BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

DOCKET NO. 20210015-EI

Petition for rate increase by Florida Power & Light Company.
_____/

VOLUME 6
PAGES 1160 - 1405

PROCEEDINGS: HEARING

COMMISSIONERS PARTICIPATING: CHAIRMAN GARY F. CLARK
COMMISSIONER ART GRAHAM
COMMISSIONER ANDREW GILES FAY
COMMISSIONER MIKE LA ROSA
COMMISSIONER GABRIELLA PASSIDOMO

DATE: Monday, September 20, 2021

TIME: Commenced: 9:30 a.m.
Concluded: 12:00 p.m.

PLACE: Betty Easley Conference Center
Room 148
4075 Esplanade Way
Tallahassee, Florida

REPORTED BY: DEBRA R. KRICK
Court Reporter

APPEARANCES: (As heretofore noted.)

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I N D E X

P R O C E E D I N G S

(Transcript follows in sequence from Volume 5.)

(Whereupon, prefiled direct testimony of J. Randall Woolridge was inserted.)

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for Rate Increase by Florida Power & Light Company	DOCKET NO.: 20210015-EI FILED: June 21, 2021

DIRECT TESTIMONY

OF

J. RANDALL WOOLRIDGE, PH.D.

ON BEHALF OF THE CITIZENS OF THE STATE OF FLORIDA

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DIRECT TESTIMONY

OF

DR. J. RANDALL WOOLRIDGE, PH.D.

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No 20210015-EI

I. IDENTIFICATION OF WITNESS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR FULL NAME, ADDRESS, AND OCCUPATION.

A. My name is J. Randall Woolridge, and my business address is 120 Haymaker Circle, State College, PA 16801. I am a Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at the University Park Campus of Pennsylvania State University. I am also the Director of the Smeal College Trading Room and President of the Nittany Lion Fund, LLC. A summary of my educational background, research, and related business experience is provided in Appendix A.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I have been asked by the Florida Office of Public Counsel ("OPC") to provide an opinion as to the appropriate return on equity for Florida Power & Light Company ("FPL" or "Company") and to evaluate FPL's rate of return testimony in this proceeding.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. First, I review my cost of equity recommendation for FPL, highlight several factors that have changed since the Company's last rate case, and discuss the primary areas of

contention between FPL's rate of return position and my position. Second, I provide an assessment of capital costs in today's capital markets. Third, I discuss the selection of a proxy group of electric utility companies for estimating the market cost of equity for FPL. Fourth, I discuss the relationship between a utility's capital structure and the return on equity that should be associated with that capital structure. Fifth, I provide an overview of the concept of the cost of equity capital, and then estimate the equity cost rate for FPL. Finally, I critique the Company's rate of return analysis and testimony.

II. OVERVIEW AND SUMMARY OF POSITIONS

A. Overview

Q. WHAT COMPRISES A UTILITY'S "RATE OF RETURN"?

A. A company's overall rate of return consists of three main categories: (1) capital structure (i.e., ratios of short-term debt, long-term debt, preferred stock and common equity); (2) cost rates for short-term debt, long-term debt, and preferred stock; and (3) common equity cost rate, otherwise known as return on equity ("ROE").

Q. WHAT IS A UTILITY'S ROE INTENDED TO REFLECT?

A. An ROE is most simply described as the allowed rate of profit for a regulated company. In a competitive market, a company's profit level is determined by a variety of factors, including the state of the economy, the degree of competition a company faces, the ease of entry into its markets, the existence of substitute or complementary products/services, the company's cost structure, the impact of technological changes, and the supply and demand for its services and/or products. For a regulated monopoly,

the regulator determines the level of profit available to the utility. The United States Supreme Court established the guiding principles for establishing an appropriate level of profitability for regulated public utilities in two cases: (1) *Bluefield* and (2) *Hope*.[1] In those cases, the Court recognized that the fair rate of return on equity should be: (1) comparable to returns investors expect to earn on investments with similar risk; (2) sufficient to assure confidence in the company's financial integrity; and (3) adequate to maintain the company's credit and to attract capital.

Thus, the appropriate ROE for a regulated utility requires determining the market-based cost of capital. The market-based cost of capital for a regulated firm represents the return investors could expect from other investments, while assuming no more and no less risk. The purpose of all of the economic models and formulas in cost of capital testimony (including those presented later in my testimony) is to estimate, using market data of similar-risk firms, the rate of return equity investors require for that risk class of firms in order to set an appropriate ROE for a regulated firm.

B. Summary of Positions

Q. PLEASE REVIEW THE COMPANY'S PROPOSED RATE OF RETURN.

A. FPL has proposed a capital structure from investor-provided capital of 38.93% long-term debt, 1.46% short-term debt, and 59.61% common equity. The Company has recommended long-term and short-term debt cost rates of 3.61% and 0.94%. FPL Witness James M. Coyne has recommended a common equity cost rate of 11.0% for FPL. FPL has also requested a ROE inflator of 0.50% for superior management

[1] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*") and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*").

performance. FPL's overall rate of return request is 8.28% from investor-provided capital and is summarized in Table 1.

Table 1
FPL Rate of Return Recommendation from Investor-Provided Capital

Capital Source	Capitalization Ratios	Cost Rate	Weighted Cost Rate
Long-Term Debt	**38.93%**	**3.61%**	**1.41%**
Short-Term Debt	**1.46%**	**0.94%**	**0.01%**
Common Equity	**59.61%**	**11.50%**	**6.86%**
Total Capital	**100.00%**		**8.28%**

Q. WHAT ARE YOUR RECOMMENDATIONS REGARDING THE APPROPRIATE RATE OF RETURN FOR FPL?

A. I have reviewed the Company's proposed capital structure and overall cost of capital. FPL's proposed capitalization has much more equity and much less financial risk than the average current capitalizations of electric utility companies. OPC Witness Kevin O'Donnell presents OPC's capital structure position, which includes a capital structure with a common equity ratio from investor capital of 55.00%. To estimate an equity cost rate for the Company, I have applied the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM") to my proxy group of electric utilities ("Electric Proxy Group"). I have also used Witness Coyne's proxy group ("Coyne Proxy Group"). Witness Coyne has also employed an alternative risk premium approach as well as an Expected Earnings approach.

My DCF and CAPM results indicate a ROE range of 7.80%-9.00%. However, since I rely primarily on the DCF approach, I conclude that the appropriate ROE range is 8.50%-9.00%. Given this range, my recommended ROE for the Company is 8.75%. This equity cost rate is based on Witness Kevin O'Donnell's capital structure with a

common equity ratio of 55.0% from investor-provided capital. If the Commission were to adopt the Company's recommended capital structure with a 59.60% common equity ratio, my recommended ROE would be 8.50%. Given my recommended capitalization ratios, debt cost rate, and the 8.75% ROE, my rate of return or cost of capital recommendation on investor-provided capital for FPL is 6.40% and is summarized in Table 2 and Exhibit JRW-1.

Table 2
OPC's Rate of Return Recommendation from Investor Capital

Capital Source	Capitalization Ratios	Cost Rate	Weighted Cost Rate
Long-Term Debt	**43.37%**	**3.61%**	**1.57%**
Short-Term Debt	**1.63%**	**0.94%**	**0.02%**
Common Equity	**55.00%**	**8.75%**	**4.81%**
Total Capital	**100.00%**		**6.40%**

C. Primary Rate of Return Issues in this Case

Q. PLEASE PROVIDE AN OVERVIEW OF THE PRIMARY ISSUES REGARDING RATE OF RETURN IN THIS PROCEEDING.

A. The primary issues related to the Company's rate of return include the following:

1. Capital Market Conditions – Witness Coyne's analyses, ROE results, and recommendations are based on assumptions of higher interest rates and capital costs. However, despite the recent rise in rates, interest rates and capital costs remain at historically low levels. In 2019, interest rates fell due to slow economic growth and low inflation. Interest rates fell even further to record low levels in 2020 due to the impact of the novel coronavirus on the world's population and economy. The

benchmark 30-year Treasury yield has rebounded since mid-2020, but it is still in the 2.25% range.

2. <u>Capital Structure</u> – As I have just noted, FPL's proposed capital structure has much more equity and less financial risk than the average capital structure of the two proxy groups as well as FPL's parent company, NextEra Energy. As a result, Witness O'Donnell has proposed a capital structure with a common equity ratio for investor-provided capital of 55.0%.

3. <u>Investment Risk of FPL</u> – FPL's issuer credit rating is A according to S&P and A1 according to Moody's. The average S&P and Moody's ratings for the two proxy groups are BBB+ and Baa1. As such, FPL's S&P rating is two notches above the average of the two proxy groups, and FPL's Moody's rating is three notches above the average of the two proxy groups. This clearly indicates that FPL is less risky than the average of the two proxy groups. Witness Coyne has not recognized that FPL is less risky than his proxy group, and he has not made an adjustment to his recommended equity cost rate to account for FPL's lower level of investment risk. My 8.75% ROE recommendation explicitly recognizes the lower investment risk of FPL.

4. <u>DCF Equity Cost Rate</u> - The DCF Equity Cost Rate is estimated by summing the stock's dividend yield and investors' expected long-run growth rate in dividends paid per share. There are two issues with Witness Coyne's DCF study: (1) he gives little weight to his DCF results. His mean DCF result for his proxy group is 9.23%, yet he concludes that FPL's cost of equity is 11.00%; and (2) he relies exclusively on the overly optimistic and upwardly biased growth-rate forecasts for earnings per share ("EPS") put forth by Wall Street analysts and *Value Line*.

I also have used a traditional constant-growth DCF model. In developing a growth rate for my DCF model for the proxy group, I have reviewed thirteen growth-rate measures including historic and projected growth-rate measures and have evaluated growth in dividends, book value, and earnings per share. I give primary weight to analysts' projected EPS growth rates.

5. <u>CAPM Approach</u> - The CAPM approach requires an estimate of the risk-free interest rate, the beta, and the market or equity risk premium. There are two primary issues with Witness Coyne's CAPM analyses: (1) he has used a projected risk-free interest rate of 2.80% which is above current market interest rates; and (2) much more significantly, his market-risk premium of 12.95%, is excessive and includes highly unrealistic assumptions about future earnings growth and stock returns. The 12.95% market risk premium is much larger than: (1) indicated by historic stock and bond return data; and (2) well-above that found in the published studies and surveys of the market risk premium. To compute his market risk premium, Witness Coyne has applied the DCF to the S&P 500 and employed analysts' three-to-five-year earnings per share ("EPS") growth-rate projections as a growth rate to compute an expected market return and market risk premium. As I demonstrate later in my testimony, Witness Coyne's approach produces an expected market return of 15.75% which is 50% higher than historic market returns. This 15.75% expected stock market return is based on a projected S&P 500 EPS growth-rate rate of 14.11% and it produces the projected market risk premium of 12.95% (15.75% - 2.80%).[2] The bottom line is that the

[2] The 15.75% expected market return, the 14.11% projected S&P 500 growth rate, and the 12.95% market risk premium represent the average of three approaches used by Mr. Coyne in Exhibit JMC-5 to estimate a market risk premium using projected S&P 500 EPS growth rates from S&P, Bloomberg, and *Value Line*.

projected S&P 500 EPS growth rate of 14.11% and the resulting expected market return (15.75%) and market risk premium (12.95%) are totally unrealistic. Simply put, S&P 500 companies cannot grow their earnings forever at a rate that is over three times the projected GDP growth.

As I highlight in my testimony, there are three commonly-used procedures for estimating a market risk premium – historic returns, surveys, and expected return models. I have used a market risk premium of 6.00%, which: (1) factors in all three approaches – historic returns, surveys, and expected return models – to estimate a market premium; and (2) employs the results of many studies of the market risk premium. As I note, the 6.00% figure reflects the market risk premiums: (1) determined in recent academic studies by leading finance scholars; (2) employed by leading investment banks and management consulting firms; and (3) found in surveys of companies, financial forecasters, financial analysts, and corporate CFOs.

6. <u>Alternative Risk Premium Model</u> – Witness Coyne also estimates an equity cost rate using an alternative risk premium model. His risk premium method is based on the historical relationship between the yields on long-term Treasury bonds and authorized ROEs for electric utility companies. There are several issues with this approach which I discuss in more depth later, but the two primary problems are that (1) his risk premium approach is a gauge of *commission* behavior rather than *investor* behavior, and (2) Witness Coyne's methodology produces an inflated measure of the risk premium because his approach uses historical authorized ROEs and Treasury yields, and the resulting risk premium is applied to projected Treasury yields. Finally, the risk premium is inflated as a measure of investors' required risk premium since electric

utility companies have been selling at market-to-book ratios in excess of 1.0. This indicates that the authorized rates of return have been greater than the return that investors require.

7. Expected Earnings Approach - Witness Coyne also uses the Expected Earnings approach to estimate an equity cost rate for the Company. Witness Coyne computes the expected ROE as forecasted by *Value Line* for his proxy group of electric utilities. The so-called "Expected Earnings" approach, however, (1) does not measure the market cost of equity capital, (2) is independent of most cost of capital indicators, and (3) has several other empirical problems. Therefore, the Commission should ignore Witness Coyne's "Expected Earnings" approach in determining the appropriate ROE for FPL.

8. Other Issues - Witness Coyne concludes that his equity-cost-rate studies suggest a ROE range of 9.23% to 14.17%. He then also considers a number of other factors in arriving at his 11.00% ROE recommendation. These factors include: (1) Capital expenditures; (2) Nuclear generation ownership; (3) Severe weather risk; (4) Regulatory risk; (5) Multi-year rate plan; (6) flotation costs; and (7) management performance. The first five factors are all considered by S&P and Moody's in the credit rating process and, as noted above, FPL's S&P rating is two notches above the average of the two proxy groups, and FPL's Moody's rating is three notches above the average of the two proxy groups. As such, FPL's investment risk is below the proxy groups, even considering these factors. Witness Coyne also includes a flotation cost adjustment of 0.11% in his equity cost rate recommendation of 11.0%. However, Witness Coyne has not provided any evidence that the Company has paid flotation costs. Therefore,

the Company should not be allowed to collect additional revenues in the form of a higher ROE for flotation costs which they did not incur. OPC Witness Daniel Lawton provides evidence that FPL does not deserve a 50 basis points ROE inflator for superior management performance.

III. CAPITAL MARKET CONDITIONS AND AUTHORIZED ROES

A. Capital Market Conditions

Q. PLEASE PROVIDE A SUMMARY OF THE UTILITY CAPITAL MARKET INDICATORS IN EXHIBIT JRW-2.

A. Page 1 of Exhibit JRW-2 shows the yields on A-rated public-utility bonds. These yields have gradually declined in the past decade from 7.5% to the 3.0% range. They have increased since the middle of 2020 to the 3.5% range. Page 2 of Exhibit JRW-2 shows the average dividend yield for publicly-held electric utilities. These yields declined over the past decade, bottoming out at 3.1% in 2019. They increased to 3.6% in 2020. The average earned ROE and market-to-book ratio for publicly-held electric utilities is shown on page 3 of Exhibit JRW-2. The average earned ROE has been in the 9.0% to 10.0% range over the past five years. The average market-to-book ratio increased over the decade, peaking at 2.0X in 2019, and declined to 1.75X in 2020.

Q. PLEASE REVIEW THE FINANCIAL MARKETS IN 2020.

A. The financial markets began the year 2020 in good form – stock prices rose about five percent in the first six weeks of the year and interest rates declined. Then came weeks of chaos. In the middle of February 2020, the spread of the novel coronavirus went global and the virus became a major risk factor for the world's population and global economy. From mid-February until the third week of March, the S&P 500 declined 35 percent and investors fled to low-risk financial assets, most notably long-term Treasury bonds. The yield on the benchmark 30-year Treasury bond declined from 2.0 percent and traded as low as 1.25 percent, an all-time low. Furthermore, the day-to-day volatility of prices in financial markets was at extremes. The VIX, which is the Chicago Board Options Exchange ("CBOE") volatility index and is known as Wall Street's Fear Index, increased from 15 and traded over 50, a level which has not been seen since the financial crisis in 2008.

In response, the federal government took unprecedented fiscal and monetary actions to support the economy and financial markets. Congress passed and President Trump signed a $2 trillion stimulus relief package to help American families and businesses, the biggest economic rescue package in modern American history. The package granted households relief in the form of stimulus checks sent directly to most Americans, expanded unemployment benefits, expanded paid sick leave, provided temporary student-debt relief and more. The Federal Reserve lowered the target range for its benchmark federal-funds rate to the current range of 0% to 0.25%, which target range it expects to maintain until the economy has recovered. In addition, the Federal Reserve implemented a broad range of unprecedented programs to support financial market liquidity and economic stability. These included financial asset purchases and

the creation of credit facilities to support households, businesses, and state and local governments.

In 2021, President Biden signed a second $1.9 trillion COVID-19 stimulus plan which included $1,400 checks for individuals, billions to help schools and colleges reopen, funding for vaccine distribution, and many other financial resources to help the U.S. recover from the pandemic.

Q. PLEASE REVIEW THE IMPACT OF THE ECONOMY ON INTEREST RATES.

A. Figure 1 shows 30-year Treasury yields over the past two years (2019-21). These yields were in the 3.0% range at the end of 2018, and declined to the 2.25% range in 2019, due primarily to slow economic growth and low inflation. As noted, in 2020, with the proliferation of the COVID-19 pandemic in February, 30-year Treasury yields declined to record low levels, declining about 100 basis points to the 1.25% range. They began their recovery in the summer of 2020 and have increased to the 2.25% range in 2021. Despite their recovery, these rates are still at historically low levels.

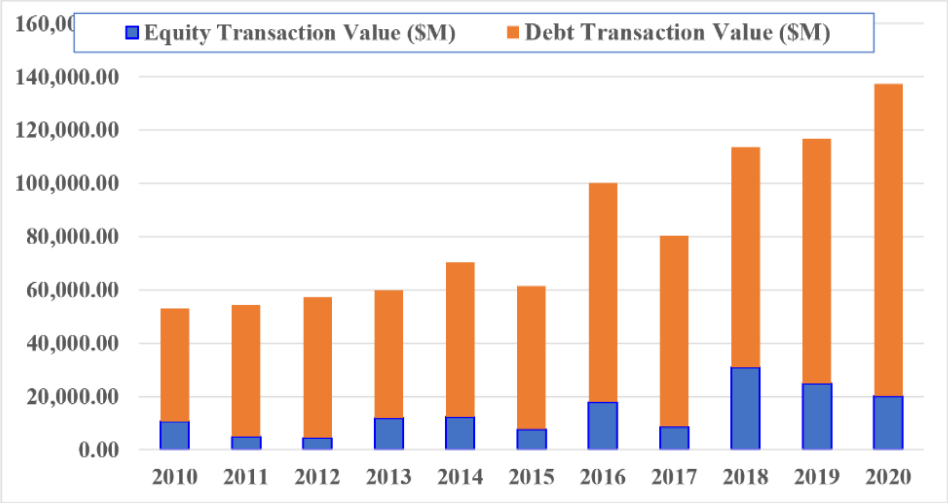
Figure 1
30-Year Treasury Yields

Data Source: https://fred.stlouisfed.org/series/DGS30

Q. HAVE UTILITIES TAKEN ADVANTAGE OF THE LOWER BOND YIELDS TO RAISE CAPITAL?

A. Yes. Figure 2 shows the annual amounts of debt- and equity-capital raised by public utility companies over the past decade. Electric utility and gas distribution companies have taken advantage of the low interest rate and capital cost environment of recent years and raised record amounts of capital in the markets. In fact, in each of the last three years, public utilities have raised a total of over $100 billion in debt and equity.

Figure 2
Debt and Equity Capital Raised by Public Utilities
2010-20



Source: S&P Global Market Intelligence, S&P Cap IQ, 2021.

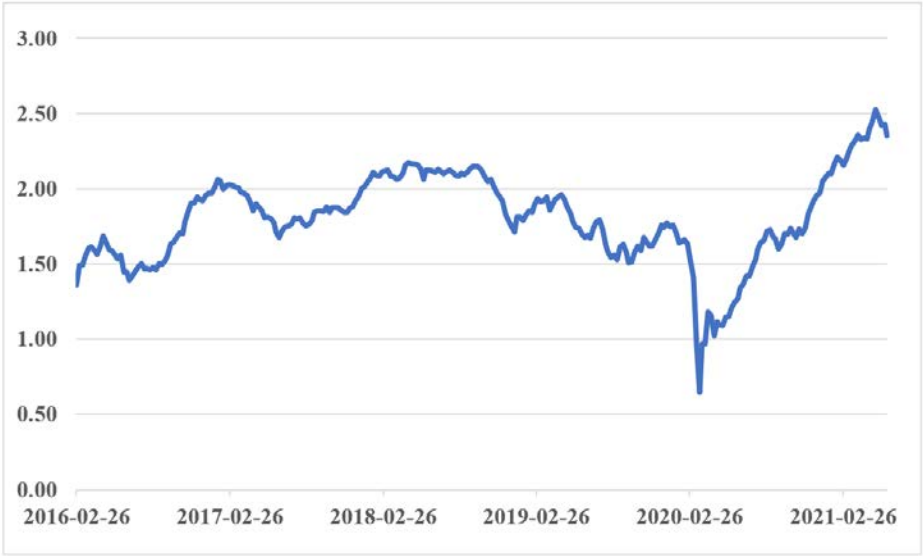
Q. PLEASE DISCUSS THE INCREASE IN INTEREST RATES SINCE THE SUMMER OF 2020.

