once in service, the assets will be amortized, to the extent of
6 annual fuel savings achieved, to account 111, Accumulated Provision for
7 Amortization of Electric Utility Plant and account 404, Amortization of
8 Limited-term Electric Plant. In the USOA, the description of this account
9 states that it:

10
11 shall include amortization charges applicable to amounts
12 included in the electric plant accounts for limited-term
13 franchises, licenses, patent rights, limited-term interests in
14 land, and expenditures on leased property where the service life
15 of the improvements is terminable by action of the lease. The
16 charges to this account shall be such as to distribute the book
17 cost of each investment as evenly as may be over the period of
18 its benefit to the utility. (Emphasis added)

19
20 Q. WHAT ISSUES DO YOU TAKE WITH THE PROPOSED
21 ACCOUNTING TREATMENT?

22 A. First, the account title, *Amortization of Limited-term Electric Plant*, does not
23 even contemplate that long-term generation plant assets will be amortized by
24 this means. The instructions address specific types of limited-term assets, not
25 generation plant. Second, the amortization expense is to be evenly spread over

1 the period of time that the asset provides benefits to the utility, not the period
2 that fuel savings provide recovery of this cost. Both of these requirements are
3 clearly inconsistent with the Company's requested accounting and recovery
4 method. While the USOA requirements can be waived by the Commission,
5 PEF has not made any showing in this case why a deviation is proper or sound
6 regulatory policy.

7
8 **Q. WHAT CONCLUSION CAN YOU MAKE ABOUT THE**
9 **DEPRECIATION TREATMENT THAT PEF IS REQUESTING?**

10 A. Not only does PEF want the Commission to drastically cut the depreciation
11 period required by regulatory accounting conventions, it also wants to
12 depreciate it in a far shorter time than the accelerated depreciable life for tax
13 purposes. This dramatically short recovery time requires the current
14 generation of customers to recover the full cost of this long-term asset that
15 will provide benefits to customers out to the year 2036. This recovery scheme
16 is an extreme example of intergenerational inequity that the Commission
17 should deny outright.

18
19
20 **Q. HAS PEF TAKEN INTO CONSIDERATION IN THE ANALYSIS OF**
21 **SAVINGS THE COST OF USING THE MORE GREATLY ENRICHED**
22 **URANIUM FUEL THAT WILL BE USED IN PHASE 3 OF THE CR 3**
23 **UPRATE?**

24 A. No it has not. Below is PEF's response to OPC Interrogatory 17.
25

1 The effect of the Uprate is that more highly enriched uranium
2 fuel will be used, but there will also be more megawatts
3 produced. While this additional fuel will cost more, the net
4 effect is that the price of fuel per megawatt or megawatt hour
5 will remain the same. The fuel savings models were run
6 based on the price of fuel per megawatt hour.

7
8 In his deposition, Mr. Roderick also stated that the amount of the extra cost of
9 the more highly enriched uranium is offset because the cost per MWe will be
10 the same. I would point out that PEF has not provided any other support
11 which reflects that the cost per megawatt hour proportion will be the same
12 using more highly enriched uranium. If the cost of the more highly enriched
13 uranium proves to be more expensive in cents/kwh than the normal fuel now
14 being used, PEF's estimate of savings will have been fundamentally skewed
15 and overstated.

16
17 **Q. WHAT IS YOUR CONCLUSION ABOUT INCLUDING THE CR 3**
18 **PROJECT COSTS IN THE FUEL CLAUSE BECAUSE THE**
19 **CUSTOMERS WILL RECEIVE NET BENEFITS?**

20 Based on Mr. Lawton's analysis, customers will have to wait until 2015 to see
21 any measurable savings based on the Company's requested cost recovery
22 mechanism, which would only be farther away if the Company's very
23 preliminary cost estimates are understated. The end result of including these
24 base rate costs in the fuel clause is guaranteed recovery for the shareholders
25 with much greater reduced risk and no guaranteed cost savings for the

1 customers until at least 8 years out in the overall project. While the project
2 appears reasonable and prudent, the Commission should require the Company
3 to employ the proper regulatory mechanism for recovery as addressed in the
4 testimony of OPC's witnesses and require the costs to be recovered through
5 base rates over the estimated service life of the assets. Because available
6 time permits PEF to purpose a base rate request prior to the in-service dates of
7 the significant phases, there is no harm or prejudice to PEF in doing so.

8
9 **Q WOULD YOUR VIEW OF THE PROPER FUNCTIONS OF BASE**
10 **RATES AND COST RECOVERY CLAUSES CHANGE IF THE**
11 **UTILITY WAS EARNING LESS THAN A FAIR RATE OF RETURN**
12 **AT THE TIME IT INCURS THE COST FOR WHICH IT SEEKS**
13 **RECOVERY THROUGH A CLAUSE?**

14 A. No. If, hypothetically, the utility is earning less than the bottom of the range
15 of its authorized rate of return, then its appropriate recourse is -- not abuse a
16 clause -- but to avail itself of the opportunity afforded it by statute to seek an
17 adjustment in base rates. If it does so, then customers and the Commission
18 will have an opportunity to assess the company's condition on an overall
19 basis. Ultimately, the responsibility belongs solely with the utility's
20 management to consider the need to seek base rate relief.