A. As noted, with the economy improving and the passage of the second COVID-19 stimulus plan, interest rates increased about 100 basis points since mid-2020. The increase in rates reflect the prospect that expanded economic growth could lead to higher inflation. Investors' inflation expectation can be seen by looking at the difference between yields on ordinary Treasuries and the yields on inflation-protected Treasuries, known as Treasury Inflation-Protected Securities ("TIPS"). Panel A of Figure 3 shows the expected inflation rate over the next five years. Panel A of Figure 3 shows a noticeable increase over the past year, with an expected inflation rate of 2.47% over the next five years. Panels B and C of Figure 3 show the expected inflation rate over the next ten and thirty years. The expected inflation rates over the next ten and thirty years are 2.36% and 2.30%. When the expected inflation rate is higher over five years than over ten and thirty years, as is the case now, it is known as a bond-

market inversion and it reflects that, despite a short-term expectation of higher inflation, the long-term inflation rate is still a little above 2.0%.[3]

Figure 3
Panel A
5-Year Treasury Yields Minus 5-Year Treasury TIPs

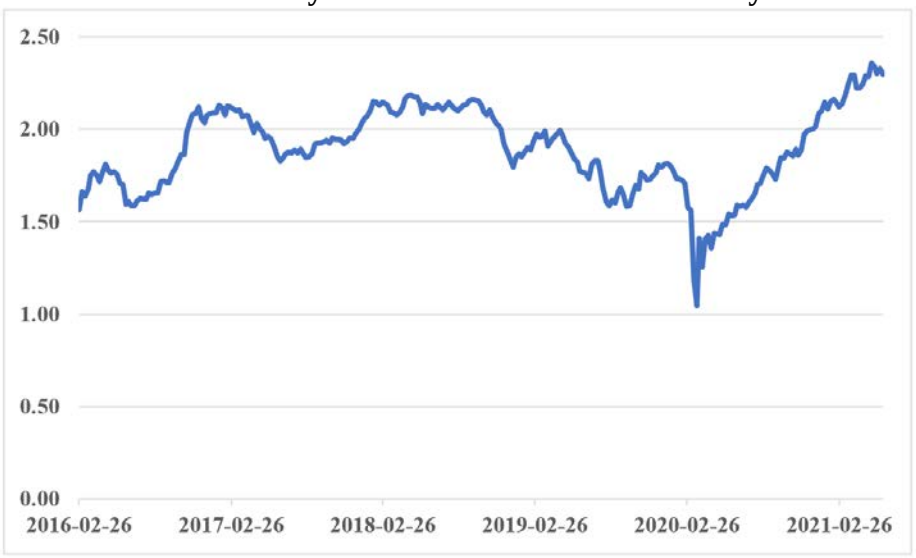
Panel B
10-Year Treasury Yields Minus 10-Year Treasury TIPs



[3] Paul J. Davies – "Rare Bond-Market Inversion Signals Short-Lived Boost to Inflation," *Wall Street Journal*, February 25, 2021.

Panel C

30-Year Treasury Yields Minus 30-Year Treasury TIPs



Date Source: https://fred.stlouisfed.org/

Q. HOW HAS THE CHANGE IN INTEREST RATES OVER THE PAST YEAR IMPACTED CAPITAL COSTS FOR UTILITIES?

A. As discussed below, with COVID-19 and the record low interest rates in 2020, authorized ROEs for utilities reached record low levels in 2020. However, whereas interest rates declined by about 100 basis points in 2020, authorized ROEs only declined by about 25 basis points. Therefore, utility ROEs never declined to the extent that interest rates declined in 2020.

Q. MUCH HAS BEEN MADE IN THE FINANCIAL PRESS IN RECENT MONTHS ABOUT THE INCREASE IN REPORTED INFLATION OVER THE PAST YEAR. PLEASE COMMENT.

A. In the second quarter of 2021, consumer prices have increased from a year ago at inflation rates as high as 5.0%. This has created alarm in the markets that inflation is back at much higher levels than the 2.0 percent of past ten years. However, a recent *Wall Street Journal* article highlighted an issue with the current one-year numbers. [4] Year-over-year comparisons of corporate profits, consumer prices, and other economic and corporate data are reported because they provide a sense of how the economy is changing over time. With respect to the economy, a year ago the economy was reeling from the onset of COVID-19 and prices for goods and services like apparel, gasoline, hotels, air flights and car rentals collapsed. As a result, the higher inflation rate of four or five percent being reported over the past year may be overstated as a picture of price pressures in the economy because it is from a very deflated base in the second quarter

[4] J. Hilsenrath, "The Fed's Inflation View is all About That Base," *Wall Street Journal*, June 6, 2021.

of 2020. The author suggested an approach to looking at this data - look at how the economy compares today with two years ago rather than one. He concludes the following after a review of data over two years: "This subdues the effects of the Covid-19 shock and shows how close activity is to normal. On average, the consumer-price index rose 3.5% every two years during the decade before the Covid-19 crisis. That was within a range between 5.8% in 2012 and 0.8% in 2016."[5] The bottom line is that the current one-year inflation data is coming from a deflated base and hence likely overstates prospective inflation in the future. The fact that the 30-year Treasury yield has remained in the 2.25 percent range while these one-year inflation rates are being reported suggests that investors understand this issue.

Q. WHAT OTHER ECONOMIC SIGNALS ARE INDICATED BY THE RECENT CHANGES IN INTEREST RATES?

A. As discussed above, the spreads between utility and Treasury bond yields has declined, indicating two things: (1) utility bond yields have not increased as much as Treasury yields since mid-2020; and (2) investors have confidence in the economy and hence their degree of risk aversion is lower. This was highlighted in recent *Wall Street Journal* article, in which the author indicated the following:[6]

> The spread relative to Treasuries, however, is arguably an even better measure of investors' outlook for the economy, since it shows how much investors feel they need to be compensated for the risk that companies may default on their debt. The narrow speculative-grade bond spreads indicate debt investors think that the economic environment for businesses over the next several years could be better than at any time since the 2008-2009 financial crisis—a striking

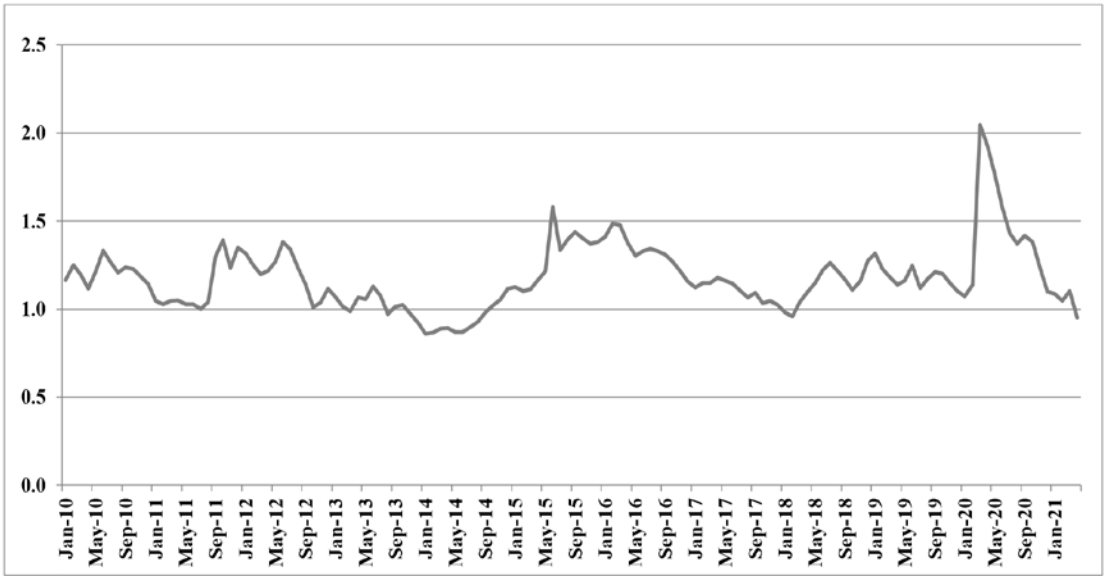
[5] *Id*.

[6] D. Goldfarb, "Corporate Bond Gauge Signals Dwindling Economist Risk," *Wall Street Journal*, April, 22, 2021.

development after many feared a severe, long-lasting economic downturn just last year.

I have shown the yield differential between 30-year 'A' rated utility bonds and 30-year Treasury yields over the past decade in Figure 4. The yield differential was in the 100 to 150 basis points range in the years prior to 2020. The differential jumped to over 200 basis points in the spring of 2020 as the pandemic spread and the global economy was shut down. However, the yield differential has declined over the past year, and is at its low point of about 100 basis points. As indicted above, this reflects increased confidence in the economy as indicated by the lower spread and risk aversion, and also means that utility yields have not increased as much as Treasury yields.

Figure 4
30-Year 'A' Rates Utility Yields Minus 30-Year Treasury Yields
2010-21



Date Source: https://fred.stlouisfed.org/ and Mergent Bond Yields

Q. IS THERE ANY OTHER EVIDENCE THAT THE FINANCIAL MARKETS VOLATILITY ASSOCIATED WITH THE PANDEMIC HAS SUBSIDED?

A. Yes. The VIX, which is the Chicago Board Options Exchange ("CBOE") volatility index, is known as Wall Street's Fear Index.[7] Figure 5 shows the level of the VIX from 2000 to 2021. The VIX increased from 15 to over 50 in 2020, a level which has not been seen since the financial crisis in 2008. It has since decreased and is now below its long-term average of 20.

Figure 5
The VIX
2000-2021

Date Source: https://fred.stlouisfed.org/. Shaded areas represent economic recessions time periods.

Q. PLEASE SUMMARIZE YOUR ASSESSMENT OF THE CURRENT CAPITAL MARKET SITUATION.

A. The U.S. economy has rebounded significantly over the past year after declining nearly twenty percent in the first half of 2020. Gross Domestic Product ("GDP") is expected

[7] The Chicago Board Options Exchange Volatility Index, or **VIX**, is a real-time market index representing the market's expectations for volatility over the coming 30 days. Investors use the VIX to measure the level of risk, fear, or stress in the market when making investment decisions.

to grow at about 6.0% for the remainder of 2021. The U.S. unemployment rate peaked in the second quarter of 2020 at about 15% and is now at 6.0%. The stock market began its recovery in the third week of March of 2020 and despite the negative health and economic issues with COVID-19, the S&P 500 has come back strong and is at record levels. The 30-year Treasury yield, which dropped to 1.25% in 2020, has come back to its pre-COVID level of 2.25%. But, as noted above, the spread between utility and Treasury bond yields has declined, which means that the yields on utility bonds have not increased as much as Treasury bond yields. Finally, the markets "fear index," the VIX, which topped out over 50, is below its long-time average of 20.

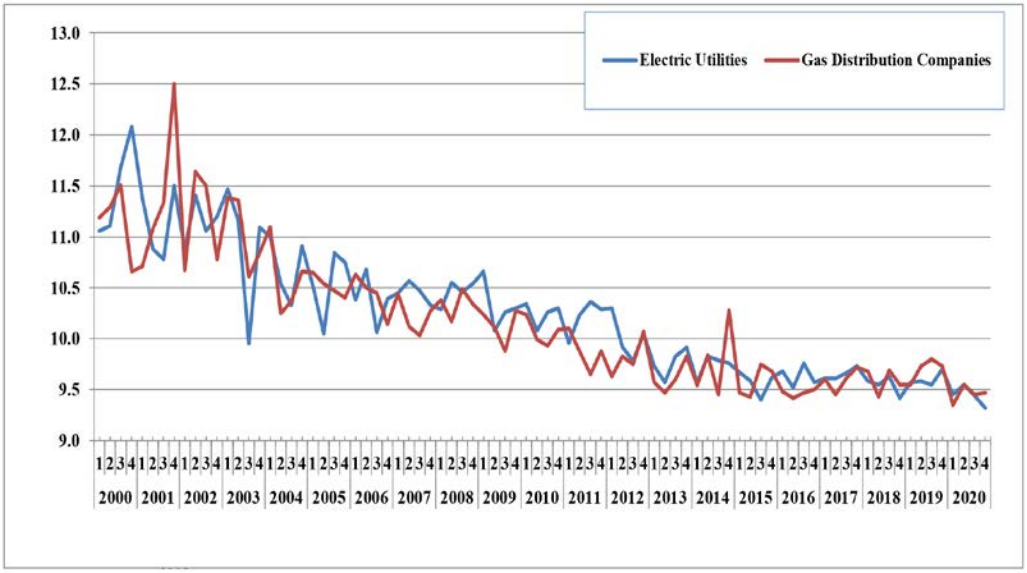
B. Authorized ROEs

Q. PLEASE DISCUSS THE TREND IN AUTHORIZED ROES FOR ELECTRIC AND GAS COMPANIES.

A. In Figure 6, I have graphed the quarterly authorized ROEs for electric and gas companies from 2000 to 2020. Over the years, as interest rates have come down, authorized ROEs for electric utility and gas distribution companies have slowly declined to reflect a low capital-cost environment. In 2020, authorized ROEs for utilities hit an all-time low. On an annual basis, the average authorized ROEs for electric utilities have declined from an average of 10.01% in 2012; 9.8% in 2013; 9.76% in 2014; 9.58% in 2015; 9.60% in 2016; 9.68% in 2017; 9.58% in 2018; 9.65% in of 2019; to 9.39% in 2020, according to Regulatory Research Associates.[8]

[8] S&P Global Market Intelligence, RRA *Regulatory Focus*, 2021.

Figure 6
Authorized ROEs for Electric Utility and Gas Distribution Companies
2000-2020



Date Source: S&P Global Market Intelligence, RRA *Regulatory Focus*, 2021.

Q. PLEASE REVIEW THE COMMISSION'S COST OF CAPITAL DETERMINATIONS IN FPL'S MOST RECENT RATE CASE.

A. On November 29, 2016, in Docket No**.** 20160021-EI**,** the Commission approved a settlement between FPL and intervening parties which included a ROE of 10.55%. Since that time, interest rates and electric utility authorized ROEs have declined.

Q. PLEASE REVIEW THE AUTHORIZED ROES IN FLORIDA RELATIVE TO AUTHORIZED ROES IN THE U.S.

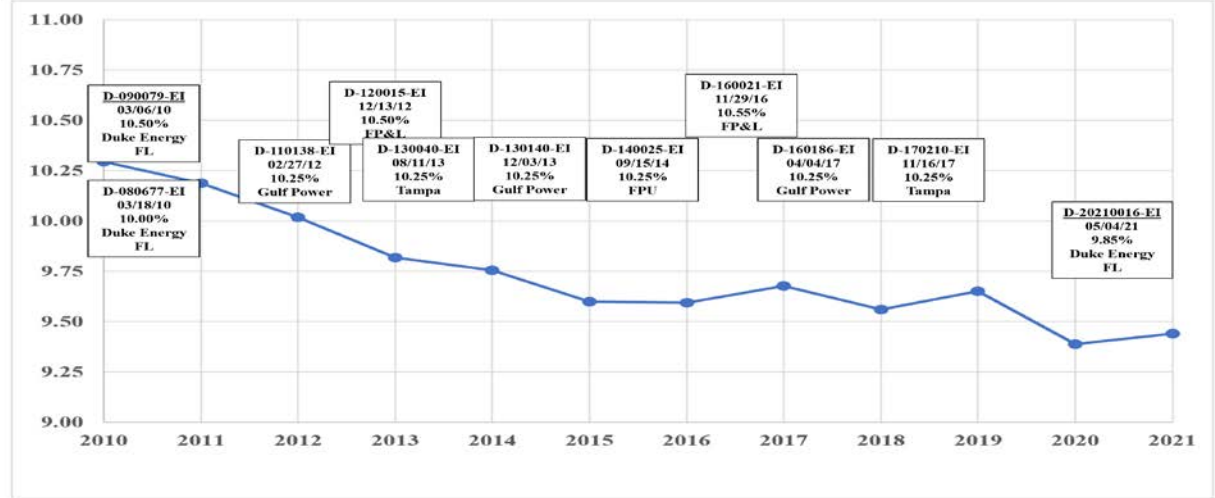
A. In Figure 7, I show: (1) the authorized ROEs in Florida relative to the average annual authorized ROEs for electric utilities in the U.S over the past decade. Details of the Florida cases are provided in Table 3. I have several observations from Figure 7.

1. Authorized ROEs in Florida have consistently been above the average authorized ROEs for electric utilities in the U.S;
2. Between 2012 and 2020, while authorized ROEs declined from 10.0% to about

9.50%, the authorized ROEs in Florida remained in the 10.25%-10.55% range; and

3. There has been only one electric ROE determination in Florida since 2017. In 2021, in Docket No. 20210016-EI, the Commission approved a settlement with a ROE of 9.85% for Duke Energy Florida.

Figure 7
Florida vs. U.S. Authorized Electric ROEs
2010-2021



Date Source: S&P Global Market Intelligence, RRA *Regulatory Focus*, 2021

Table 3
Florida Authorized ROEs for Electric Utility Companies
2010-21

Company	TKR	Docket	Service	Case Type	Order Date	Decision	Increase	ROE	Equity %
Duke Energy Florida LLC	DUK	D-090079-EI	Electric	Vertically Integrated	3/5/2010	Settled	126.2	10.50	46.74
Florida Power & Light Co.	NEE	D-080677-EI	Electric	Vertically Integrated	3/17/2010	Settled	75.5	10.00	47.00
Gulf Power Co.	NEE	D-110138-EI	Electric	Vertically Integrated	2/27/2012	Litigated	68.1	10.25	38.50
Florida Power & Light Co.	NEE	D-120015-EI	Electric	Vertically Integrated	12/13/2012	Settled	350.0	10.50	NA
Tampa Electric Co.	EMA	D-130040-EI	Electric	Vertically Integrated	9/11/2013	Settled	70.0	10.25	42.00
Gulf Power Co.	NEE	D-130140-EI	Electric	Vertically Integrated	12/3/2013	Settled	55.0	10.25	NA
Florida Public Utilities Co.	CPK	D-140025-EI	Electric	Vertically Integrated	9/15/2014	Settled	3.8	10.25	NA
Florida Power & Light Co.	NEE	D-160021-EI	Electric	Vertically Integrated	11/29/2016	Settled	811.0	10.55	NA
Gulf Power Co.	NEE	D-160186-EI	Electric	Vertically Integrated	4/4/2017	Settled	62.0	10.25	NA
Tampa Electric Co.	EMA	D-170210-EI	Electric	Vertically Integrated	11/6/2017	Settled	0.0	10.25	NA
Duke Energy Florida LLC	DUK	D-20210016-EI	Electric	Vertically Integrated	5/4/2021	Settled	67.2	9.85	NA

Date Source: S&P Global Market Intelligence, RRA *Regulatory Focus*, 2021

IV. PROXY GROUP SELECTION

Q. PLEASE DESCRIBE YOUR APPROACH TO DEVELOPING A FAIR RATE OF RETURN RECOMMENDATION FOR FPL.

A. To develop a fair rate-of-return recommendation for the Company, I have evaluated the return requirements of investors on the common stock of a proxy group of publicly-held utility companies.

Q. WHAT PROXY GROUPS HAVE YOU USED?

A. I have used my Electric Proxy Group and Witness Coyne's proxy group.

Q. PLEASE DESCRIBE YOUR PROXY GROUP OF ELECTRIC COMPANIES.

A. The selection criteria for the Electric Proxy Group include the following:

1. At least 50% of revenues from regulated electric operations as reported by *AUS Utilities Report*;
2. Listed as an U.S.-based Electric Utility by *Value Line Investment Survey;*
3. An investment-grade corporate credit rating from S&P and Moody's;
4. Has paid a cash dividend in the past six months, with no cuts or omissions;
5. Not involved in an acquisition of another utility, the target of an acquisition, or in the sale or spin-off of utility assets, in the past six months; and
6. Analysts' long-term earnings per share ("EPS") growth rate forecasts available from Yahoo, S&P Cap IQ, and/or Zacks.

Q. PLEASE DISCUSS THE ELECTRIC PROXY GROUP.

A. The Electric Proxy Group includes twenty-six companies. Summary financial statistics for the proxy group are listed in Panel A of page 1 of Exhibit JRW-3.[9] The median operating revenues among members of the Electric Proxy Group are $6,245.5 million and the median net-plant value is $21,439.2 million. On average, the group receives 80% of its revenues from regulated electric operations; has BBB+/Baa1 issuer credit ratings from S&P and Moody's respectively; has an average current common equity ratio of 44.5% and an average earned return on common equity of 10.3%.

Q. PLEASE DESCRIBE WITNESS COYNE'S PROXY GROUP OF ELECTRIC UTILITY COMPANIES.

A. The Coyne Proxy Group consists of fourteen electric utility companies. Summary financial statistics for the proxy group are listed on Panel B of page 1 of Exhibit JRW-3. The median operating revenues and net plant among members of the Coyne Proxy Group are $4,397.8 million and $16,735.6 million, respectively. On average the group receives 92% of revenues from regulated electric operations; has an average BBB+ issuer credit rating from S&P and an average Baa1 long-term rating from Moody's; has a current common equity ratio of 45.4%; and has an earned return on common equity of 9.9%.

[9] In my testimony, I present financial results using both mean and medians as measures of central tendency. However, due to outliers among means, I have primarily used the median as a measure of central tendency.

Q. HOW DOES THE INVESTMENT RISK OF FPL COMPARE TO THAT OF THE PROXY GROUPS?

A. I believe that bond ratings provide a good assessment of the investment risk of a company. Page 1 of Exhibit JRW-3 also shows S&P and Moody's issuer credit ratings for the companies in the two groups. The average S&P and Moody's ratings for the two groups are BBB+ and Baa1. FPL's issuer credit rating is "A" according to S&P and A1 according to Moody's. As such, FPL's S&P rating is two notches above the average of the two proxy groups, and FPL's Moody's rating is three notches above the average of the two proxy groups. This clearly indicates that FPL is less risky than the average of the two proxy groups.

Q. HOW DOES THE INVESTMENT RISK OF THE TWO GROUPS COMPARE BASED ON THE VARIOUS RISK METRICS PUBLISHED BY *VALUE LINE*?

A. On page 2 of Exhibit JRW-3, I have assessed the riskiness of the two proxy groups using five different accepted risk measures. These measures include Beta, Financial Strength, Safety, Earnings Predictability, and Stock Price Stability. These risk measures suggest that the two proxy groups are similar in risk. The comparisons of the risk measures include Beta (0.87 vs. 0.88), Financial Strength (A vs. A), Safety (1.8 vs. 1.9), Earnings Predictability (84 vs. 83), and Stock Price Stability (89 vs. 89). On balance, these measures suggest that these two proxy groups are very low risk relative to the overall stock market and are similar in risk to each other.

V. CAPITAL STRUCTURE RATIOS AND DEBT COST RATES

Q. PLEASE DESCRIBE FPL'S PROPOSED CAPITAL STRUCTURE AND SENIOR CAPITAL COST RATES.

A. FPL has proposed a capital structure from investor-provided capital of 38.93% long-term debt, 1.46% short-term debt, and 59.6% common equity and long-term and short-term debt cost rates of 3.61% and 0.94%.

Q. WHAT ARE THE COMMON EQUITY RATIOS IN THE CAPITALIZATIONS OF THE TWO PROXY GROUPS?

A. As shown in Exhibit JRW-3, the average common equity ratios of the Electric and Coyne Proxy Groups are 44.5% and 45.4%, respectively. As such, FPL's proposed capitalization from investor-provided capital and as proposed for rate setting purposes has much more equity and much less financial risk than the average current capitalizations of the electric utility companies in the proxy groups.

Q. WHAT ARE THE COMMON EQUITY RATIOS OF FPL'S PARENT, NEXTERA?

A. As shown in Exhibit JRW-3, the common equity ratio as of December 31, 2020 for NextEra Energy is 43.8%. Hence, FPL's proposed capitalization also has much more equity and much less financial risk than the average current capitalizations of the electric utility companies in the two proxy groups.

Q. IS IT APPROPRIATE TO USE THE COMMON EQUITY RATIOS OF THE PARENT HOLDING COMPANIES OR SUBSIDIARY OPERATING UTILITIES FOR COMPARISON PURPOSES WITH FPL'S PROPOSED CAPITALIZATION?

A. Yes. It is appropriate to use the common equity ratios of the utility holding companies because the *holding companies* are publicly-traded and their stocks are used in the cost-of-equity capital studies. The equities of the *operating utilities* are not publicly-traded and hence their stocks cannot be used to compute the cost-of-equity capital for FPL.

Q. IS IT APPROPRIATE TO INCLUDE SHORT-TERM DEBT IN THE CAPITALIZATION IN COMPARING THE COMMON EQUITY RATIOS OF THE HOLDING COMPANIES WITH FPL'S PROPOSED CAPITALIZATION?

A. Yes; short-term debt, like long-term debt, has a higher claim on the assets and earnings of the company and requires timely payment of interest and repayment of principal. Thus, in comparing the common-equity ratios of the holding companies with FPL's recommendation, it is appropriate to include short-term debt when computing the holding company common-equity ratios. Additionally, the financial risk of a company is based on total debt, which includes both short-term and long-term debt.

Q. PLEASE DISCUSS THE ISSUE OF PUBLIC UTILITY HOLDING COMPANIES SUCH AS NEXTERA USING DEBT TO FINANCE THE EQUITY IN SUBSIDIARIES SUCH AS FPL.

A. Moody's published an article on the use of low-cost, debt financing by public utility holding companies to increase their ROEs. The summary observations included the following about how these holding companies use "leverage" and how an increase in leverage at the parent holding company can "hurt the credit profiles of its regulated subsidiaries":

> U.S. utilities use leverage at the holding-company level to invest in other businesses, make acquisitions and earn higher returns on equity. In some cases, an increase in leverage at the parent can hurt the credit profiles of its regulated subsidiaries.[10]

This financial strategy has traditionally been known as "double leverage." Noting that "double leverage" results in a consolidated debt-to-capitalization ratio that is higher at the parent than at the subsidiary because of the additional debt at the parent," Moody's defined double leverage as follows:

> Double leverage is a financial strategy whereby the parent raises debt but downstreams the proceeds to its operating subsidiary, likely in the form of an equity investment. Therefore, the subsidiary's operations are financed by debt raised at the subsidiary level and by debt financed at the holding-company level. In this way, the subsidiary's equity is leveraged twice, once with the subsidiary debt and once with the holding-company debt. In a simple operating-company / holding-company structure, this practice results in a consolidated debt-to-capitalization ratio that is higher at the parent than at the subsidiary because of the additional debt at the parent.[11]

Moody's goes on to discuss the potential risk "down the road" to utilities of this financing corporate strategy if regulators were to ascribe the debt at the parent level to the subsidiaries or adjust the authorized return on capital:

> **"Double leverage" drives returns for some utilities but could pose risks down the road.** The use of double leverage, a long-

[10] Moody's Investors' Service, "High Leverage at the Parent Often Hurts the Whole Family," May 11, 2015, p. 1.

[11] *Id*. at p. 5.

> standing practice whereby a holding company takes on debt and downstreams the proceeds to an operating subsidiary as equity, could pose risks down the road if regulators were to ascribe the debt at the parent level to the subsidiaries or adjust the authorized return on capital.[12]

Q. PLEASE DISCUSS THE SIGNIFICANCE OF THE AMOUNT OF EQUITY THAT IS INCLUDED IN A UTILITY'S CAPITAL STRUCTURE.

A. A utility's decision as to the amount of equity capital it will incorporate into its capital structure involves fundamental trade-offs relating to the amount of financial risk the firm carries, the overall revenue requirements its customers are required to bear through the rates they pay, and the return on equity that investors will require.

Q. PLEASE DISCUSS A UTILITY'S DECISION TO USE DEBT VERSUS EQUITY TO MEET ITS CAPITAL NEEDS.

A. Utilities satisfy their capital needs through a mix of equity and debt. Because equity capital is more expensive than debt, the issuance of debt enables a utility to raise more capital for a given commitment of dollars than it could raise with just equity. Debt is, therefore, a means of "leveraging" capital dollars. However, as the amount of debt in the capital structure increases, financial risk increases and the risk of the utility, as perceived by equity investors, also increases. Significantly, for this case, the converse is also true. As the amount of debt in the capital structure decreases, the financial risk decreases. The required return on equity capital is a function of the amount of overall risk that investors perceive, including financial risk in the form of debt.

[12] *Id*. at p. 1.

Q. CAN THE IMPACT OF A UTILTY'S AWARDED ROE BE DETERMINED WITHOUT REFERENCE TO THAT UTILITY'S CAPITAL STRUCTURE?

A. No. A high equity component can amplify the overall impact of a relatively low ROE while a low equity component can mitigate the overall impact of a relatively high ROE. For example, suppose an electric utility has an authorized ROE and common equity ratio of 10.0% and 50.0%. Financially, the same utility would be at about the same point with authorized ROE of 9.0% but with a common equity ratio of 55.0%.

Q. IS THERE ALSO A DIRECT CORRELATION BETWEEN THE AMOUNT OF EQUITY IN A COMPANY'S CAPITAL STRUCTURE AND THE REVENUE REQUIREMENTS THAT CUSTOMERS ARE CALLED ON TO BEAR?

A. Yes. Just as there is a direct correlation between the utility's authorized return on equity and the utility's revenue requirements (the higher the return, the greater the revenue requirement), there is a direct correlation between the amount of equity in the capital structure and the revenue requirements that customers are called on to bear. As the equity ratio increases, the utility's revenue requirement increases and the rates paid by customers increase. If the proportion of equity is too high, rates will be higher than they need to be. For this reason, the utility's management should pursue a capital acquisition strategy that results in the proper balance in the capital structure.

Q. CAN A REGULATED UTILITY SAFELY TAKE ON MORE DEBT THAN A NON-REGULATED COMPANY?

A. Yes. Due to regulation and the essential nature of its output, a regulated utility is exposed to less business risk than other companies that are not regulated. This means that a utility can reasonably carry relatively more debt in its capital structure than can most unregulated companies. Thus, a utility should take appropriate advantage of its lower business risk to employ cheaper debt capital at a level that will benefit its customers through lower revenue requirements.

Q. GIVEN THAT FPL HAS PROPOSED AN EQUITY RATIO THAT IS MUCH HIGHER THAN (1) THE AVERAGE COMMON EQUITY RATIO OF OTHER ELECTRIC UTILITY COMPANIES, AND (2) THE COMMON EQUITY RATIO OF ITS PARENT COMPANY, NEXTERA, WHAT SHOULD THE COMMISSION DO IN THIS RATEMAKING PROCEEDING?

A. When a regulated utility's actual capital structure contains a high equity ratio, the options are: (1) to impute a more reasonable capital structure that is comparable to the average of the proxy group used to determine the cost of equity and to reflect the imputed capital structure in revenue requirements; or (2) to recognize the downward impact that an unusually high equity ratio will have on the financial risk of a utility and authorize a common equity-cost rate lower than that of the proxy group.

Q. PLEASE ELABORATE ON THIS "DOWNWARD IMPACT."

A. As I stated earlier, there is a direct correlation between the amount of debt in a utility's capital structure and the financial risk that an equity investor will associate with that utility. A relatively lower proportion of debt translates into a lower required return on

equity, all other things being equal. Stated differently, a utility should not be permitted to "have it both ways." Specifically, a utility cannot propose to maintain an unusually high equity ratio and not expect to have the resulting lower risk reflected in its authorized return on equity. The fundamental relationship between lower risk and the appropriate authorized return should not be ignored.

Q. WHAT CAPITAL STRUCTURE IS OPC RECOMMENDING IN THIS CASE?

A. Witness Kevin O'Donnell has proposed a capital structure from investor-provided capital of 43.37% long-term debt, 1.63% short-term debt, and 55.0% common equity. Witness O'Donnell notes that this capital structure represents a "gradual" adjustment to FPL's capital structure and common equity ratio. As noted above, the average common equity ratios of the Electric and Coyne Proxy Groups are 44.5% and 45.4%, respectively, and NextEra's common equity ratio as of December 31, 2020 was 43.8%. As such, OPC's proposed capital structure includes significantly more equity than the proxy groups and therefore is very generous to the Company.

VI. THE COST OF COMMON EQUITY CAPITAL

A. Overview

Q. WHY MUST AN OVERALL COST OF CAPITAL OR FAIR RATE OF RETURN BE ESTABLISHED FOR A PUBLIC UTILITY?

A. In a competitive industry, the return on a firm's common equity capital is determined through the competitive market for its goods and services. Due to the capital requirements needed to provide utility services and the economic benefit to society from avoiding duplication of these services and the construction of utility-infrastructure facilities, most public utilities are monopolies. Because of the lack of competition and the essential nature of their services, it is not appropriate to permit monopoly utilities to set their own prices.

Thus, regulation seeks to establish prices that are fair to consumers and, at the same time, sufficient to meet the operating and capital costs of the utility, *i.e.*, provide an adequate return on capital to attract investors.

Q. PLEASE PROVIDE AN OVERVIEW OF THE COST OF CAPITAL IN THE CONTEXT OF THE THEORY OF THE FIRM.

A. The total cost of operating a business includes the cost of capital. The cost of common-equity capital is the expected return on a firm's common stock that the marginal investor would deem sufficient to compensate for risk and the time value of money. In equilibrium, the expected and required rates of return on a company's common stock are equal.

Normative economic models of a company or firm, developed under very restrictive assumptions, provide insight into the relationship between a firm's performance or profitability, capital costs, and the value of the firm. Under the economist's ideal model of perfect competition, where entry and exit are costless, products are undifferentiated, and there are increasing marginal costs of production,

firms produce up to the point where price equals marginal cost. Over time, a long-run equilibrium is established where price of the firm equals average cost, including the firm's capital costs. In equilibrium, total revenues equal total costs, and because capital costs represent investors' required return on the firm's capital, actual returns equal required returns, and the market value must equal the book value of the firm's securities.

In a competitive market, firms can achieve competitive advantage due to product-market imperfections. Most notably, companies can gain competitive advantage through product differentiation (adding real or perceived value to products) and by achieving economies of scale (decreasing marginal costs of production). Competitive advantage allows firms to price products above average cost and thereby earn accounting profits greater than those required to cover capital costs. When these profits are in excess of those required by investors, or when a firm earns a return on equity in excess of its cost of equity, investors respond by valuing the firm's equity in excess of its book value.

James M. McTaggart, founder of the international management consulting firm Marakon Associates, described this essential relationship between the return on equity, the cost of equity, and the market-to-book ratio in the following manner:

> Fundamentally, the value of a company is determined by the cash flow it generates over time for its owners, and the minimum acceptable rate of return required by capital investors. This "cost of equity capital" is used to discount the expected equity cash flow, converting it to a present value. The cash flow is, in turn, produced by the interaction of a company's return on equity and the annual rate of equity growth. High [return on equity] ROEcompanies in low-growth markets, such as Kellogg, are prodigious generators of cash flow, while low ROE companies in high-growth markets, such

> as Texas Instruments, barely generate enough cash flow to finance growth.
>
> A company's ROE over time, relative to its cost of equity, also determines whether it is worth more or less than its book value. If its ROE is consistently greater than the cost of equity capital (the investor's minimum acceptable return), the business is economically profitable and its market value will exceed book value. If, however, the business earns an ROE consistently less than its cost of equity, it is economically unprofitable and its market value will be less than book value. [13]

As such, the relationship between a firm's return on equity, cost of equity, and market-to-book ratio is relatively straightforward. A firm that earns a return on equity above its cost of equity will see its common stock sell at a price above its book value. Conversely, a firm that earns a return on equity below its cost of equity will see its common stock sell at a price below its book value.

Q. PLEASE PROVIDE ADDITIONAL INSIGHTS INTO THE RELATIONSHIP BETWEEN ROE AND MARKET-TO-BOOK RATIOS.

A. This relationship is discussed in a classic Harvard Business School case study entitled "Note on Value Drivers." On page 2 of that case study, the author describes the relationship very succinctly:

> For a given industry, more profitable firms – those able to generate higher returns per dollar of equity – should have higher market-to-book ratios. Conversely, firms which are unable to generate returns in excess of their cost of equity [(K)] should sell for less than book value.
>
> | *Profitability* | *Value* |
> |---|---|
> | *If ROE > K* | *then Market/Book > 1* |
> | *If ROE = K* | *then Market/Book =1* |
> | *If ROE < K* | *then Market/Book< 1* [14] |

[13] James M. McTaggart, "The Ultimate Poison Pill: Closing the Value Gap," *Commentary* (Spring 1986), p.3.

[14] Benjamin Esty, "Note on Value Drivers," Harvard Business School, Case No. 9-297-082, April 7, 1997.

To assess the relationship by industry, as suggested above, I performed a regression study between estimated ROE and market-to-book ratios using natural gas distribution and electric utility companies. I used all companies in these two industries that are covered by *Value Line* and have estimated ROE and market-to-book ratio data. The results are presented on page 1 of Exhibit JRW-5. The average R-square is 0.50.[15] This demonstrates the strong positive relationship between ROEs and market-to-book ratios for public utilities. Given that the market-to-book ratios have been above 1.0 for a number of years, this also demonstrates that utilities have been earning ROEs above the cost-of-equity capital for many years.

Q. WHAT FACTORS DETERMINE INVESTORS' EXPECTED OR REQUIRED RATE OF RETURN ON EQUITY?

A. The expected or required rate of return on common stock is a function of market-wide as well as company-specific factors. The most important market factor is the time value of money, as indicated by the level of interest rates in the economy. Common-stock investor requirements generally increase and decrease with like changes in interest rates. The perceived risk of a firm is the predominant factor that influences investor return requirements on a company-specific basis. A firm's investment risk is often separated into business risk and financial risk. Business risk encompasses all factors that affect a firm's operating revenues and expenses. Financial risk results from incurring fixed obligations in the form of debt in financing its assets.

[15] R-square measures the percent of variation in one variable (e.g., market-to-book ratios) explained by another variable (e.g., expected ROE). R-squares vary between zero and 1.0, with values closer to 1.0 indicating a higher relationship between two variables.

Q. HOW DOES THE INVESTMENT RISK OF UTILITIES COMPARE WITH THAT OF OTHER INDUSTRIES?

A. Due to the essential nature of their service as well as their regulated status, public utilities are exposed to a lesser degree of business risk than other, non-regulated businesses. The relatively low level of business risk allows public utilities to meet much of their capital requirements through borrowing in the financial markets, thereby incurring greater than average financial risk. Nonetheless, the overall investment risk of public utilities is below most other industries.

Page 2 of Exhibit JRW-5 provides an assessment of investment risk for 94 industries as measured by beta, which, according to modern capital market theory, is the only relevant measure of investment risk. These betas come from the *Value Line Investment Survey*. The study shows that the investment risk of utilities is low compared to other industries. The average betas for electric, gas, and water utility companies are 0.89, 0.89, and 0.79, respectively.[16] As such, the cost of equity for utilities is the lowest of all industries in the U.S., based on modern capital market theory.

Q. WHAT IS THE COST OF COMMON EQUITY CAPITAL?

A. The costs of debt and preferred stock are normally based on historical or book values and can be determined with a great degree of accuracy. The cost of common-equity-

[16] The beta for the *Value Line* electric utilities is the simple average of *Value Line*'s Electric East (0.89), Central (0.89), and West (0.90) group betas.

capital, however, cannot be determined precisely and must instead be estimated from market data and informed judgment. This return requirement of the stockholder should be commensurate with the return requirement on investments in other enterprises having comparable risks.

According to valuation principles, the present value of an asset equals the discounted value of its expected future cash flows. Investors discount these expected cash flows at their required rate of return that, as noted above, reflects the time value of money and the perceived riskiness of the expected future cash flows. As such, the cost of common equity is the rate at which investors discount expected cash flows associated with common stock ownership.

Q. HOW CAN THE EXPECTED OR REQUIRED RATE OF RETURN ON COMMON EQUITY CAPITAL BE DETERMINED?

A. Models have been developed to ascertain the cost of common-equity capital for a firm. Each model, however, has been developed using restrictive economic assumptions. Consequently, judgment is required in selecting appropriate financial valuation models to estimate a firm's cost of common-equity capital, in determining the data inputs for these models, and in interpreting the models' results. All of these decisions must take into consideration the firm involved as well as current conditions in the economy and the financial markets.

Q. HOW DID YOU ESTIMATE THE COST OF EQUITY CAPITAL FOR THE COMPANY?

A. Primarily, I rely on the DCF model to estimate the cost-of-equity capital. Given the investment-valuation process and the relative stability of the utility business, the DCF model provides the best measure of equity-cost rates for public utilities. I have also performed an analysis using the capital asset pricing model ("CAPM"); however, I give these results less weight because I believe that risk-premium studies, of which the CAPM is one form, provide a less reliable indication of equity-cost rates for public utilities.

Q. PLEASE EXPLAIN WHY YOU BELIEVE THAT THE CAPM PROVIDES A LESS RELIABLE INDICATOR OF EQUITY COST RATES?

A. I believe that the CAPM provides a less reliable measure of a utility's equity-cost rate because it requires an estimate of the market-risk premium. As discussed below, there is a wide variation in estimates of the market-risk premium found in studies by academics and investment firms as well as in surveys of market professionals.

B. Discounted Cash Flow (DCF) Approach

Q. PLEASE DESCRIBE THE THEORY BEHIND THE TRADITIONAL DCF MODEL.

A. According to the DCF model, the current stock price is equal to the discounted value of all future dividends that investors expect to receive from investment in the firm. As such, stockholders' returns ultimately result from current as well as future dividends.

As owners of a corporation, common stockholders are entitled to a *pro rata* share of the firm's earnings. The DCF model presumes that earnings that are not paid out in the form of dividends are reinvested in the firm to provide for future growth in earnings and dividends. The rate at which investors discount future dividends, which reflects the timing and riskiness of the expected cash flows, is interpreted as the market's expected or required return on the common stock. Therefore, this discount rate represents the cost of common equity. Algebraically, the DCF model can be expressed as:

$$P = \frac{D_1}{(1+k)^1} + \frac{D_2}{(1+k)^2} + \cdots + \frac{D_n}{(1+k)^n}$$

where P is the current stock price, D_1, D_2, D_n are the dividends in (respectively) year 1, 2, and in the future years n, and k is the cost of common equity.

Q. IS THE DCF MODEL CONSISTENT WITH VALUATION TECHNIQUES EMPLOYED BY INVESTMENT FIRMS?

A. Yes. Virtually all investment firms use some form of the DCF model as a valuation technique. One common application for investment firms is called the three-stage DCF or dividend discount model ("DDM"). The stages in a three-stage DCF model are presented in Exhibit JRW-6. This model presumes that a company's dividend payout progresses initially through a growth stage, then proceeds through a transition stage, and finally assumes a maturity (or steady-state) stage. The dividend-payment stage of a firm depends on the profitability of its internal investments which, in turn, is largely a function of the life cycle of the product or service.

1. **Growth stage**: Characterized by rapidly expanding sales, high profit margins, and an abnormally high growth in earnings per share. Because of highly profitable expected investment opportunities, the payout ratio is low. Competitors are attracted by the unusually high earnings, leading to a decline in the growth rate.

2. **Transition stage**: In later years, increased competition reduces profit margins and earnings growth slows. With fewer new investment opportunities, the company begins to pay out a larger percentage of earnings.

3. **Maturity (steady-state) stage**: Eventually, the company reaches a position where its new investment opportunities offer, on average, only slightly more attractive ROEs. At that time, its earnings growth rate, payout ratio, and ROE stabilize for the remainder of its life. As I will explain below, the constant-growth DCF model is appropriate when a firm is in the maturity stage of the life cycle.

In using the 3-stage model to estimate a firm's cost-of-equity capital, dividends are projected into the future using the different growth rates in the alternative stages, and then the equity-cost rate is the discount rate that equates the present value of the future dividends to the current stock price.

Q. PLEASE BRIEFLY EXPLAIN THE CONCEPT OF "PRESENT VALUE."

A. Present value is the concept that an amount of money today is worth more than that same amount in the future. In other words, money received in the future is not worth as much as an equal amount received today. Present value tells an investor how much he or she would need in today's dollars to earn a specific amount in the future.

Q. HOW DO YOU ESTIMATE STOCKHOLDERS' EXPECTED OR REQUIRED RATE OF RETURN USING THE DCF MODEL?

A. Under certain assumptions, including a constant and infinite expected growth rate, and constant dividend/earnings and price/earnings ratios, the DCF model can be simplified to the following:

$$P = \frac{D_1}{k - g}$$

where P is the current stock price, D_1 represents the expected dividend over the coming year, k is investor's required return on equity, and g is the expected growth rate of dividends. This is known as the constant-growth version of the DCF model. To use the constant-growth DCF model to estimate a firm's cost of equity, one solves for "k" in the above expression to obtain the following:

$$k = \frac{D_1}{P} + g$$

Q. IN YOUR OPINION, IS THE CONSTANT-GROWTH DCF MODEL APPROPRIATE FOR PUBLIC UTILITIES?

A. Yes. The economics of the public utility business indicate that the industry is in the steady-state or constant-growth stage of a three-stage DCF. The economics include the relative stability of the utility business, the maturity of the demand for public utility services, and the regulated status of public utilities (especially the fact that their returns on investment are effectively set through the ratemaking process). The DCF valuation procedure for companies in this stage is the constant-growth DCF. In the constant-growth version of the DCF model, the current dividend payment and stock price are

directly observable. However, the primary problem and controversy in applying the DCF model to estimate equity-cost rates entails estimating investors' expected dividend growth rate.