21
22 **Q. DOES THIS COMPLETE YOUR TESTIMONY?**

23 A. Yes, it does.

DOCKET NO. 070052-EI
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing Direct Testimony of Patricia W. Merchant, CPA. has been furnished by U.S. Mail on this 19th day of June, 2007, to the following:

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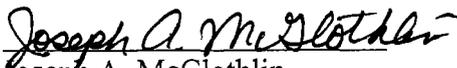
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Resume

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Professional Experience:

March, 2005 to Present

Office of Public Counsel – Senior Legislative Analyst

In my current position, I perform financial and accounting analysis and reviews, and provide testimony, as required, involving utility filings before the Florida Public Service Commission on behalf of the Citizens of the State of Florida.

1981 to February, 2005 - Florida Public Service Commission

2000 to February, 2005

Public Utilities Supervisor – File and Suspend Rate Case Section, Bureau of Rate Filings, Division of Economic Regulation

In this capacity I supervised 5 to 8 regulatory professionals. This section performed financial, accounting, engineering and rate review and evaluation of rate proceedings for large water and wastewater utilities, as well as electric and gas utilities regulated by the Commission. The types of cases included file and suspend rate cases, limited proceedings, overearning investigations, annual report reviews, service availability and tariff filings, rulemaking, and customer complaints. The section reviewed utility filings, requested and reviewed Commission staff audits, and generated and analyzed discovery requests. I coordinated and prepared staff recommendations to the Commission for agenda conferences. I reviewed the analyses and written documentation of all analysts in this section for proper regulatory theory, grammar and accuracy. I also made presentations to customer groups at Commission staff customer meetings for the rate proceedings to which I was assigned. We presented recommendations at agenda conferences, providing responses to comments and questions by other parties and Commissioners. I also prepared and presented testimony, and assisted in the preparation of cross-examination questions for depositions and formal hearings. Additionally, I provided training in regulatory theory for new staff and provided training on regulatory and accounting issues for other analysts at the Commission.

1989 – 2000

Regulatory Analyst Supervisor, Accounting Section, Bureau of Economic Regulation, Division of Water and Wastewater

I supervised 5-7 regulatory accounting analysts. This section performed the same job activities as above specifically for the larger Commission regulated Class A and B water and wastewater companies.

1983 – 1989

Regulatory Analyst – Accounting Bureau, Division of Water and Wastewater

As an accounting analyst, I performed the same job activities as described above for water and wastewater companies in a non-supervisory role.

1981 – 1983

Public Utilities Auditor, Division of Auditing and Financial Analysis

As an auditor in the Tallahassee district of the Commission, I performed financial and accounting audits of electric, gas, telephone, water and wastewater utilities under the Commission's jurisdiction.

Education and Professional Licenses

1981 Bachelor of Science with a major in accounting from Florida State University

1983 Received a Certified Public Accountant license in Florida

List of Cases in which Testimony was Submitted

Dockets Before the Florida Public Service Commission:

060162-EI – Petition by Progress Energy Florida, Inc. to recover modular cooling tower costs through the Environmental Cost recovery clause. (filed testimony stipulated into record)

050958-EI – Petition for approval of new environmental program for cost recovery through Environmental Cost Recovery Clause by Tampa Electric Company. (testified at hearing)

060658-EI - Petition on Behalf of Citizens of the State of Florida to require Progress Energy Florida, Inc. to Refund Customers \$143 million. (filed testimony stipulated into record)

060362-EI - Petition to Recover Natural Gas Storage Project Costs through Fuel Cost Recovery Clause, by Florida Power & Light Company. (testified at hearing)

050045-EI - Petition for Rate Increase by Florida Power & Light Company. (filed testimony, deposed, case settled prior to hearing)

991643-SU - Application for Increase in Wastewater Rates in Seven Springs System in Pasco County by Aloha Utilities, Inc. (testified at hearing)

971663-WS - Application of Florida Cities Water Company, Inc. for a limited proceeding to recover environmental litigation costs. (all testimony and exhibits stipulated into record without hearing)

940847-WS - Application of Ortega Utility Company for increased water and wastewater rates. (testified at hearing)

911082-WS - Water and Wastewater Rule Revisions to Chapter 25-30, Florida Administrative Code. (testified at hearing)

881030-WU - Investigation of Sunshine Utilities of Central Florida rates for possible over earnings. (testified at hearing)

850151-WS - Application of Marco Island Utilities, Inc. for increased water and wastewater rates. (testified at hearing)

850031-WS - Application of Orange/Osceola Utilities, Inc. for increased water and wastewater rates in Osceola County (testified at hearing)

840047-WS - Application of Poinciana Utilities, Inc. for increased water and wastewater rates (testified at hearing)

Cases Before the Division of Administrative Hearings:

97-2485RU - Aloha Utilities, Inc., and Florida Waterworks Association, Inc., Petitioners, vs. Public Service Commission, Respondents, and Citizens of the State of Florida, Office of Public Counsel, Intervenors (deposed and testified at hearing)