Q. WHAT FACTORS SHOULD ONE CONSIDER WHEN APPLYING THE DCF METHODOLOGY?

A. One should be sensitive to several factors when using the DCF model to estimate a firm's cost of equity capital. In general, one must recognize the assumptions under which the DCF model was developed in estimating its components (the dividend yield and the expected growth rate). The dividend yield can be measured precisely at any point in time; however, it tends to vary somewhat over time. Estimation of expected growth is considerably more difficult. One must consider recent firm performance, in conjunction with current economic developments and other information available to investors, to accurately estimate investors' expectations.

Q. WHAT DIVIDEND YIELDS HAVE YOU REVIEWED?

A. I have calculated the dividend yields for the companies in the proxy group using the current annual dividend and the 30-day, 90-day, and 180-day average stock prices. These dividend yields are provided in Panels A and B on page 2 of Exhibit JRW-7. I have shown the mean and median dividend yields using 30-day, 90-day, and 180-day average stock prices. For the Electric Proxy Group, the mean and median dividend yields using the 30-day, 90-day, and 180-day average stock prices range from 3.3% to 3.7%. However, the recent (30-day) average dividend yield is only 3.30%. As a result,

I am using 3.40%, as the dividend yield for the Electric Proxy Group. The dividend yields for the Coyne Proxy Group are shown in Panel B on page 2 of Exhibit JRW-7. The mean and median dividend yields range from 3.4% to 3.8% using the 30-day, 90-day, and 180-day average stock prices. However, the recent (30-day) average dividend yield is only 3.40%. As a result, I am using 3.50%, as the dividend yield for the Coyne Proxy Group.

Q. PLEASE DISCUSS THE APPROPRIATE ADJUSTMENT TO THE SPOT DIVIDEND YIELD.

A. According to the traditional DCF model, the dividend yield term relates the dividend paid over the coming period to the current stock price. As indicated by Professor Myron Gordon, who is commonly associated with the development of the DCF model for popular use, this is obtained by: (1) multiplying the expected dividend over the coming quarter by 4, and (2) dividing this dividend by the current stock price to determine the appropriate dividend yield for a firm that pays dividends on a quarterly basis.[17]

In applying the DCF model, some analysts adjust the current dividend for growth over the coming year as opposed to the coming quarter. This can be complicated because firms tend to announce changes in dividends at different times during the year. As such, the dividend yield computed based on presumed growth over the coming quarter as opposed to the coming year can be quite different. Consequently,

[17] *Petition for Modification of Prescribed Rate of Return*, Federal Communications Commission, Docket No. 79-05, Direct Testimony of Myron J. Gordon and Lawrence I. Gould at 62 (April 1980).

it is common for analysts to adjust the dividend yield by some fraction of the long-term expected growth rate.

Q. GIVEN THIS DISCUSSION, WHAT ADJUSTMENT FACTOR DO YOU USE FOR YOUR DIVIDEND YIELD?

A. I adjust the dividend yield by one-half (1/2) of the expected growth to reflect growth over the coming year. This is the approach employed by the Federal Energy Regulatory Commission ("FERC").[18] The DCF equity-cost rate ("K") is computed as:

$$K = \left[\left(\frac{D}{P}\right) \times (1 + 0.5g)\right] + g$$

Q. PLEASE DISCUSS THE GROWTH RATE COMPONENT OF THE DCF MODEL.

A. There is debate as to the proper methodology to employ in estimating the growth component of the DCF model. By definition, this component is investors' expectations of the long-term dividend growth rate. Presumably, investors use some combination of historical and/or projected growth rates for earnings and dividends per share and for internal or book-value growth to assess long-term potential.

[18] Opinion No. 414-A, *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶61,084 (1998).

Q. WHAT GROWTH DATA HAVE YOU REVIEWED FOR THE PROXY GROUPS?

A. I have analyzed a number of measures of growth for companies in the proxy groups. I reviewed *Value Line's* historical and projected growth rate estimates for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS"). In addition, I utilized the average EPS growth-rate forecasts of Wall Street analysts as provided by Yahoo, Zacks and S&P Cap IQ. These services solicit five-year earnings growth-rate projections from securities analysts and compile and publish the means and medians of these forecasts. Finally, I also assessed prospective growth as measured by prospective earnings retention rates and earned returns on common equity.

Q. PLEASE DISCUSS HISTORICAL GROWTH IN EARNINGS AND DIVIDENDS, AS WELL AS SUSTAINABLE OR INTERNAL GROWTH.

A. Historical growth rates for EPS, DPS, and BVPS are readily available to investors and are presumably an important ingredient in forming expectations concerning future growth. However, one must use historical growth numbers as measures of investors' expectations with caution. In some cases, past growth may not reflect future growth potential. Also, employing a single growth-rate number (for example, for five or ten years) is unlikely to accurately measure investors' expectations, due to the sensitivity of a single growth-rate figure to fluctuations in individual firm performance as well as overall economic fluctuations (*i.e.*, business cycles). Thus, one must appraise the context in which the growth rate is being employed. According to the conventional DCF model, the expected return on a security is equal to the sum of the dividend yield

and the expected long-term growth in dividends. Therefore, to best estimate the cost of common-equity capital using the conventional DCF model, one must look to long-term growth rate expectations.

Q. PLEASE DEFINE AND EXPLAIN THE RELEVANCE OF SUSTAINABLE OR INTERNAL GROWTH.

A. A company's sustainable or internal (or "organic") growth occurs when a business expands its own operations rather than relying on takeovers and mergers. It can come about through various means, for example, increasing existing production capacity through investment in new capital and technology, or development and launch of new products.

Internally generated growth is a function of the percentage of earnings retained within the firm (the earnings retention rate) and the rate of return earned on those earnings (the return on equity). The internal growth rate is computed as the retention rate times the return on equity. Internal growth is significant in determining long-run earnings and, therefore, dividends. Investors recognize the importance of internally-generated growth and pay premiums for stocks of companies that retain earnings and earn high returns on internal investments.

Q. PLEASE DISCUSS THE SERVICES THAT PROVIDE ANALYSTS' EPS FORECASTS.

A. Analysts' EPS forecasts for companies are collected and published by several different investment information services, including Institutional Brokers Estimate System

("I/B/E/S"), Bloomberg, FactSet, S&P Cap IQ, Zacks, First Call, and Reuters, among others. Thompson Reuters publishes analysts' EPS forecasts under different product names, including I/B/E/S, First Call, and Reuters. Bloomberg, FactSet, S&P Cap IQ, and Zacks each publish their own set of analysts' EPS forecasts for companies. These services do not reveal (1) the analysts who are solicited for forecasts; or (2) the identity of the analysts who actually provide the EPS forecasts that are used in the compilations published by the services. I/B/E/S, Bloomberg, FactSet, S&P Cap IQ, and First Call are fee-based services. These services usually provide detailed reports and other data in addition to analysts' EPS forecasts. In contrast, Thompson Reuters and Zacks provide limited EPS forecast data free-of-charge on the Internet. Yahoo finance (http://finance.yahoo.com) lists Thompson Reuters as the source of its summary EPS forecasts. Zacks (www.zacks.com) publishes its summary forecasts on its website. Zacks estimates are also available on other websites, such as MSN.money (http://money.msn.com).

Q. ARE YOU RELYING EXCLUSIVELY ON THE EPS FORECASTS OF WALL STREET ANALYSTS IN ARRIVING AT A DCF GROWTH RATE FOR THE PROXY GROUP?

A. No. There are several issues with using the EPS growth rate forecasts of Wall Street analysts as DCF growth rates. First, the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate. Nonetheless, over the very long term, dividend and earnings will have to grow at a similar growth rate. Therefore, consideration must be given to other indicators of growth, including prospective

dividend growth, internal growth, as well as projected earnings growth. Second, a study by Lacina, Lee, and Xu (2011) has shown that analysts' three-to-five year EPS growth-rate forecasts are not more accurate at forecasting future earnings than naïve random walk forecasts of future earnings.[19] Employing data over a twenty-year period, these authors demonstrate that using the most recent year's actual EPS figure to forecast EPS in the next 3-5 years proved to be just as accurate as using the EPS estimates from analysts' three-to-five year EPS growth-rate forecasts. In the authors' opinion, these results indicate that analysts' long-term earnings growth-rate forecasts should be used with caution as inputs for valuation and cost-of-capital purposes. Finally, and most significantly, it is well known that the long-term EPS growth-rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased. This has been demonstrated in a number of academic studies over the years.[20] Hence, using these growth rates as a DCF growth rate will provide an overstated equity cost rate. On this issue, a study by Easton and Sommers (2007) found that optimism in analysts' growth rate forecasts leads to an upward bias in estimates of the cost of equity capital of almost 3.0 percentage points.[21]

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[19] M. Lacina, B. Lee & Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101.

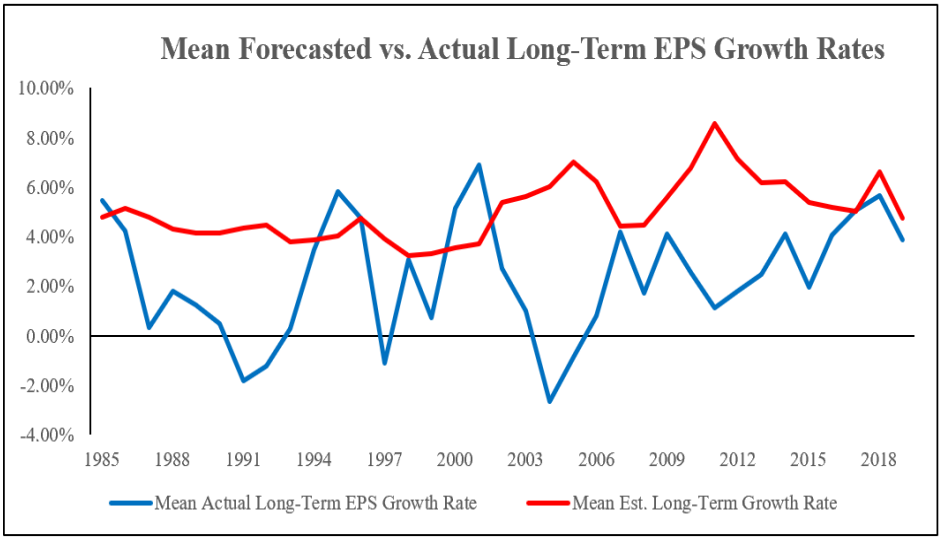
[20] The studies that demonstrate analysts' long-term EPS forecasts are overly-optimistic and upwardly biased include: R.D. Harris, "The Accuracy, Bias, and Efficiency of Analysts' Long Run Earnings Growth Forecasts," *Journal of Business Finance & Accounting*, pp. 725-55 (June/July 1999); P. DeChow, A. Hutton, and R. Sloan, "The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings," *Contemporary Accounting Research* (2000)*;* K. Chan, L., Karceski, J., & Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, pp. 643−684, (2003); M. Lacina, B. Lee, and Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101; and Marc H. Goedhart, Rishi Raj, and Abhishek Saxena, "Equity Analysts, Still Too Bullish," *McKinsey on Finance*, pp. 14-17, (Spring 2010).

[21] Peter D. Easton & Gregory A. Sommers, *Effect of Analysts' Optimism on Estimates of the Expected Rate of Return Implied by Earnings Forecasts*, 45 J. ACCT. RES. 983–1015 (2007).

Q. ARE ANALYSTS' PROJECTED EPS GROWTH RATES FOR ELECTRIC UTILITIES LIKEWISE OVERLY OPTIMISTIC AND UPWARDLY BIASED?

A. Yes. I have completed a study of the accuracy of analysts' EPS growth rates for electric utilities over the 1985-2020 time period. In the study, I used the utilities listed in the East, West, and Central Electric Utilities sectors by *Value Line*. I collected the three-to-five year projected EPS growth rate from I/B/E/S for each utility, and compared that growth rate to the utility's actual subsequent three-to-five year EPS growth rate. As shown in Figure 8, the mean forecasted EPS growth rate (depicted in the red line in Figure 8) is consistently greater than the achieved actual EPS growth rate over the time period, with the exception of 1994-96 and 2000-2002. Over the entire period, the mean forecasted EPS growth rate is over 200 basis points above the actual EPS growth rate. As such, the projected EPS growth rates for electric utilities are overly-optimistic and upwardly-biased.

Figure 8
Mean Forecasted vs. Actual Long-Term EPS Growth Rates
Electric Utilities
1985-2020



Data Source: S&P Global Market Intelligence, Capital IQ, I/B/E/S, 2021.

Q. ARE THE PROJECTED EPS GROWTH RATES OF *VALUE LINE* ALSO OVERLY OPTIMISTIC AND UPWARDLY BIASED?

A. Yes. A study by Szakmary, Conover, and Lancaster (2008) evaluated the accuracy of *Value Line*'s three-to-five-year EPS growth rate forecasts using companies in the Dow Jones Industrial Average over a thirty-year time period and found these forecasted EPS growth rates to be significantly higher than the EPS growth rates that these companies subsequently achieved.[22]

Szakmary, Conover, and Lancaster (SCL) studied the predicted versus the projected stock returns, sales, profit margins, and earnings per share made by *Value Line* over the 1969 to 2001 time period. *Value Line* projects variables from a three-year base period (e.g., 2012-2014) to a future three-year projected period (e.g., 2016-18). SCL used the sixty-five stocks included in the Dow Jones Indexes (30 Industrials, 20 Transports and 15 Utilities). SCL found that the projected annual stock returns for the Dow Jones stocks were "incredibly overoptimistic" and of no predictive value. The mean annual stock return of 20% for the Dow Jones' stocks *Value Line*'s forecasts was nearly double the realized annual stock return. The authors also found that *Value Line*'s forecasts of earnings per share and profit margins were termed "strikingly overoptimistic." *Value Line*'s forecasts of annual sales were higher than achieved levels, but not statistically significant. SCL concluded that the overly-optimistic projected annual stock returns were attributable to *Value Line*'s upwardly-biased forecasts of earnings per share and profit margins.

[22] Szakmary, A., Conover, C., & Lancaster, C. (2008), "An Examination of *Value Line*'s Long-Term Projections," *Journal of Banking & Finance*, May 2008, pp. 820-833.

Q. IS IT YOUR OPINION THAT STOCK PRICES REFLECT THE UPWARD BIAS IN THE EPS GROWTH RATE FORECASTS?

A. Yes, I do believe that investors are well aware of the bias in analysts' EPS growth-rate forecasts, and therefore stock prices reflect the upward bias.

Q. HOW DOES THAT AFFECT THE USE OF THESE FORECASTS IN A DCF EQUITY COST RATE STUDY?

A. According to the DCF model, the equity cost rate is a function of the dividend yield and expected growth rate. Because I believe that investors are aware of the upward bias in analysts' long-term EPS growth-rate forecasts, stock prices reflect the bias. But the DCF growth rate needs to be adjusted downward from the projected EPS growth rate to reflect the upward bias in the DCF model.

Q. PLEASE DISCUSS THE HISTORICAL GROWTH OF THE COMPANIES IN THE PROXY GROUPS, AS PROVIDED BY *VALUE LINE.*

A. Page 3 of Exhibit JRW-7 provides the 5- and 10- year historical growth rates for EPS, DPS, and BVPS for the companies in the two proxy groups, as published in the *Value Line Investment Survey*. The median historical growth measures for EPS, DPS, and BVPS for the Electric Proxy Group, as provided in Panel A, range from 4.0% to 6.0%, with an average of the medians of 4.9%. For the Coyne Proxy Group, as shown in Panel B on page 3 of Exhibit JRW-7, the historical growth measures in EPS, DPS, and BVPS, as measured by the medians, range from 3.5% to 5.5%, with an average of the medians of 4.1%.

Q. PLEASE SUMMARIZE *VALUE LINE'S* PROJECTED GROWTH RATES FOR THE COMPANIES IN THE PROXY GROUPS.

A. *Value Line's* projections of EPS, DPS, and BVPS growth for the companies in the proxy groups are shown on page 4 of Exhibit JRW-7. As stated above, due to the presence of outliers, the medians are used in the analysis. For the Electric Proxy Group, as shown in Panel A on page 4 of Exhibit JRW-7, the medians range from 4.0% to 6.0%, with an average of the medians of 5.0%. The range of the medians for the Coyne Proxy Group, shown in Panel B on page 4 of Exhibit JRW-7, is from 3.5% to 6.0%, with an average of the medians of 5.0%.

Also provided on page 4 of Exhibit JRW-7 are the prospective sustainable growth rates for the companies in the two proxy groups as measured by *Value Line*'s average projected retention rate and return on shareholders' equity. As noted above, sustainable growth is a significant and a primary driver of long-run earnings growth. For the Electric Proxy Group and Coyne Proxy Group, the median prospective sustainable growth rates are 3.9% and 3.9%, respectively.

Q. PLEASE ASSESS GROWTH FOR THE PROXY GROUPS AS MEASURED BY ANALYSTS' FORECASTS OF EXPECTED THREE-TO-FIVE YEAR EPS GROWTH.

A. Yahoo, Zacks, and S&P Cap IQ collect, summarize, and publish Wall Street analysts' three-to-five year EPS growth-rate forecasts for the companies in the proxy groups. These forecasts are provided for the companies in the proxy groups on page 5 of Exhibit JRW-7. I have reported both the mean and median growth rates for the groups. Since

there is considerable overlap in analyst coverage between the three services, and not all of the companies have forecasts from the different services, I have averaged the expected five-year EPS growth rates from the three services for each company to arrive at an expected EPS growth rate for each company. The mean/median of analysts' projected EPS growth rates for the Electric and Coyne Proxy Groups are 5.7%/5.9% and 5.6%/5.6%, respectively.[23]

Q. PLEASE SUMMARIZE YOUR ANALYSIS OF THE HISTORICAL AND PROSPECTIVE GROWTH OF THE PROXY GROUPS.

A. Page 6 of Exhibit JRW-7 shows the summary DCF growth rate indicators for the proxy groups.

The historical growth rate indicators for my Electric Proxy Group imply a baseline growth rate of 4.9%. The average of the projected EPS, DPS, and BVPS growth rates from *Value Line* is 5.0%, and *Value Line*'s projected sustainable growth rate is 3.9%. The projected EPS growth rates of Wall Street analysts for the Electric Proxy Group are 5.7% and 5.9% as measured by the mean and median growth rates. The overall range for the projected growth-rate indicators (ignoring historical growth) is 3.9% to 5.9%. Giving primary weight to the projected EPS growth rate of Wall Street analysts, but recognizing the upward bias nature of these forecasts, I believe that the appropriate projected growth rate is 5.5%. This growth rate figure is in the upper end of the range of historic and projected growth rates for the Electric Proxy Group.

[23] Given variation in the measures of central tendency of analysts' projected EPS growth rates proxy groups, I have considered both the means and medians figures in the growth rate analysis.

For the Coyne Proxy Group, the historical growth rate indicators suggest a growth rate of 4.1%. The average of the projected EPS, DPS, and BVPS growth rates from *Value Line* is 5.0%, and *Value Line*'s projected sustainable growth rate is 3.9%. The projected EPS growth rates of Wall Street analysts are 5.6% and 5.6% as measured by the mean and median growth rates. The overall range for the projected growth rate indicators is 3.9% to 5.6%. Giving primary weight to the projected EPS growth rate of Wall Street analysts, but recognizing the upward bias nature of these forecasts, I believe that the appropriate projected growth rate is in the 5.0% to 5.5% ranges. I will use the midpoint of this range, 5.25%, as my DCF growth rate. Similar to the Electric Proxy Group, this growth rate figure is in the upper end of the range of historic and projected growth rates for the Coyne Proxy Group.

Q. BASED ON THE ABOVE ANALYSIS, WHAT ARE YOUR INDICATED COMMON EQUITY COST RATES FROM THE DCF MODEL FOR THE PROXY GROUPS?

A. My DCF-derived equity cost rates for the groups are summarized on page 1 of Exhibit JRW-7 and in Table 4 below.

Table 4
DCF-Derived Equity Cost Rate/ROE

	Dividend Yield	1 + ½ Growth Adjustment	DCF Growth Rate	Equity Cost Rate
Electric Proxy Group	**3.40%**	**1.02750**	**5.50%**	**9.00%**
Coyne Proxy Group	**3.50%**	**1.02625**	**5.25%**	**8.85%**

The result for the Electric Proxy Group is the 3.40% dividend yield, times the one and one-half growth adjustment of 1.0275, plus the DCF growth rate of 5.50%, which

results in an equity cost rate of 9.00%. The result for the Coyne Proxy Group is 8.85%, which includes a dividend yield of 3.50%, an adjustment factor of 1.02625, and a DCF growth rate of 5.25%.

C. Capital Asset Pricing Model ("CAPM")

Q. PLEASE DISCUSS THE CAPITAL ASSET PRICING MODEL ("CAPM").

A. The CAPM is a risk premium approach to gauging a firm's cost of equity capital. According to the risk-premium approach, the cost of equity is the sum of the interest rate on a risk-free bond (R_f) and a risk premium (RP), as in the following:

$$k = R_f + RP$$

The yield on long-term U. S. Treasury securities is normally used as R_f. Risk premiums are measured in different ways. The CAPM is a theory of the risk and expected returns of common stocks. In the CAPM, two types of risk are associated with a stock: firm-specific risk or unsystematic risk, and market or systematic risk, which is measured by a firm's beta. The only risk that investors receive a return for bearing is systematic risk.

According to the CAPM, the expected return on a company's stock, which is also the equity cost rate (K), is expressed as:

$$K = (R_f) + \beta \times [E(R_m) - (R_f)]$$

Where:

- *K* represents the estimated rate of return on the stock;
- $E(R_m)$ represents the expected rate of return on the overall stock market. Frequently, the S&P 500 is used as a proxy for the "market";
- (R_f) represents the risk-free rate of interest;
- $[E(R_m) - (R_f)]$ represents the expected equity or market risk premium—the

excess rate of return that an investor expects to receive above the risk-free rate for investing in risky stocks; and

- *Beta*—(ß) is a measure of the systematic risk of an asset.

To estimate the required return or cost of equity using the CAPM requires three inputs: the risk-free rate of interest (R_f), the beta (ß), and the expected equity or market risk premium $[E(R_m) - (R_f)]$. R_f is the easiest of the inputs to measure – it is represented by the yield on long-term U.S. Treasury bonds. ß, the measure of systematic risk, is a little more difficult to measure because there are different opinions about what adjustments, if any, should be made to historical betas due to their tendency to regress to 1.0 over time. And finally, an even more difficult input to measure is the expected equity or market risk premium ($E(R_m) - (R_f)$). I will discuss each of these inputs below.

Q. PLEASE DISCUSS EXHIBIT JRW-8.

A. Exhibit JRW-8 provides the summary results for my CAPM study. Page 1 shows the results, and the following pages contain the supporting data.

Q. PLEASE DISCUSS THE RISK-FREE INTEREST RATE.

A. The yield on long-term U.S. Treasury bonds has usually been viewed as the risk-free rate of interest in the CAPM. The yield on long-term U.S. Treasury bonds, in turn, has been considered to be the yield on U.S. Treasury bonds with 30-year maturities.

Q. WHAT RISK-FREE INTEREST RATE ARE YOU USING IN YOUR CAPM?

A. As shown on page 2 of Exhibit JRW-8, the yield on 30-year U.S. Treasury bonds has been in the 1.25 percent to 4.75 percent range over the 2010–2021 time period. The

current 30-year Treasury yield is near the middle of this range. Given the recent range of yields, I have chosen to use a yield toward the middle of the range as my risk-free interest rate. Therefore, I am using 2.50 percent as the risk-free rate, or R_f, in my CAPM. This rate is consistent with Duff & Phelps, who are also using 2.50 percent (see page 7 of Exhibit JRW-8).[24]

Q. DOES YOUR 2.50 PERCENT RISK-FREE INTEREST RATE TAKE INTO CONSIDERATION FORECASTS OF HIGHER INTEREST RATES?

A. No; it does not. As I discuss later in my testimony, forecasts of higher interest rates have been notoriously wrong for a decade. My 2.50 percent risk-free interest rate takes into account the range of interest rates in the past and effectively synchronizes the risk-free rate with the market-risk premium. The risk-free rate and the market-risk premium are interrelated in that the market-risk premium is developed in relation to the risk-free rate. As discussed below, my market-risk premium is based on the results of many studies and surveys that have been published over time. Therefore, my risk-free interest rate of 2.50 percent is effectively a normalized risk-free rate of interest.

Q. WHAT BETAS ARE YOU EMPLOYING IN YOUR CAPM?

A. Beta (ß) is a measure of the systematic risk of a stock. The market, usually taken to be the S&P 500, has a beta of 1.0. The beta of a stock with the same price movement as the market also has a beta of 1.0. A stock with price movement greater than that of the

[24] Duff & Phelps, *Cost of Capital Research Center* (2020), https://www.duffandphelps.com/insights/publications/cost-of-capital.

market, such as a technology stock, is riskier than the market and has a beta greater than 1.0. A stock with below-average price movement, such as that of a regulated public utility, is less risky than the market and has a beta less than 1.0. Estimating a stock's beta involves running a linear regression of a stock's return on the market return.[25]

As shown on page 3 of Exhibit JRW-8, the slope of the regression line is the stock's ß. A steeper line indicates that the stock is more sensitive to the return on the overall market. This means that the stock has a higher ß and greater-than-average market risk. A less steep line indicates a lower ß and less market risk.

Several online investment information services, such as Yahoo and Reuters, provide estimates of stock betas. Usually these services report different betas for the same stock. The differences are usually due to: (1) the time period over which ß is measured; and (2) any adjustments that are made to reflect the fact that betas tend to regress to 1.0 over time.

Q. PLEASE DISCUSS THE RECENT CHANGE IN BETAS.

A. I have traditionally used the betas as provided in the *Value Line Investment Survey*. As discussed above, the betas for utilities recently increased significantly as a result of the volatility of utility stocks during the stock-market meltdown associated with the novel coronavirus in March of 2020. Utility betas as measured by *Value Line* have been in the 0.55 to 0.70 range for the past 10 years. But utility stocks were much more volatile

[25] Regression models describe the relationship between variables by fitting a line to the observed data. Linear regression models use a straight line, while logistic and nonlinear regression models use a curved line. Regression allows one to estimate how a dependent variable changes as the independent variable(s) change.

relative to the market in March and April of 2020, and this resulted in an increase of above 0.30 to the average utility beta.

Value Line defines their computation of beta as:[26]

> Beta - A relative measure of the historical sensitivity of a stock's price to overall fluctuations in the New York Stock Exchange Composite Index. A Beta of 1.50 indicates a stock tends to rise (or fall) 50% more than the New York Stock Exchange Composite Index. The ''Beta coefficient'' is derived from a regression analysis of the relationship between weekly percentage changes in the price of a stock and weekly percentage changes in the NYSE Index over a period of five years. In the case of shorter price histories, a smaller time period is used, but two years is the minimum. The Betas are adjusted for their long-term tendency to converge toward 1.00. Value Line then adjusts these Betas to account for their long-term tendency to converge toward 1.00.

However, there are several issues with *Value Line* betas:

1. *Value Line* betas are computed using weekly returns, and the volatility of utility stocks during March 2020 was impacted by using weekly and not monthly returns. Yahoo Finance uses five years of monthly returns to compute betas, and Yahoo Finance's betas for utilities are lower than *Value Lin*e's.

2. *Value Line* betas are computed using the New York Stock Exchange Index as the market. While about 3,000 stocks trade on the NYSE, most technology stocks are traded on the NASDAQ or over-the-counter market and not the NYSE. Technology stocks, which make up about 25 percent of the S&P 500, tend to be more volatile. If they were traded on the NYSE, they would increase the volatility of the measure of the market and thereby lower utility betas.

[26] *Value Line* (2020) www.valueline.com.

3. Major vendors of CAPM betas such as Merrill Lynch, *Value Line*, and Bloomberg publish adjusted betas. The so-called Blume adjustment cited by *Value Line* adjusts betas calculated using historical-returns data to reflect the tendency of stock betas to regress toward 1.0 over time, which means that the Betas of typical low beta stocks tend to increase toward 1.0, and the betas of typical high beta stocks tend to decrease toward 1.0.[27]

The Blume adjustment procedure is calculated as follows:

Regressed Beta = .67 * (Observed Beta) + 0.33

For example, suppose a company has an observed past beta of 0.50. The regressed (Blume-adjusted) beta would be:

Regressed Beta = .67 * (0.50) + 0.33 = 0.67

Blume offered two reasons for betas to regress toward 1.0. First, he suggested it may be a by-product of management's efforts to keep the level of firm's systematic risk close to that of the market. He also speculated that it results from management's efforts to diversify through investment projects.

However, there is an issue with using regressed betas for utilities. Specifically, a study by Michelfelder and Theodossiou investigated whether regressed Betas are appropriate for utilities.[28] Conceptually, Michelfelder and Theodossiou suggested that utilities are different from unregulated companies in several areas, which may result in betas not regressing toward 1.0:[29]

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[27] M. Blume, *On the Assessment of Risk*, J. OF FIN. (Mar. 1971).

[28] Richard A. Michelfelder and Panayiotis Theodossiou, *Public Utility Beta Adjustment and Biased Costs of Capital in Public Utility Rate Proceedings*, THE ELECTRICITY J., (Nov. 2013).

[29] *Id*. at 61.

> Being natural monopolies in their own geographic areas, public utilities have more influence on the prices of their product (gas and electricity) than other firms. The rate setting process provides public utilities with the opportunity to adjust prices of gas and electricity to recover the rising costs of fuel and other materials used in the transmission and distribution of electricity and gas.[30]

To test for a regression toward 1.0, the authors used monthly holding-period total returns for 57 publicly traded U.S. public utilities for the period from January 1962 to December 2007 using 60, 84, 96, and 108 monthly returns over five different non-lapping periods. They also used alternative time periods and obtained similar results. From their analysis of the data, the authors concluded that "public utility betas do not have a tendency to converge to 1."[31]

> Major vendors of CAPM Betas such as Merrill Lynch, Value Line, and Bloomberg distribute Blume adjusted betas to investors. We have shown empirically that public utility betas do not have a tendency to converge to 1. Short-term Betas of public utilities follow a cyclical pattern with recent downward trends, then upward structural breaks with long-term betas following a downward trend.

The authors concluded that utility betas converge to 0.59 as opposed to 1.0. The implication is that using regressed betas such as those from *Value Line* will result in an inflated expected return using the CAPM for utilities.

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[30] *Id*.

[31] *Id*.

Q. GIVEN THIS DISCUSSION, WHAT BETAS ARE YOU USING IN YOUR CAPM?

A. As shown on page 3 of Exhibit JRW-8, the median *Value Line* beta for the Electric and Coyne Proxy Groups are 0.90 and 0.88 respectively. At present, I will continue to use *Value Line* betas in my CAPM, which I believe is a conservative approach.

Q. PLEASE DISCUSS THE MARKET RISK PREMIUM.

A. The market-risk premium is equal to the expected return on the stock market (e.g., the expected return on the S&P 500, $E(R_m)$ minus the risk-free rate of interest (R_f)). The market-risk premium is the difference in the expected total return between investing in equities and investing in "safe" fixed-income assets, such as long-term government bonds. However, while the market-risk premium is easy to define conceptually, it is difficult to measure because it requires an estimate of the expected return on the market - $E(R_m)$. As I discuss below, there are different ways to measure $E(R_m)$, and studies have been developed with significantly different magnitudes for $E(R_m)$. As Merton Miller, the 1990 Nobel Prize winner in economics indicated, $E(R_m)$ it is very difficult to measure and is one of the "great mysteries in finance."[32]

Q. PLEASE DISCUSS THE ALTERNATIVE APPROACHES TO ESTIMATING THE MARKET-RISK PREMIUM.

A. Page 4 of Exhibit JRW-8 highlights the primary approaches to, and issues in, estimating the expected market-risk premium. The traditional way to measure the market-risk

[32] Merton Miller, *The History of Finance: An Eyewitness Account*, J. OF APPLIED CORP. FIN., 3 (2000).

premium was to use the difference between historical average stock and bond returns. In this case, historical stock and bond returns, also called *ex post* returns, were used as the measures of the market's expected return (known as the *ex ante* or forward-looking expected return). This type of historical evaluation of stock and bond returns is often called the "Ibbotson approach" after Professor Roger Ibbotson, who popularized this method of using historical financial market returns as measures of expected returns. However, this historical evaluation of returns can be a problem because: (1) *ex post* returns are not the same as *ex ante* expectations; (2) market-risk premiums can change over time, increasing when investors become more risk-averse and decreasing when investors become less risk-averse; and (3) market conditions can change such that *ex post* historical returns are poor estimates of *ex ante* expectations.

The use of historical returns as market expectations has been criticized in numerous academic studies, which I discuss later. The general theme of these studies is that the large equity risk premium discovered in historical stock and bond returns cannot be justified by the fundamental data. These studies, which fall under the category "*Ex Ante* Models and Market Data," compute *ex ante* expected returns using market data to arrive at an expected equity risk premium. These studies have also been called "Puzzle Research" after the famous study by Mehra and Prescott in which the authors first questioned the magnitude of historical equity risk premiums relative to fundamentals.[33]

In addition, there are a number of surveys of financial professionals regarding the market-risk premium, as well as several published surveys of academics on the

[33] Rajnish Mehra & Edward C. Prescott, The Equity Premium: A Puzzle, J. OF MONETARY ECON. 145 (1985).

equity risk premium. Duke University has published a CFO Survey on a quarterly basis for over 10 years.[34] Questions regarding expected stock and bond returns are also included in the Federal Reserve Bank of Philadelphia's annual survey of financial forecasters, which is published as the *Survey of Professional Forecasters*.[35] This survey of professional economists has been published for almost 50 years. In addition, Pablo Fernandez conducts annual surveys of financial analysts and companies regarding the equity risk premiums used in their investment and financial decision making.[36]

Q. PLEASE PROVIDE A SUMMARY OF THE MARKET RISK PREMIUM STUDIES.

A. Derrig and Orr, Fernandez, and Song completed the most comprehensive reviews of the research on the market risk premium.[37] Derrig and Orr's study evaluated the various approaches to estimating market-risk premiums, discussed the issues with the

[34] DUKE UNIVERSITY, *The CFO Survey* (2020) https://www.richmondfed.org/cfosurvey.

[35] FEDERAL RESERVE BANK OF PHILADELPHIA, *Survey of Professional Forecasters* (Feb. 2020), https://www.philadelphiafed.org/-/media/research-and-data/real-time-center/survey-of-professional-forecasters/2019/spfq119.pdf?la=en. The Survey of Professional Forecasters was formerly conducted by the American Statistical Association (ASA) and the National Bureau of Economic Research (NBER) and was known as the ASA/NBER survey. The survey, which began in 1968, is conducted each quarter. The Federal Reserve Bank of Philadelphia, in cooperation with the NBER, assumed responsibility for the survey in June 1990.

[36] Pablo Fernandez, Eduardo Apellániz, & Javier Acín, SURVEY: MARKET RISK PREMIUM AND RISK-FREE RATE USED FOR 81 COUNTRIES IN 2020 (Mar. 25, 2020), IESE Business School Working Paper No. WP-1244-E, Available at SSRN: https://ssrn.com/abstract=3560869 or http://dx.doi.org/10.35139/ssrn.3560869.

[37] *See* Richard Derrig & Elisha Orr, EQUITY RISK PREMIUM: EXPECTATIONS GREAT AND SMALL, Working Paper (version 3.0), Automobile Insurers Bureau of Massachusetts, (Aug. 28, 2003); Pablo Fernandez, EQUITY PREMIUM: HISTORICAL, EXPECTED, REQUIRED, AND IMPLIED, IESE Business School Working Paper (2007); Zhiyi Song, THE EQUITY RISK PREMIUM: AN ANNOTATED BIBLIOGRAPHY, CFA Institute (2007).

alternative approaches, and summarized the findings of the published research on the market risk premium.

Fernandez examined four alternative measures of the market-risk premium – historical, expected, required, and implied. He also reviewed the major studies of the market-risk premium and presented the summary market-risk premium results.

Song provided an annotated bibliography and highlighted the alternative approaches to estimating the market risk premium.

Page 5 of Exhibit JRW-8 provides a summary of the results of the primary risk-premium studies reviewed by Derrig and Orr, as well as other more recent studies of the market risk premium.

In developing page 5 of Exhibit JRW-8, I have categorized the types of studies as discussed on page 4 of Exhibit JRW-8. I have also included the results of studies of the "Building Blocks" approach to estimating the equity risk premium. The Building Blocks approach is a hybrid approach employing elements of both historical and *ex ante* models.

Q. PLEASE DISCUSS PAGE 5 OF EXHIBIT JRW-8.

A. Page 5 of Exhibit JRW-8 provides a summary of the results of the market risk-premium studies that I have reviewed. These include the results of: (1) the various studies of the historical risk premium, (2) *ex ante* market risk-premium studies, (3) market risk-premium surveys of CFOs, financial forecasters, analysts, companies and academics, and (4) the Building Blocks approach to the market risk premium. There are results

reported for over 30 studies, and the median market-risk premium of these studies is 4.83 percent.

Q. PLEASE HIGHLIGHT THE RESULTS OF MORE RECENT RISK-PREMIUM STUDIES AND SURVEYS.

A. The studies cited on page 5 of Exhibit JRW-8 include every market risk-premium study and survey I could identify that was published over the past 15 years and that provided a market risk-premium estimate. Many of these studies were published prior to the financial crisis that began in 2008. In addition, some of these studies were published in the early 2000s at the market peak. It should be noted that many of these studies (as indicated) used data over long periods of time (as long as 50 years of data) and so were not estimating a market-risk premium as of a specific point in time (e.g., the year 2001). To assess the effect of the earlier studies on the market-risk premium, I have reconstructed page 5 of Exhibit JRW-8 on page 6 of Exhibit JRW-8; however, I have eliminated all studies dated before January 2, 2010. The median market-risk-premium estimate for this subset of studies is 5.13 percent.

Q. PLEASE SUMMARIZE THE MARKET RISK PREMIUM STUDIES AND SURVEYS.

A. As noted above, there are three approaches to estimating the market-risk premium – historic stock and bond returns, *ex ante* or expected returns models, and surveys. The studies on page 6 of Exhibit JRW-8 can be summarized in the following manners:

Historic Stock and Bond Returns - Historic stock and bond returns suggest a market-risk premium in the 4.40 percent to 6.44 percent range, depending on whether one uses arithmetic or geometric mean returns.

Ex Ante Models - Market risk-premium studies that use expected or ex ante return models indicate a market-risk premium in the range of 3.42 percent to 6.00 percent.

Surveys – Market-risk premiums developed from surveys of analysts, companies, financial professionals, and academics are lower, with a range from 3.36 percent to 5.70 percent.

Building Block – The mean reported market risk premiums reported in studies using the building block approach range from 3.00 percent to 5.21 percent.

Q. PLEASE HIGHLIGHT THE *EX ANTE* MARKET RISK-PREMIUM STUDIES AND SURVEYS THAT YOU BELIEVE ARE MOST TIMELY AND RELEVANT.

A. I will highlight several studies/surveys.

Pablo Fernandez conducts annual surveys of financial analysts and companies regarding the equity risk premiums used in their investment and financial decision-making.[38] His survey results are included on pages 5 and 6 of Exhibit JRW-8. The results of his 2021 survey of academics, financial analysts, and companies, which included 4,000 responses, indicated a mean market-risk premium employed by U.S.

[38] Pablo Fernandez, Sofia Bamuls, and Pablo Acín, A Survey: MARKET RISK PREMIUM AND RISK-FREE RATE USED FOR 88 COUNTRIES IN 2021, IESE Business School (June 2021).

analysts and companies of 5.5 percent.[39] His estimated market-risk premium for the U.S. has been in the 5.00 percent to 5.60 percent range in recent years.

Professor Aswath Damodaran of New York University, a leading expert on valuation and the market-risk premium, provides a monthly updated market-risk premium based on projected S&P 500 EPS and stock-price level and long-term interest rates. His estimated market-risk premium, shown graphically in Figure 9, below, for the past 20 years, has primarily been in the range of 5.0 percent to 6.0 percent since 2010. As of March 2021, his estimate of the implied market-risk premium was 4.63 percent.[40]

Figure 9
Damodaran Market Risk Premium

Source: Aswath Damodaran, Damodaran Online, N.Y. UNIVERSITY, http://pages.stern.nyu.edu/~adamodar/ (last visited March 9, 2021).

Duff & Phelps, an investment advisory firm, provides recommendations for the normalized risk-free interest rate and market-risk premiums to be used in calculating the cost-of-capital data. Its recommendations over the 2008–2020 time periods are

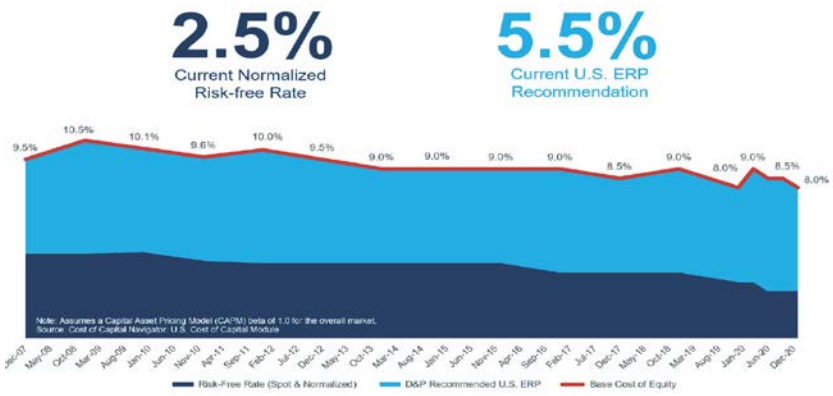
[39] *Id*. at 3.

[40] Aswath Damodaran, *Damodaran Online*, N.Y. UNIVERSITY. http://pages.stern.nyu.edu/~adamodar/.

shown on page 7 of Exhibit JRW-8 and are shown graphically in Figure 10. Over the past decade, Duff & Phelps' recommended normalized risk-free interest rates have been in the 2.50 percent to 4.00 percent and market-risk premiums have been in the 5.0 percent to 6.0 percent range. In early 2020, in the wake of the novel coronavirus in 2020, Duff & Phelps decreased its recommended normalized risk-free interest rate from 2.50 percent to 3.0 percent and increased its market-risk premium from 5.00 percent to 6.00 percent. Subsequently, on December 9, 2020, Duff & Phelps reduced its recommended market-risk premium to 5.50%.[41]

Finally, KPMG, the international accounting firm, regularly publishes an update to their market risk premium to be used in their valuation practice. KPMG's market risk premium, which was as high as 6.75% in 2020, was lowered on March 31, 2021 to 5.75%.[42]

Figure 10
Duff & Phelps
Normalized Risk-Free Rate and Market-Risk Premium Recommendations
2007-2021



Source: https://www.duffandphelps.com/insights/publications/cost-of-capital

41 https://www.duffandphelps.com/insights/publications/cost-of-capital/duff-and-phelps-recommended-us-equity-risk-premium-decreased-december-2020.

42 KPMG Corporate Finance NL recommends a MRP of 5.75% as per 31 March 2021. https://indialogue.io/clients/reports/public/5d9da61986db2894649a7ef2/5d9da63386db2894649a7ef5

Q. GIVEN THESE RESULTS, WHAT MARKET RISK PREMIUM ARE YOU USING IN YOUR CAPM?

A. The studies on page 6 of Exhibit JRW-8, and more importantly, the more timely and relevant studies just cited, suggest that the appropriate market-risk premium in the U.S. is in the 4.0 percent to 6.0 percent range. I will use an expected market-risk premium of 6.00 percent, which is the upper end of the range, as the market-risk premium. I gave most weight to the market risk-premium estimates of Duff & Phelps, KPMG, the Fernandez survey, and Damodaran. This is a conservatively high estimate of the market-risk premium considering the many studies and surveys of the market-risk premium.

Q. WHAT EQUITY COST RATE IS INDICATED BY YOUR CAPM ANALYSIS?

A. The results of my CAPM study for the proxy groups are summarized on page 1 of Exhibit JRW-8 and in Table 5 below.

Table 5
CAPM-Derived Equity Cost Rate/ROE
$K = (R_f) + ß * [E(R_m) - (R_f)]$

	Risk-Free Rate	Beta	Equity Risk Premium	Equity Cost Rate
Electric Proxy Group	**2.50%**	**0.90**	**6.0%**	**7.9%**
Coyne Proxy Group	**2.50%**	**0.88**	**6.0%**	**7.8%**

For the Electric Proxy Group, the risk-free rate of 2.50% plus the product of the beta of 0.90 times the equity risk premium of 6.0% results in a 7.9% equity cost rate. For the Coyne Proxy Group, the risk-free rate of 2.50% plus the product of the beta of 0.88 times the equity risk premium of 6.0% results in a 7.8% equity cost rate.

D. Equity Cost Rate Summary

Q. PLEASE SUMMARIZE THE RESULTS OF YOUR EQUITY COST RATE STUDIES.

A. My DCF analyses for the Electric Proxy Group indicate an equity-cost rate of 9.00%, and for the Coyne Proxy Group an equity cost rate of 8.85%. The CAPM equity cost rates for the Electric and Coyne are 7.90% and 7.80% respectively.

Table 6
ROEs Derived from DCF and CAPM Models

	DCF	CAPM
Electric Proxy Group	**9.00%**	**7.90%**
Coyne Proxy Group	**8.85%**	**7.80%**

Q. GIVEN THESE RESULTS, WHAT IS YOUR ESTIMATED EQUITY COST RATE FOR THE GROUPS?

A. Given these results, I conclude that the appropriate equity-cost rate is in the range of 7.80% to 9.0% for the companies in the Electric Proxy Group and in the Coyne Proxy Group. However, since I rely primarily on the DCF model, I believe that the appropriate range is in the 8.50%-9.00% range. Given FPL's lower level of investment risk, I will use 8.75% as the equity cost rate for FPL. This equity cost rate is appropriate using Witness O'Donnell's capital structure with a common equity ratio of 55.0% from investor-provided capital.

Q. WHAT IS YOUR ROE RECOMMENDATION IF THE COMMISSION ADOPTS THE COMPANY'S PROPOSED CAPITAL STRUCTURE WITH A COMMON EQUITY RATIO OF 59.6% FROM INVESTOR-PROVIDED CAPITAL?

A. If the Commission adopts the Company's proposed capital structure, my recommended ROE is 8.50% which is at the bottom of my ROE range of 8.50%-9.00%.

Q. PLEASE INDICATE WHY YOUR EQUITY-COST RATE RECOMMENDATIONS ARE APPROPRIATE FOR FPL.

A. There are a number of reasons why an equity-cost rate of 9.00% is appropriate and fair for the Company in this case:

1. As shown in Exhibits JRW-5 (page 1), capital costs for utilities, as indicated by long-term, utility-bond yields, are still at historically low levels;
2. As shown in Exhibit JRW-5 (page 2), the electric utility industry are among the lowest risk industries in the U.S. as measured by beta. As such, the cost of equity capital for this industry is the lowest in the U.S., according to the CAPM;
3. I have employed the capital structure developed by Witness O'Donnell which includes a common equity ratio of 55.0% from investor-provided capital. This capital structure includes a higher common equity ratio and lower financial risk than the averages of the two proxy groups;
4. The investment risk of FPL is significantly lower than the averages of the two proxy groups, as indicated by its S&P and Moody's issuer credit ratings; and
5. My recommended equity-cost rate lies at the high end of the range of my ROE

outcomes.

Q. DO YOU BELIEVE THAT YOUR ROE RECOMMENDATION MEETS THE *HOPE* AND *BLUEFIELD* STANDARDS?

A. Yes.

Q. IN MARCH 2015 MOODY'S PUBLISHED AN ARTICLE ON UTILITY ROES AND CREDIT QUALITY. PLEASE DISCUSS YOUR RECOMMENDATION IN LIGHT OF THE MOODY'S ARTICLE.

A. Moody's March 2015 article recognized that authorized ROEs for electric and gas companies were declining due to lower interest rates. The article explains:[43]

> The credit profiles of US regulated utilities will remain intact over the next few years despite our expectation that regulators will continue to trim the sector's profitability by lowering its authorized returns on equity (ROE). Persistently low interest rates and a comprehensive suite of cost recovery mechanisms ensure a low business risk profile for utilities, prompting regulators to scrutinize their profitability, which is defined as the ratio of net income to book equity. We view cash flow measures as a more important rating driver than authorized ROEs, and we note that regulators can lower authorized ROEs without hurting cash flow, for instance by targeting depreciation, or through special rate structures.

Moody's stated that even with lower authorized ROEs, electric and gas companies were earning ROEs of 9.0% to 10.0%, their credit profiles were not being impaired and they were undeterred from raising record amounts of capital.

[43] Moody's Investors Service, "Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles," March 10, 2015.

With respect to authorized ROEs, Moody's recognized that utilities and regulatory commissions were "struggling" to justify higher ROEs in the face of lower interest rates and risk-reducing, cost-recovery mechanisms:[44]

> Robust cost recovery mechanisms will help ensure that US regulated utilities' credit quality remains intact over the next few years. As a result, falling authorized ROEs are not a material credit driver at this time, but rather reflect regulators' struggle to justify the cost of capital gap between the industry's authorized ROEs and persistently low interest rates. We also see utilities struggling to defend this gap, while at the same time recovering the vast majority of their costs and investments through a variety of rate mechanisms.

Overall, this article further supports the emerging belief that lower authorized ROEs were unlikely to hurt the financial integrity of utilities or their ability to attract capital.

VII. CRITIQUE OF FPL'S RATE OF RETURN TESTIMONY

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED RATE OF RETURN RECOMMENDATION.

A. The Company's rate-of-return recommendation is summarized on page 1 of Exhibit JRW-9. FPL has proposed a capital structure from investor-provided capital of 38.93% long-term debt, 1.46% short-term debt, and 59.6% common equity and long-term and short-term debt cost rates of 3.61% and 0.94%. FPL witness James M. Coyne has recommended a common equity cost rate of 11.0% for FPL. FPL has also requested a

[44] *Id*.

ROE inflator of 0.50% for superior management performance. FPL's overall rate of return request from investor-provided capital is 8.28%.

Q. PLEASE REVIEW WITNESS COYNE'S EQUITY COST RATE APPROACHES AND RESULTS.

A. Witness Coyne has developed a proxy group of electric utility companies and employs DCF, CAPM, risk premium, and expected-earnings equity-cost-rate approaches. Witness Coyne's equity-cost-rate estimates for FPL are summarized in Table 7 below. His range of results is 9.23% to 14.17%. He uses the midpoint of this range - 10.89% - and then adds 0.11% for flotation costs - to arrive at his 11.00% ROE recommendation. The Company then adds the 0.50% ROE inflator for superior management performance to get to 11.50%.

Table 7
Coyne's ROE Results

	ROE Estimate
DCF	9.29%
CAPM	14.17%
Risk Premium	9.88%
Expected Earnings	10.22%
Range	9.23 – 14.17%
Average ROE	10.89%

Q. WHAT ARE THE PRIMARY ISSUES REGARDING RATE OF RETURN IN THIS PROCEEDING?

A. The primary issues related to the Company's rate of return include the following:

1. Capital Market Conditions – Witness Coyne's analyses, ROE results, and recommendations are based on assumptions of higher interest rates and capital costs. However, despite the recent rise in rates, interest rates and capital costs remain at historically low levels.

2. Capital Structure – FPL's proposed capital structure has much more equity and less financial risk than the average capital structure of the two proxy groups as well as FPL's parent company, NextEra Energy. As a result, Witness O'Donnell has proposed a capital structure with a common equity ratio for investor-provided capital of 55.0%.

3. Investment Risk of FPL – FPL's issuer credit rating is A according to S&P and A1 according to Moody's. The average S&P and Moody's ratings for the two proxy groups are BBB+ and Baa1. As such, FPL's S&P rating is two notches above the average of the two proxy groups, and FPL's Moody's rating is three notches above the average of the two proxy groups. This clearly indicates that FPL is less risky than the average of the two proxy groups. Witness Coyne has not recognized that FPL is less risky than his proxy group, and he has not made an adjustment to his recommended equity cost rate to account for FPL's lower level of investment risk.

4. DCF Equity Cost Rate – The DCF Equity Cost Rate is estimated by summing the stock's dividend yield and investors' expected long-run growth rate in dividends paid per share. There are two issues with Witness Coyne's DCF study: (1) he gives little weight to his DCF results. His mean DCF result for his proxy group is 9.29%, yet he

concludes that FPL's cost of equity is 11.00%; and (2) he relies exclusively on the overly optimistic and upwardly biased growth-rate forecasts for earnings per share ("EPS") put forth by Wall Street analysts and *Value Line*.

5. <u>CAPM Approach</u> – The CAPM approach requires an estimate of the risk-free interest rate, the beta, and the market or equity risk premium. There are two primary issues with Witness Coyne's CAPM analyses: (1) he has used a projected risk-free interest rate of 2.80% which is above current market interest rates; and (2) much more significantly, his market-risk premium of 12.95%, is excessive and includes highly unrealistic assumptions about future earnings growth and stock returns. The 12.95% market risk premium is much larger than: (1) indicated by historic stock and bond return data; and (2) well-above that found in the published studies and surveys of the market risk premium. To compute his market risk premium, Witness Coyne has applied the DCF to the S&P 500 and employed analysts' three-to-five-year earnings per share ("EPS") growth-rate projections as a growth rate to compute an expected market return and market risk premium. Witness Coyne's approach produces an expected market return of 15.75% which is 50% higher than historic market returns. This 15.75% expected stock market return is based on a projected S&P 500 EPS growth-rate rate of 14.11% and it produces the projected market risk premium of 12.95% (15.75% - 2.80%). The bottom line is that the projected S&P 500 EPS growth rate of 14.11% and the resulting expected market return (15.75%) and market risk premium (12.95%) are totally unrealistic. Simply put, S&P 500 companies cannot grow their earnings forever at a rate that is over three times the projected GDP growth.

6. Alternative Risk Premium Model - Witness Coyne also estimates an equity cost rate using an alternative risks premium model. His risk premium method is based on the historical relationship between the yields on long-term Treasury bond yields and authorized ROEs for electric utility companies. There are several issues with this approach which I discuss in more depth later, but the two primary problems are that (1) his risk premium approach is a gauge of *commission* behavior rather than *investor* behavior, and (2) Witness Coyne's methodology produces an inflated measure of the risk premium because his approach uses historical authorized ROEs and Treasury yields, and the resulting risk premium is applied to projected Treasury yields. Finally, the risk premium is inflated as a measure of investors' required risk premium since electric utility companies have been selling at market-to-book ratios in excess of 1.0. This indicates that the authorized rates of return have been greater than the return that investors require.

7. Expected Earnings Approach - Witness Coyne also uses the Expected Earnings approach to estimate an equity cost rate for the Company. Witness Coyne computes the expected ROE as forecasted by *Value Line* for his proxy group of electric utilities. The so-called "Expected Earnings" approach, however, (1) does not measure the market cost of equity capital, (2) is independent of most cost of capital indicators, and (3) has several other empirical problems. Therefore, the Commission should ignore Witness Coyne's "Expected Earnings" approach in determining the appropriate ROE for FPL.

8. Other Issues - Witness Coyne concludes that his equity-cost-rate studies suggest a ROE range of 9.23% to 14.17%. He then also considers a number of other factors in

arriving at his 11.00% ROE recommendation. These factors include: (1) Capital expenditures; (2) Nuclear generation ownership; (3) Severe weather risk; (4) Regulatory risk; (5) Multi-year rate plan; (6) flotation costs; and (7) management performance. The first five factors are all considered by S&P and Moody's in the credit rating process and, as noted above, FPL's S&P rating is two notches above the average of the two proxy groups, and FPL's Moody's rating is three notches above the average of the two proxy groups. As such, FPL's investment risk is below the proxy groups, even considering these factors. Witness Coyne also includes a flotation cost adjustment of 0.11% in his equity cost rate recommendation of 11.0%. However, Witness Coyne has not provided any evidence that the Company has paid flotation costs. Therefore, the Company should not be allowed to collect additional revenues in the form of a higher ROE for flotation costs which they did not incur. Witness Daniel Lawton provides evidence that FPL does not deserve a 50 basis points ROE inflator for superior management performance.

Capital market conditions, FPL's proposed capital structure, and FPL's investment risk were previously discussed. The other issues are addressed below.

A. DCF Approach

Q. PLEASE SUMMARIZE WITNESS COYNE'S DCF ESTIMATES.

A. On pages 46-55 of his testimony and in his Exhibit No. JMC-4, Witness Coyne develops an equity cost rate by applying the DCF model to his electric group. Witness Coyne's DCF results are summarized on page 2 of Exhibit JRW-9. In the traditional

DCF approach, the equity cost rate is the sum of the dividend yield and expected growth. He uses three dividend yield measures (30, 90, and 180 days) in his DCF models. In his constant-growth DCF models, Witness Coyne has relied on the forecasted EPS growth rates of Zacks, Yahoo Finance, and *Value Line*. He reports a mean DCF ROE of 9.29%.

Q. WHAT ARE THE ERRORS IN WITNESS COYNE'S DCF ANALYSES?

A. There are three issues with Witness Coyne's DCF study: (1) he gives little weight to his DCF results; (2) he relies exclusively on the overly-optimistic and upwardly-biased earnings per share ("EPS"), growth-rate forecasts of Wall Street analysts and *Value Line*; and (3) he has claimed that the DCF results underestimate the market-determined cost of equity capital due to high utility stock valuations and low dividend yields.

1. The Low Weight Given to the DCF Results

Q. HAS WITNESS COYNE GIVEN HIS DCF RESULTS APPROPRIATE WEIGHT IN ARRIVING AT AN EQUITY COST RATE FOR THE COMPANY?

A. No, I believe he has given them too little weight. As described above, Witness Coyne used the mean results from his DCF, CAPM, risk premium, and expected-earnings equity-cost-rate approaches to establish a range of outcomes and then uses the midpoint of this range. He reports a DCF equity cost rate of 9.29%. As detailed below, there

are numerous errors in his CAPM, risk premium, and expected earnings approaches which result in grossly inflated equity cost rate estimates.

2. Exclusive Reliance on Analysts' EPS Growth-Rate Forecasts

Q. PLEASE REVIEW WITNESS COYNE'S DCF GROWTH RATE.

A. In his constant-growth DCF model, Witness Coyne's DCF growth rate is the average of the projected EPS growth-rate forecasts of Wall Street analysts as compiled by Yahoo Finance, Zack's, and *Value Line*.

Q. PLEASE DISCUSS WITNESS COYNE'S EXCLUSIVE RELIANCE ON THE PROJECTED GROWTH RATES OF WALL STREET ANALYSTS AND *VALUE LINE*.

A. It seems highly unlikely that investors today would rely exclusively on the EPS growth rate forecasts of Wall Street analysts and ignore other growth rate measures in arriving at their expected growth rates for equity investments. As I previously indicated, the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate. Hence, consideration must be given to other indicators of growth, including historical prospective dividend growth, internal growth, as well as projected earnings growth. In addition, a recent study by Lacina, Lee, and Xu (2011) has shown that analysts' long-term earnings growth rate forecasts are not more accurate at forecasting future earnings than naïve random walk forecasts of future earnings.[45] As such, the weight given to analysts' projected EPS growth rates should be limited. And

[45] M. Lacina, B. Lee and Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101

finally, and most significantly, it is well-known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased.[46] Hence, using these growth rates as a DCF growth rate produces an overstated equity cost rate. A recent study by Easton and Sommers (2007) found that optimism in analysts' earnings growth rate forecasts leads to an upward bias in estimates of the cost of equity capital of almost 3.0 percentage points.[47] Therefore, exclusive reliance on these forecasts for a DCF growth rate results in failure of one the basic inputs in the equation. In addition, as noted above, a study by Szakmary, Conover, and Lancaster (2008) discovered that the three-to-five-year EPS growth rate forecasts of *Value Line* were significantly higher than the EPS growth rates that these companies subsequently achieved.[48]

Q. HAVE CHANGES IN REGULATIONS IMPACTING WALL STREET ANALYSTS AND THEIR RESEARCH IMPACTED THE UPWARD BIAS IN THEIR PROJECTED EPS GROWTH RATES?

A. No. A number of the studies I have cited above demonstrate that the upward bias has continued despite changes in regulations and reporting requirements over the past two decades. This observation is highlighted by a 2010 McKinsey study entitled "Equity Analysts: Still Too Bullish," which involved a study of the accuracy of analysts' long-term EPS growth rate forecasts. The authors conclude that after a decade of stricter

[46] See references in footnote 15.

[47] Easton, P., & Sommers, G. (2007). Effect of analysts' optimism on estimates of the expected rate of return implied by earnings forecasts. *Journal of Accounting Research*, 45(5), 983–1015.

[48] Szakmary, A., Conover, C., & Lancaster, C. (2008). "An Examination of *Value Line*'s Long-Term Projections," *Journal of Banking & Finance*, May 2008, pp. 820-833.

regulation, analysts' long-term earnings forecasts continue to be excessively optimistic. They made the following observation:[49]

> Alas, a recently completed update of our work only reinforces this view—despite a series of rules and regulations, dating to the last decade, that were intended to improve the quality of the analysts' long-term earnings forecasts, restore investor confidence in them, and prevent conflicts of interest. For executives, many of whom go to great lengths to satisfy Wall Street's expectations in their financial reporting and long-term strategic moves, this is a cautionary tale worth remembering. This pattern confirms our earlier findings that analysts typically lag behind events in revising their forecasts to reflect new economic conditions. When economic growth accelerates, the size of the forecast error declines; when economic growth slows, it increases. So as economic growth cycles up and down, the actual earnings S&P 500 companies report occasionally coincide with the analysts' forecasts, as they did, for example, in 1988, from 1994 to 1997, and from 2003 to 2006. *Moreover, analysts have been persistently overoptimistic for the past 25 years, with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth of 6 percent. Over this time frame, actual earnings growth surpassed forecasts in only two instances, both during the earnings recovery following a recession (citation omitted). On average, analysts' forecasts have been almost 100 percent too high.*

This is the same observation made in a *Bloomberg Businessweek* article.[50] The author concluded:

> **The bottom line:** Despite reforms intended to improve Wall Street research, stock analysts seem to be promoting an overly rosy view of profit prospects.

[49] Marc H. Goedhart, Rishi Raj, and Abhishek Saxena, "Equity Analysts, Still Too Bullish," *McKinsey on Finance*, pp. 14-17, (Spring 2010) (emphasis added).

[50] Roben Farzad, "For Analysts, Things Are Always Looking Up," *Bloomberg Businessweek* (June 10, 2010), https://www.bloomberg.com/news/articles/2010-06-10/for-analysts-things-are-always-looking-up.

3. Claim that the DCF Model Understates the Cost of Equity Capital

Q. PLEASE DISCUSS WITNESS COYNE'S CLAIM THAT THE DCF MODEL UNDERSTATES THE COST OF EQUITY CAPITAL.

A. On pages 51-53 of his testimony, Witness Coyne makes the claim that using current utility stock valuations and low dividend yields will underestimate the market-determined ROE using the DCF model.

Q. WHAT IS YOUR RESPONSE TO THIS CLAIM?

A. Witness Coyne's claim is totally without merit. He is saying that utility stocks are overvalued, and their stock prices will decline in the future (and therefore their dividend yield will increase). Hence, Witness Coyne presumes that he knows more than investors in the stock market. Actually, if he believes that utility stock prices will decline in the future, he should be forecasting negative returns.

B. CAPM Approach

Q. PLEASE DISCUSS WITNESS COYNE'S CAPM RESULTS.

A. On pages 55-60 of his testimony and in Exhibit No. JMC-5.2, Witness Coyne develops an equity cost rate by applying the CAPM model to his proxy group. Witness Coyne reports a mean CAPM result of 14.17%. The CAPM approach requires an estimate of the risk-free interest rate, Beta, and the equity risk premium. Witness Coyne uses (1) a projected 30-year Treasury yield of 2.80%; (2) betas from *Value Line* and Bloomberg; and (3) a market risk premium of 12.95%.

Q. WHAT ARE THE ERRORS IN WITNESS COYNE'S CAPM ANALYSIS?

A. The primary errors with Witness Coyne's CAPM analyses are: (1) his projected 30-year Treasury yield of 2.80%; and (2) most significantly, his expected market risk premium of 12.95%.

1. <u>The Projected Risk-Free Interest Rate</u>

Q. PLEASE DISCUSS WITNESS COYNE'S RISK-FREE RATE OF INTEREST IN HIS CAPM.

A. Witness Coyne uses a risk-free rate of interest of 2.80% in his CAPM. This figure represents the average projected rate on twenty-year Treasury bonds by Blue Chip Financial Forecasts. The current rate on thirty-year Treasury bonds is about 2.25%. As such, Witness Coyne's risk-free interest rate is overstated.

Q. WHAT DO YOU RECOMMEND THE COMMISSION DO REGARDING WITNESS COYNE'S USE OF FORECASTS OF HIGHER INTEREST RATES AND CAPITAL COSTS?

A. I suggest that the Commission set an equity cost rate based on current indicators of market-cost rates and not speculate on the future direction of interest rates.

Economists have been predicting that interest rates would be going up for a decade, and they consistently have been wrong. For example, after the announcement of the end of the Quantitative Easing III ("QE III") program in 2014, all the economists in Bloomberg's interest rate survey forecasted interest rates would increase in 2014,

and 100% of the economists were wrong. According to the *Market Watch* article:[51]

> The survey of economists' yield projections is generally skewed toward rising rates — only a few times since early 2009 have a majority of respondents to the Bloomberg survey thought rates would fall. But the unanimity of the rising rate forecasts in the spring was a stark reminder of how one-sided market views can become. It also teaches us that economists can be universally wrong.

Two other financial publications produced studies on how economists consistently predict higher interest rates, and yet they too, have been wrong. The first publication, entitled "How Interest Rates Keep Making People on Wall Street Look Like Fools," evaluated economists' forecasts for the yield on 10-year Treasury bonds at the beginning of the year for the last ten years.[52] The results demonstrated that economists consistently predict that interest rates will go higher, and interest rates have not fulfilled those predictions.

The second study tracked economists' forecasts for the yield on 10-year Treasury bonds on an ongoing basis from 2010 until 2015.[53] The study, entitled "Interest Rate Forecasters are Shockingly Wrong Almost All of the Time," indicates that economists are continually forecasting that interest rates are going up, yet they do not. Indeed, as Bloomberg has reported, economists' continued failure in forecasting

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[51] Ben Eisen, "Yes, 100% of economists were dead wrong about yields, *Market Watch*," October 22, 2014**.** Perhaps reflecting this fact, *Bloomberg* reported that the Federal Reserve Bank of New York has stopped using the interest rate estimates of professional forecasters in the Bank's interest rate model due to the unreliability of those interest rate forecasts. See Susanne Walker and Liz Capo McCormick, "Unstoppable $100 Trillion Bond Market Renders Models Useless," *Bloomberg.com* (June 2, 2014). http://www.bloomberg.com/news/2014-06-01/the-unstoppable-100-trillion-bond-market-renders-models-useless.html.

[52] Joe Weisenthal, "How Interest Rates Keep Making People on Wall Street Look Like Fools," Bloomberg.com, March 16, 2015. http://www.bloomberg.com/news/articles/2015-03-16/how-interest-rates-keep-making-people-on-wall-street-look-like-fools.

[53] Akin Oyedele, "Interest Rate Forecasters are Shockingly Wrong Almost All of the Time," *Business Insider*, July 18, 2015. http://www.businessinsider.com/interest-rate-forecasts-are-wrong-most-of-the-time-2015-7.

increasing interest rates has caused the Federal Reserve Bank of New York to stop using the interest-rate estimates of professional forecasters in the Bank's interest-rate model due to the unreliability of those interest-rate forecasts.[54]

Obviously, investors are well aware of the consistently wrong forecasts of higher interest rates, and therefore place little weight on such forecasts. Investors would not be buying long-term Treasury bonds or utility stocks at their current yields if they expected interest rates to suddenly increase, thereby producing higher yields and negative returns.

In sum, it is practically impossible to accurately forecast interest rates and prices of investments that are determined in financial markets, such as interest rates and prices for stocks and commodities. For interest rates, I am not aware of any study that suggests one forecasting service is consistently better than others or that interest-rate forecasts are consistently better than just assuming the current interest rate will be the rate in the future.

2. Market Risk Premium

Q. PLEASE ASSESS WITNESS COYNE'S MARKET RISK PREMIUM DERIVED FROM APPLYING THE DCF MODEL TO THE S&P 500.

A. The most blatant error in Witness Coyne's CAPM analysis is the magnitude of the market (or equity) risk premium – which he uses to produce very high ROE results, with an average of 14.17%. Witness Coyne develops an expected market risk premium by: (1) applying the DCF model to the S&P 500 to get an expected market return; and (2) subtracting the risk-free rate of interest of 2.80%. As summarized in Table 8, Witness

[54] "*Market Watch,*" October 22, 2014.

Coyne develops a market risk premium by taking the average risk premium from three different approaches to project stock-market returns: (1) S&P DCF Expected Return – this approach uses S&P's projected EPS growth rate of 16.06% to produce an expected stock market return of 17.70% and a market risk premium of 14.90%; (2) Bloomberg DCF Expected Return – this approach uses Bloomberg's projected EPS growth rate of 13.87% to produce an expected stock market return of 15.46% and a market risk premium of 12.66%; and (3) *Value Line* DCF Expected Return – this approach uses *Value Line*'s projected EPS growth rate of 12.41% to produce an expected stock market return of 14.07% and a market risk premium of 11.27%. Witness Coyne then averages the results of the three approaches, which results in an average expected EPS growth rate, projected stock market return, and projected market risk premium of 14.11%, 15.75%, and 12.95%.

Table 8
Risk Premiums Derived from Expected Market Returns
Using *Value Line* and Bloomberg Projected EPS Growth Rate

	S&P DCF Exp. Ret.	BL DCF Exp. Ret.	VL DCF Exp. Ret.	Average
Dividend Yield	1.52%	1.49%	1.57%	1.53%
+ Expected EPS Growth	16.06%	13.87%	12.41%	14.11%
= Expected Market Return	17.70%	15.46%	14.07%	15.75%
+ Risk-Free Rate	2.80%	2.80%	2.80%	2.80%
= Market Risk Premium	14.90%	12.66%	11.27%	12.95%

The primary error in this approach is Witness Coyne's expected DCF growth rate of 14.11%. As previously discussed, the expected EPS growth rates of Wall Street analysts are upwardly biased. In addition, as explained below, the projected EPS

growth rate of 14.11% and resulting projected market return of 15.75% are totally unrealistic and inconsistent with historic and projected earnings growth rates in the U.S.

Q. INITIALLY, PLEASE PROVIDE ADDITIONAL INSIGHTS INTO THE EXPECTED STOCK MARKET RETURN OF 15.75%.

A. Simply put, the assumption of a 15.75% expected stock market return is excessive and unrealistic. The compounded annual return in the U.S. stock market is about 10% (9.79% according to Damodaran between 1928-2020).[55] Witness Coyne's CAPM results assume that the return on the U.S. stock market will be more than 50% higher in the future than it has been in the past! The extremely high expected stock market return, and the resulting market risk premium and equity cost rate results, is directly related to computing the expected stock market return as the sum of the adjusted dividend yield plus the expected EPS growth rate of 14.11%.

Q. PLEASE ONCE AGAIN ADDRESS THE ISSUES WITH ANALYSTS' EPS GROWTH RATE FORECASTS.

A. The key point is that Witness Coyne's CAPM market risk premium methodology is based entirely on the concept that analyst projections of companies' three-to-five EPS growth rates reflect investors' expected *long-term* EPS growth for those companies. However, this seems highly unrealistic given the published research on these projections. As previously noted, numerous studies have shown that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and

[55] http://pages.stern.nyu.edu/~adamodar/.

upwardly biased.[56] Moreover, as discussed above, the Lacina, Lee and Xu study showed that analysts' forecasts of EPS growth over the next three-to-five years earnings are no more accurate than their forecasts of the next single year's EPS growth (and the single year forecasts are notoriously inaccurate). The overly-optimistic inaccuracy of analysts' growth rate forecasts leads to an upward bias in equity cost estimates that has been estimated at about 300 basis points.[57]

Q. IS WITNESS COYNE'S MARKET RISK PREMIUM Of 12.95% REFLECTIVE OF THE MARKET RISK PREMIUMS FOUND IN STUDIES AND SURVEYS OF THE MARKET RISK PREMIUM?

A. No. This figure is well in excess of market risk premiums: (1) found in studies of the market risk premiums by leading academic scholars; (2) produced by analyses of historic stock and bond returns; and (3) found in surveys of financial professionals. Page 5 of Exhibit JRW-8 provides the results of over thirty market risk premiums studies from the past fifteen years. Historic stock and bond returns suggest a market risk premium in the 4.40-6.44% range, depending on whether one uses arithmetic or geometric mean returns. There have been many studies using expected return (also called *ex ante*) models, and their market risk premiums results vary from as low as

[56] Such studies include: R.D. Harris, "The Accuracy, Bias, and Efficiency of Analysts' Long Run Earnings Growth Forecasts," *Journal of Business Finance & Accounting*, pp. 725-55 (June/July 1999); P. DeChow, A. Hutton, and R. Sloan, "The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings," *Contemporary Accounting Research* (2000); K. Chan, L., Karceski, J., & Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance*, pp. 643−684, (2003); M. Lacina, B. Lee, and Z. Xu, *Advances in Business and Management Forecasting (Vol. 8)*, Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101 (2011).

[57] Peter D. Easton & Gregory A. Sommers, "Effect of Analysts' Optimism on Estimates of the Expected Rate of Return Implied by Earnings Forecasts," 45, *Journal of Accounting Research*, pp. 983–1015 (2007).

3.42% to as high as 6.00%. Finally, the market risk premiums developed from surveys of analysts, companies, financial professionals, and academics suggest even potentially lower market risk premiums, in a range from 3.36% to 5.70%. The bottom line is that there is no support in historic return data, surveys, academic studies, or reports for investment firms for a market risk premium as high as the 12.95% used by Witness Coyne.

Q. IS A PROJECTED EPS GROWTH RATE OF 14.11%, WHICH WITNESS COYNE USES TO COMPUTE HIS MARKET RISK PREMIUM OF 12.95%, REASONABLE GIVEN THE PROJECTED GROWTH IN U.S. GDP?

A. No. A long-term EPS growth rate of 14.11% is inconsistent with both historic and projected economic and earnings growth in the U.S. for several reasons: (1) long-term EPS and economic growth is about one-half of Witness Coyne's projected EPS growth rate of 14.11%; (2) long-term EPS and GDP growth are directly linked; and (3) more recent trends in GDP growth, as well as projections of GDP growth, suggest slower economic and earnings growth in the near future, during the period when the rates from this case will be effective.

Long-Term Historic EPS and GDP Growth have been in the 6%-7% Range – In Exhibit JRW-10, I performed a study of the growth in nominal GDP, S&P 500 stock price appreciation, and S&P 500 EPS and DPS growth since 1960. The results are provided on page 1 of Exhibit JRW-10, and a summary is shown in Table 9.

Table 9
GDP, S&P 500 Stock Price, EPS, and DPS Growth
1960-Present

Nominal GDP	**6.28**
S&P 500 Stock Price	**7.20**
S&P 500 EPS	**6.53**
S&P 500 DPS	**5.75**
Average	**6.44**

The results show that the historical long-run growth rates for GDP, S&P EPS, and S&P DPS are in the 6% to 7% range. By comparison, Witness Coyne's long-run growth rate projection of 14.11% is at best overstated. This estimate suggests that companies in the U.S. would be expected to: (1) increase their growth rate of EPS by 100% in the future, and (2) maintain that growth indefinitely in an economy that is expected to grow at about one-third of his projected growth rates.

There is a Direct Link between Long-Term EPS and GDP Growth - The results in Exhibit JRW-10 and Table 9 show that historically there has been a close link between long-term EPS and GDP growth rates. Brad Cornell of the California Institute of Technology published a study on GDP growth, earnings growth, and equity returns. He finds that long-term EPS growth in the U.S. is directly related to GDP growth, with GDP growth providing an upward limit on EPS growth. In addition, he finds that long-term stock returns are determined by long-term earnings growth. He concludes with the following observations:[58]

> The long-run performance of equity investments is fundamentally linked to growth in earnings. Earnings growth, in turn, depends on growth in real GDP. This article demonstrates that both theoretical

[58] Bradford Cornell, "Economic Growth and Equity Investing," *Financial Analysts Journal* (January- February 2010), p. 63.

> research and empirical research in development economics suggest relatively strict limits on future growth. In particular, real GDP growth in excess of 3 percent in the long run is highly unlikely in the developed world. In light of ongoing dilution in earnings per share, this finding implies that investors should anticipate real returns on U.S. common stocks to average no more than about 4–5 percent in real terms.

The Trend and Projections Indicate Slower GDP Growth in the Future - The components of nominal GDP growth are real GDP growth and inflation. On page 1 of Exhibit JRW-10 to my testimony, I provide an analysis of GDP growth since 1960. Since 1960, nominal GDP has grown at a compounded rate of 6.28%. Whereas GDP has grown at a compounded rate of 6.28% since 1960, economic growth in the U.S. has slowed considerably in recent decades. Page 2 of Exhibit JRW-10 provides the nominal annual GDP growth rates over the 1961 to 2020 time period. Nominal GDP growth grew from 6.0% to over 12.0% from the 1960s to the early 1980s due in large part to inflation and higher prices. Despite an uptick during the mid-2000s, and notwithstanding the negative 2.3% growth rate in 2020, the annual nominal GDP growth rates have declined to the 4.0% range over the past decade.[59]

The components of nominal GDP growth are real GDP growth and inflation. Page 3 of Exhibit JRW-10 shows annual real GDP growth rate over the 1961 to 2020 time period. Real GDP growth has gradually declined from the 5.0% to 6.0% range in the 1960s to the 2.0% range during the most recent five-year period, notwithstanding the negative 3.5% growth rate in 2020. The second component of nominal GDP growth is inflation. Page 4 of Exhibit JRW-10 shows inflation as measured by the annual

[59] Nominal GDP did increase to 5.5% in 2018. However, this is a one-time boost associated with the 2017 decrease in income taxes.

growth rate in the Consumer Price Index (CPI) over the 1960 to 2018 time period. The large increase in prices from the late 1960s to the early 1980s is readily evident. Equally evident is the rapid decline in inflation during the 1980s as inflation declined from above 10% to about 4%. Since that time inflation has gradually declined and has been in the 2.0% range or below over the past five years.

The graphs on pages 2, 3, and 4 of Exhibit JRW-10 provide very clear evidence of the decline in nominal GDP as well as its components—real GDP and inflation—in recent decades. To gauge the magnitude of the decline in nominal GDP growth, Table 10 and page 5 of Exhibit JRW-10 provide the compounded GDP growth rates for 10-, 20-, 30-, 40- and 50- years. Whereas the 50-year compounded GDP growth rate is 6.28%, there has been a monotonic and significant decline in nominal GDP growth over subsequent 10-year intervals, especially in the most recent 10-year interval. These figures clearly suggest that nominal GDP growth in recent decades has slowed and that a growth rate in the range of 3.50% to 4.0% is more appropriate today for the U.S. economy.

Table 10
Historic GDP Growth Rates

10-Year Average	**3.40%**
20-Year Average	**3.63%**
30-Year Average	**4.27%**
40-Year Average	**5.10%**
50-Year Average	**6.12%**

Long-Term GDP Projections also Indicate Slower GDP Growth in the Future - A lower range is also consistent with long-term GDP forecasts. There are several forecasts of annual GDP growth that are available from economists and government

agencies. These are listed in Panel B on page 5 of Exhibit JRW-10. The mean 10-year nominal GDP growth forecast (as of March 2020) by economists in the recent *Survey of Financial Forecasters* is 4.30 percent.[60] The federal Energy Information Administration (EIA), in its projections used in preparing the *Annual Energy Outlook*, forecasts long-term GDP growth of 4.2% for the period 2019–2050.[61] The Congressional Budget Office (CBO), in its forecasts for the period 2019 to 2029, projects a nominal GDP growth rate of 3.8%.[62] Finally, the Social Security Administration (SSA), in its Annual OASDI Report, provides a projection of nominal GDP from 2020–2095.[63] SSA's projected growth GDP growth rate over this period is 4.1%. Overall, these forecasts suggest long-term GDP growth rate in the 4.0–4.3% range.

Q. WHAT FUNDAMENTAL FACTORS HAVE LED TO THE DECLINE IN PROSPECTIVE GDP GROWTH?

A. As addressed in a study by the consulting firm McKinsey & Co., two factors drive real GDP growth over time: (1) the number of workers in the economy (employment); and (2) the productivity of those workers (usually defined as output per hour).[64] According to McKinsey, real GDP growth over the past 50 years was driven by population and

[60] https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/

[61] U.S. Energy Information Administration, *Annual Energy Outlook 2020*, Table: Macroeconomic Indicators.

[62] Congressional Budget Office, *The 2020 Long-Term Budget Outlook*, June 25, 2020.

[63] Social Security Administration, *2020 Annual Report of the Board of Trustees of the Old-Age, Survivors, and Disability Insurance (OASDI) Program*, Table VI.G4, (July 1, 2020), The 4.1% growth rate is the growth in projected GDP from $22,341 trillion in 2020 to $450,425 trillion in 2095.

[64] McKinsey & Co., "Can Long-Term Growth be Saved?", McKinsey Global Institute, (Jan. 2015).

productivity growth which grew at compound annual rates of 1.7% and 1.8%, respectively.

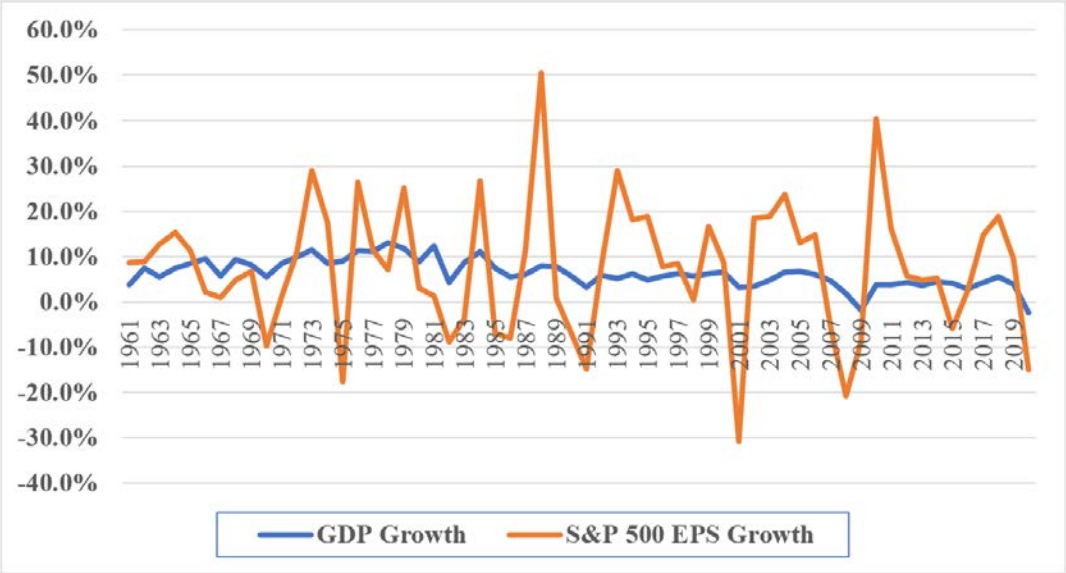
However, global economic growth is projected to slow significantly in the years to come. The primary factor leading to the decline is slow growth in employment (working-age population), which results from slower population growth and longer life expectancy. McKinsey estimates that employment growth will slow to 0.3% over the next fifty years. They conclude that even if productivity remains at the rapid rate of the past fifty years of 1.8%, real GDP growth will fall by 40% to 2.1%.

Q. PLEASE PROVIDE MORE INSIGHTS INTO THE RELATIONSHIP BETWEEN S&P 500 EPS AND GDP GROWTH.

A. Figure 11 shows the average annual growth rates for GDP and the S&P 500 EPS since 1960. The one very apparent difference between the two is that the S&P 500 EPS growth rates are much more volatile than the GDP growth rates, when compared using the relatively short, and somewhat arbitrary, annual conventions used in these data.[65] Volatility aside, however, it is clear that over the medium to long run, S&P 500 EPS growth does not outpace GDP growth.

[65] Timing conventions such as years and quarters are needed for measurement and benchmarking but are somewhat arbitrary. In reality, economic growth and profit accrual occur on continuous bases. A 2014 study evaluated the timing relationship between corporate profits and nominal GDP growth. The authors found that aggregate accounting earnings growth is a leading indicator of the GDP growth with a quarter-ahead forecast horizon. *See* Yaniv Konchitchki and Panos N. Patatoukas, "Accounting Earnings and Gross Domestic Product," *Journal of Accounting and Economics* 57 (2014), pp. 76–88.

Figure 11
Average Annual Growth Rates
GDP and S&P 500 EPS
1960-2020



Data Sources: GDPA - http://research.stlouisfed.org/fred2/series/GDPA/downloaddata.
S&P EPS - http://pages.stern.nyu.edu/~adamodar/

A fuller understanding of the relationship between GDP and S&P 500 EPS growth requires consideration of several other factors.

Corporate Profits are Constrained by GDP – Milton Friedman, the noted economist, warned investors and others not to expect corporate profit growth to sustainably exceed GDP growth, stating, "Beware of predictions that earnings can grow faster than the economy for long periods. When earnings are exceptionally high, they don't just keep booming."[66] Friedman also noted in the *Fortune* interview that profits must move back down to their traditional share of GDP. In Table 11 below, I show that currently the

[66] Shaun Tully, "Corporate Profits Are Soaring. Here's Why It Can't Last," Fortune, (Dec. 7, 2017), http://fortune.com/2017/12/07/corporate-earnings-profit-boom-end/.

aggregate net income levels for the S&P 500 companies, using 2020 figures, represent 5.47% of nominal GDP.

Table 11
S&P 500 Aggregate Net Income as a Percent of GDP

	2020 Value
Aggregate Net Income for S&P 500	$1,144,698.40
2020 Nominal U.S. GDP	$ 20,934,000.00
Net Income/GDP (%)	5.47%

Data Sources: 2020 Net Income for S&P 500 companies – *Value Line* (April 5, 2021).
2020 Nominal GDP – Moody's - https://www.economy.com/united-states/nominal-gross-domestic-product.

Short-Term Factors Impact S&P 500 EPS – The growth rates in the S&P 500 EPS and GDP can diverge on a year-to-year basis due to short-term factors that impact S&P 500 EPS in a much greater way than GDP. As shown above, S&P EPS growth rates are much more volatile than GDP growth rates. The EPS growth for the S&P 500 companies has been influenced by low labor costs and interest rates, commodity prices, the recovery of different sectors such as the energy and financial sectors, the cut in corporate tax rates, etc. These short-term factors can make it appear that there is a disconnect between the economy and corporate profits.

The Differences between the S&P 500 EPS and GDP – In recent years, when the EPS for the S&P 500 has grown at a faster rate than U.S. nominal GDP, some have pointed to the differences between the S&P 500 and GDP.[67] These differences include:

[67] *See* the following studies: Burt White and Jeff Buchbinder, "The S&P and GDP are not the Same Thing," LPL Financial, (Nov. 4, 2014), https://www.businessinsider.com/sp-is-not-gdp-2014-11; Matt Comer, "How Do We Have 18.4% Earnings Growth In A 2.58% GDP Economy?," Seeking Alpha, (Apr. 2018), https://seekingalpha.com/article/4164052-18_4-percent-earnings-growth-2_58-percent-gdp-economy; Shaun Tully, "How on Earth Can Profits Grow at 10% in a 2% Economy?," Fortune, (July 27, 2017), http://fortune.com/2017/07/27/profits-economic-growth/.

(a) corporate profits are about 2/3 manufacturing driven, while GDP is 2/3 services driven; (b) consumer discretionary spending accounts for a smaller share of S&P 500 profits (15%) than of GDP (23%); (c) corporate profits are more international-trade driven, while exports minus imports tend to drag on GDP; and (d) S&P 500 EPS is impacted not just by corporate profits but also by share buybacks on the positive side (fewer shares boost EPS) and by share dilution on the negative side (new shares dilute EPS). While these differences may seem significant, it must be remembered that the Income Approach to measure GDP includes corporate profits (in addition to employee compensation and taxes on production and imports) and therefore effectively accounts for the first three factors.[68]

The bottom line is that despite the intertemporal short-term differences between S&P 500 EPS and nominal GDP growth, the long-term link between corporate profits and GDP is inevitable.

Q. PLEASE PROVIDE ADDITIONAL INSIGHTS INTO THE UNREASONABLENESS OF WITNESS COYNE'S 14.11% PROJECTED S&P EPS GROWTH RATE IN LIGHT OF PROJECTED GDP GROWTH.

A. Beyond my previous discussion, I have performed the following analysis of S&P 500 EPS and GDP growth in Table 12 below. Specifically, I started with the 2020 aggregate net income for the S&P 500 companies and 2020 nominal GDP for the U.S. As shown

[68] The Income Approach to measuring GDP includes wages, salaries, and supplementary labor income, corporate profits, interest and miscellaneous investment income, farmers' incomes, and income from non-farm unincorporated businesses.

in Table 11, the aggregate profit for the S&P 500 companies represented 5.47% of nominal GDP in 2020. In Table 12, I then projected the aggregate net income level for the S&P 500 companies and GDP as of the year 2050. For the growth rate for the S&P 500 companies, I used Witness Coyne's projected S&P 500 EPS growth rate of 14.11%. As a growth rate for nominal GDP, I used the average of the long-term projected GDP growth rates from SFF, CBO, SSA, and EIA (4.3%, 3.8%, 4.1%, and 4.0%), which is 4.09%. The projected 2050 level for the aggregate net income level for the S&P 500 companies is $60.0 trillion. Over the same period GDP is expected to grow to $69.7 trillion. As such, if the aggregate net income for the S&P 500 grows in accordance with the growth rate used by Witness Coyne, and if nominal GDP grows at rates projected by major government agencies, the net income of the S&P 500 companies will represent growth from 5.47% of GDP in 2020 to 86.15% of GDP in 2050. Obviously, this is totally unrealistic for the net income of the S&P 500 to become almost 90% of GDP.

Table 12
Projected S&P 500 Earnings and Nominal GDP
2020-2050
S&P 500 Aggregate Net Income as a Percent of GDP

	2020 Value	Growth Rate	No. of Years	2050 Value
Aggregate Net Income for S&P 500	$1,144,698.40	14.11%	30	$ 60,034,685.09
2020 Nominal U.S. GDP	$20,934,000.00	4.09%	30	$ 69,682,299.83
Net Income/GDP (%)	5.47%			86.15%

2020 Nominal GDP – Moody's - https://www.economy.com/united-states/nominal-gross-domestic-product.
S&P 500 EPS Growth Rate - Witness Coyne's projected S&P 500 growth rate of 14.11%;
Nominal GDP Growth Rate – The average of the long-term projected GDP growth rates from SFF, CBO, SSA, and EIA (4.3%, 3.8%, 4.0%, and 4.1%).

Q. PLEASE PROVIDE A SUMMARY ANALYSIS ON GDP AND S&P 500 EPS GROWTH RATES.

A. As noted above, the long-term link between corporate profits and GDP is inevitable. The short-term differences in growth between the two has been highlighted by some notable market observers, including Warren Buffet, who indicated that corporate profits as a share of GDP tend to go far higher after periods where they are depressed, and then drop sharply after they have been hovering at historically high levels. In a famous 1999 *Fortune* article, Mr. Buffet made the following observation:[69]

> You know, someone once told me that New York has more lawyers than people. I think that's the same fellow who thinks profits will become larger than GDP. When you begin to expect the growth of a component factor to forever outpace that of the aggregate, you get into certain mathematical problems. In my opinion, you have to be wildly optimistic to believe that corporate profits as a percent of GDP can, for any sustained period, hold much above 6%.

In sum, Witness Coyne's long-term S&P 500 EPS growth rate of 14.11% is grossly overstated and has little (if any) basis in economic reality. In the end, the big question remains as to whether corporate profits can grow faster than GDP. Jeremy Siegel, the renowned finance professor at the Wharton School of the University of Pennsylvania, believes that going forward, earnings per share can grow about half a point faster than nominal GDP, or about 5.0%, due to the big gains in the technology sector. But he also believes that sustained EPS growth matching analysts' near-term projections is absurd: "The idea of 8% or 10% or 12% growth is ridiculous. It will not happen."[70]

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[69] Carol Loomis, "Mr. Buffet on the Stock Market," *Fortune*, (Nov. 22, 1999), https://money.cnn.com/magazines/fortune/fortune_archive/1999/11/22/269071/.

[70] Shaun Tully, "Corporate Profits Are Soaring. Here's Why It Can't Last," *Fortune*, (Dec. 7, 2017),

C. Alternative Risk Premium Approach

Q. PLEASE DISCUSS WITNESS COYNE'S ALTERNATIVE RISK PREMIUM APPROACH.

A. On pages 60-63 of his testimony and in Exhibit No. JMC-6, Witness Coyne develops an equity cost rate using his bond yield risk premium ("BYRP") approach. Witness Coyne develops an equity cost rate by: (1) regressing the average quarterly authorized returns on equity for electric utility companies from the January 1, 1980, to December 31, 2020, time period on the thirty-year Treasury Yield; and (2) adding the appropriate risk premium established in step (1) to a projected yield of 2.80%. Witness Coyne's reports a ROE of 9.88% using his BYRP approach.

Q. WHAT ARE THE ERRORS IN WITNESS COYNE'S BYRP ANALYSIS?

A. The errors include the base yield as well as the measurement and magnitude of the risk premium.

1. <u>Base Interest Rate</u>

Q. PLEASE DISCUSS THE BASE YIELD OF WITNESS COYNE'S BYRP ANALYSIS.

A. The base yield in Witness Coyne's BYRP analyses is the prospective yield on long-term, Treasury bonds. This includes a long-term projected rate of 2.80%. The 2.80% is the

http://fortune.com/2017/12/07/corporate-earnings-profit-boom-end/.

projected 30-year Treasury yield from Blue Chip Financial forecasts. As discussed above, economists have been forecasting higher interest rates for a decade, and they have been wrong. Also, investors would not be buying Treasury bonds at their current yield of 2.25% if they expect interest rates to increase in the future. As previously discussed, this would result in a significant negative return due to the inverse relationship between interest rates and bond prices.

2. Risk Premium

Q. WHAT ARE THE ISSUES WITH WITNESS COYNE'S RISK PREMIUM?

A. There are several problems with this approach. First, his BYRP methodology produces an inflated measure of the risk premium because the approach uses historic authorized ROEs and Treasury yields, and the resulting risk premium is applied to projected Treasury Yields. Since Treasury yields are always forecasted to increase, the resulting risk premium would be smaller if done correctly, which would be to use projected Treasury yields in the analysis rather than historic Treasury yields.

In addition, Witness Coyne's BYRP approach is a gauge of *commission* behavior and not *investor* behavior. Capital costs are determined in the marketplace through the financial decisions of investors and are reflected in such fundamental factors as dividend yields, expected growth rates, interest rates, and investors' assessment of the risk and expected return of different investments. Regulatory commissions evaluate capital market data in setting authorized ROEs, but also take into account other utility- and rate case-specific information in setting ROEs. As such,

Witness Coyne's approach and results reflect other factors such as capital structure, credit ratings and other risk measures, service territory, capital expenditures, energy supply issues, rate design, investment and expense trackers, and other factors used by utility commissions in determining an appropriate ROE in addition to capital costs. This may especially be true when the authorized ROE data includes the results of rate cases that are settled and not fully litigated.

Finally, Witness Coyne's methodology produces an inflated required rate of return since utilities have been selling at market-to-book ratios well in excess of 1.0 for many years. This indicates that the authorized and earned rates of return on equity have been greater than the return that investors require. The relationship between ROE, the equity cost rate, and market-to-book ratios was explained earlier in this testimony. In short, a market-to-book ratio above 1.0 indicates a company's ROE is above its equity cost rate. Therefore, the risk premium produced from the study is overstated as a measure of investor return requirements and produces an inflated equity cost rate.

D. Expected Earnings Approach

Q. PLEASE DISCUSS WITNESS COYNE'S EXPECTED EARNINGS ANALYSIS.

A. On pages 63-64 of his testimony and in Exhibit No. JMC-7, Witness Coyne estimates equity cost rates of 10.22% using an approach he calls the Expected Earnings ("EE") approach. His methodology simply involves using the expected ROE for the companies in the proxy group as estimated by *Value Line*.

Q. PLEASE ADDRESS THE ISSUES WITH WITNESS COYNE'S EXPECTED EARNINGS APPROACH.

A. There are a number of significant issues with this so-called Expected Earnings approach. As such, I strongly suggest that the Commission ignore this approach in setting an ROE for Florida Power and Light. These issues include:

The Expected Earnings Approach Does Not Measure the Market Cost of Equity Capital – First and foremost, this is an accounting-based methodology that does not measure investor return requirements. As indicated by Professor Roger Morin, a long-time rate of return witness for utility companies, "More simply, the Comparable (Expected) Earnings standard ignores capital markets. If interest rates go up 2% for example, investor requirements and the cost of equity should increase commensurably, but if regulation is based on accounting returns, no immediate change in equity cost results."[71] As such, this method does not measure the market cost of equity capital.

Changes in ROE Ratios do not Track Capital Market Conditions - As also noted by Morin, "The denominator of accounting return, book equity, is a historical cost-based concept, which is insensitive to changes in investor return requirements. Only stock market price is sensitive to a change in investor requirements. Investors can only purchase new shares of common stock at current market prices and not at book value."[72]

[71] Roger Morin, *New Regulatory Finance* (2006), p. 293.

[72] *Id*.

The Expected Earnings Approach is Circular - The ROE ratios for the proxy companies are not determined by competitive market forces, but instead are largely the result of federal and state rate regulation, including the present proceedings.

The Proxies' ROEs Reflect Earnings on Business Activities that are not Representative of FPL's Rate-Regulated Utility Activities - The numerators of the proxy companies' ROEs include earnings from business activities that are riskier and produce more projected earnings per dollar of book investment than does the regulated electric business. These include earnings from unregulated businesses such as merchant generation, construction services, and other energy services.

Q. FINALLY PLEASE DISCUSS THE EXPECTED EARNINGS APPROACH IN LIGHT OF A STUDY OF VALUE LINE PROJECTED EARNINGS.

A. Witness Coyne's EE approach uses *Value Line*'s adjusted forecast for proxy utility ROEs. Hence, the ROE specified by the EE approach is totally dependent on the forecast of one variable (net income/shareholder's equity) by one analyst firm (Value Line), with the same single individual authoring most of the *Value Line* reports for the various proxy companies. Neither the Commission nor other parties have assessed the accuracy of these forecasts. However, there is one study that did evaluate the *Value Line* forecasts. A study by Szakmary, Conover, and Lancaster evaluated the accuracy of *Value Line*'s three-to-five-year EPS growth rate forecasts using companies in the Dow Jones Industrial Average over a 30-year time period and found these forecasted EPS growth rates to be significantly higher than the EPS growth rates that these

companies subsequently achieved.[73]

Szakmary, Conover, and Lancaster (SCL) studied the predicted versus the projected stock returns, sales, profit margins, and earnings per share made by *Value Line* over the 1969 to 2001 time period. *Value Line* projects variables from a three-year base period (e.g., 2012-2014) to a future three-year projected period (e.g., 2016-18). SCL used the sixty-five stocks included in the Dow Jones Indexes (30 Industrials, 20 Transports and 15 Utilities). SCL found that the projected annual stock returns for the Dow Jones stocks were "incredibly overoptimistic" and of no predictive value. The mean annual stock return of 20% for the Dow Jones' stocks *Value Line*'s forecasts was nearly double the realized annual stock return. The authors also found that *Value Line*'s forecasts of earnings per share and profit margins were termed "strikingly overoptimistic." *Value Line*'s forecasts of annual sales were higher than achieved levels, but not statistically significant. SCL concluded that the overly-optimistic projected annual stock returns were attributable to *Value Line*'s upwardly-biased forecasts of earnings per share and profit margins.

The SCL results suggest that *Value Line*'s projection of return on equity is upwardly biased. As noted above, the EPS and profit margins as projected by *Value Line* over this 30-year period were termed "strikingly overoptimistic." This is because Value line's projected earnings is the numerator for their calculation of return on equity (net income/book value). Therefore, the EE approach proposed by Witness Coyne is based on an upwardly-biased measure forecasted by one analyst.

[73] Szakmary, A., Conover, C., & Lancaster, C. (2008). "An Examination of *Value Line*'s Long-Term Projections," *Journal of Banking & Finance*, May 2008, pp. 820-833.

E. Other Factors

1. Flotation Costs

Q. PLEASE DISCUSS WITNESS COYNE'S FLOTATION COST ADJUSTMENT OF 0.11%.

A. Witness Coyne includes a flotation cost adjustment of 0.11% in his 11.0% ROE recommendation. However, Witness Coyne has not provided any evidence that the Company has paid flotation costs. Therefore, the Company should not be allowed to collect additional revenues in the form of a higher ROE for flotation costs to account for flotation costs that have not been identified or paid.

Beyond this issue, it is commonly argued that a flotation cost adjustment (such as that used by the Company) is necessary to prevent the stock price dilution of the existing shareholders. However, this is incorrect for several reasons:

1. If an equity flotation cost adjustment is similar to a debt flotation cost adjustment, the fact that the market-to-book ratios for electric utility companies are in the 1.75X range actually suggests that there should be a flotation cost *reduction* (and not an increase) to the equity cost rate. This is because when (a) a bond is issued at a price in excess of face or book value, and (b) the difference between its market price and the book value is greater than the flotation or issuance costs, the cost of that debt is lower than the coupon rate of the debt. The amount by which market values of electric utility companies are in excess of book values is much greater than flotation costs. Hence, if common stock flotation costs were exactly like bond flotation costs,

and one was making an explicit flotation cost adjustment to the cost of common equity, the adjustment would be downward;

2. If a flotation cost adjustment is needed to prevent dilution of existing stockholders' investment, then the reduction of the book value of stockholder investment associated with flotation costs can occur only when a company's stock is selling at a market price at or below its book value. As noted above, electric utility companies are selling at market prices well in excess of book value. Hence, when new shares are sold, existing shareholders realize an increase in the book value per share of their investment, not a decrease;

3. Flotation costs consist primarily of the underwriting spread (or fee) rather than out-of-pocket expenses. On a per-share basis, the underwriting spread is the difference between the price the investment banker receives from investors and the price the investment banker pays to the company. These are not expenses that should be recovered through the regulatory process. Furthermore, the underwriting spread is known to the investors who are buying the new issue of stock, and who are well aware of the difference between the price they are paying to buy the stock and the price that the company is receiving. The offering price which they pay is what matters when investors decide to buy a stock based on its expected return and risk prospects. Therefore, the Company is not entitled to an adjustment to the allowed return to account for those costs; and

4. Flotation costs, in the form of the underwriting spread, are a form of a transaction cost in the market. They represent the difference between the price paid by investors and the amount received by the issuing company. Whereas the Company

believes that it should be compensated for these transaction costs, it has not accounted for *other* market transaction costs in determining its cost of equity. Most notably, brokerage fees that investors pay when they buy shares in the open market are another market transaction cost. Brokerage fees increase the effective stock price paid by investors to buy shares. If the Company had included these brokerage fees or transaction costs in its DCF analysis, the higher effective stock prices paid for stocks would lead to lower dividend yields and equity cost rates. This would result in a downward adjustment to their DCF equity cost rate.

VIII. SUMMARY AND CONCLUSIONS

Q. DR. WOOLRIDGE, PLEASE SUMMARIZE YOUR TESTIMONY ON THE APPROPRIATE COST OF CAPITAL FOR FPL.

A. To estimate an equity cost rate for the Company, I have applied the DCF and CAPM approaches to my proxy group of electric utility companies as well as Witness Coyne's proxy group. My analyses indicate that an equity cost rate in the range of 7.80%-9.00% is appropriate at this time. Since I rely primarily on the DCF approach, and given the lower investment risk of FPL, I am recommending a ROE of 8.75% for FPL.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

Appendix A

Educational Background, Research, and Related Business Experience
J. Randall Woolridge

J. Randall Woolridge is a Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed Faculty Fellow in Business Administration in the College of Business Administration of the Pennsylvania State University in University Park, PA. In addition, Professor Woolridge is Director of the Smeal College Trading Room and President and CEO of the Nittany Lion Fund, LLC.

Professor Woolridge received a Bachelor of Arts degree in Economics from the University of North Carolina, a Master of Business Administration degree from the Pennsylvania State University, and a Doctor of Philosophy degree in Business Administration (major area-finance, minor area-statistics) from the University of Iowa. He has taught Finance courses including corporation finance, commercial and investment banking, and investments at the undergraduate, graduate, and executive MBA levels.

Professor Woolridge's research has centered on empirical issues in corporation finance and financial markets. He has published over 35 articles in the best academic and professional journals in the field, including the *Journal of Finance*, the *Journal of Financial Economics*, and the *Harvard Business Review*. His research has been cited extensively in the business press. His work has been featured in the *New York Times*, *Forbes*, *Fortune*, *The Economist*, *Barron's*, *Wall Street Journal*, *Business Week*, *Investors' Business Daily*, *USA Today*, and other publications. In addition, Dr. Woolridge has appeared as a guest to discuss the implications of his research on CNN's *Money Line*, CNBC's *Morning Call* and *Business Today*, and Bloomberg's *Morning Call*.

Professor Woolridge's co-authored stock valuation book, *The StreetSmart Guide to Valuing a Stock* (McGraw-Hill, 2003), was released in its second edition. He has also co-authored *Spinoffs and Equity Carve-Outs: Achieving Faster Growth and Better Performance* (Financial Executives Research Foundation, 1999), as well as a textbook entitled *Basic Principles of Finance* (Kendall Hunt, 2011).

Professor Woolridge has also consulted with corporations, financial institutions, and government agencies. In addition, he has directed and participated in university- and company-sponsored professional development programs for executives in 25 countries in North and South America, Europe, Asia, and Africa.

Over the past 35 years Dr. Woolridge has prepared testimony and/or provided consultation services in regulatory rate cases in the rate of return area in following states: Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Washington, D.C. He has also testified before the Federal Energy Regulatory Commission.

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Academic Experience

Professor of Finance, the Smeal College of Business Administration, the Pennsylvania State University (July 1, 1990 to the present).

President, Nittany Lion Fund LLC, (January 1, 2005 to the present)

Director, the Smeal College Trading Room (January 1, 2001 to the present)

Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration (July 1, 1987 to the present).

Associate Professor of Finance, College of Business Administration, the Pennsylvania State University (July 1, 1984 to June 30, 1990).

Assistant Professor of Finance, College of Business Administration, the Pennsylvania State University (September, 1979 to June 30, 1984).

Education

Doctor of Philosophy in Business Administration, the University of Iowa. Major field: Finance.
Master of Business Administration, the Pennsylvania State University.
Bachelor of Arts, the University of North Carolina. Major field: Economics.

Books

James A. Miles and J. Randall Woolridge, *Spinoffs and Equity Carve-Outs: Achieving Faster Growth and Better Performance* (Financial Executives Research Foundation), 1999

Patrick Cusatis, Gary Gray, and J. Randall Woolridge, *The StreetSmart Guide to Valuing a Stock* (2nd Edition, McGraw-Hill), 2003.

J. Randall Woolridge and Gary Gray, *The New Corporate Finance, Capital Markets, and Valuation: An Introductory Text* (Kendall Hunt, 2003).

Research

Dr. Woolridge has published over 35 articles in the best academic and professional journals in the field, including the *Journal of Finance*, the *Journal of Financial Economics*, and the *Harvard Business Review*.

(Whereupon, prefiled direct testimony of Daniel J. Lawton was inserted.)

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for Rate Increase by Florida Power & Light Company	DOCKET NO.: 20210015-EI FILED: June 21, 2021

DIRECT TESTIMONY
OF
DANIEL J. LAWTON
ON BEHALF OF
OFFICE OF PUBLIC COUNSEL

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of the State of Florida

Table of Contents

Schedules

DIRECT TESTIMONY OF
DANIEL J. LAWTON

SECTION I: INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 12600 Hill Country Boulevard, Suite R-275, Austin, Texas 78738.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

A. I have been working in the utility consulting business as an economist since 1983. My consulting engagements have included electric utility load and revenue forecasting, cost of capital analyses, financial analyses, revenue requirements/cost of service reviews, regulatory policy issues, and rate design analyses in litigated rate proceedings before federal, state and local regulatory authorities, and in court proceedings. I have worked with numerous municipal utilities developing electric rate cost of service studies for reviewing and setting rates. In addition, I have a law practice based in Austin, Texas. My main areas of legal practice include administrative law representing municipalities in electric and gas rate proceedings and other litigation and contract matters. I have included a brief description of my relevant educational background and professional work experience in Exhibit DJL-1.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN RATE PROCEEDINGS?

A. Yes, I have, including a number of cases before the Florida Public Service Commission. A list of cases where I have previously filed testimony is included in Exhibit DJL-1.

Q. ON WHOSE BEHALF ARE YOU FILING TESTIMONY IN THIS PROCEEDING?

A. I have been asked to review certain aspects of the Florida Power & Light ("FPL" or "Company") rate filing. I am filing this testimony on behalf of the Office of the Public Counsel ("OPC").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony in this proceeding is to address certain parts of the FPL four-year Rate Plan proposed by the Company in this case. Specifically, I address the Company's requested four-year rate plan forecasted 2022 test year, 2023 Subsequent Year Adjustment ("SYA") test year, the 2024 adjusted year revenue requirement for the requested Solar Base Rate Adjustment Mechanism ("SoBRA"), and the 2025 adjusted year revenue requirement for the requested subsequent year SoBRA mechanism. In addition, I address the proposed Reserve Surplus Amortization Mechanism ("RSAM"), the proposed return on equity ("ROE") Inflator, and issues related to financial integrity.

Q. WHAT MATERIALS DID YOU REVIEW AND RELY ON FOR THIS

TESTIMONY?

A. I have reviewed prior orders of the Florida Public Service Commission ("Commission"), FPL's prior rate filings, Company Direct Testimony in this docket, historical Earnings Surveillance Reports, other testimony and supporting schedules from other cases, FPL's responses to discovery, financial reports and other financial information available in the public domain. When relying on various sources, I have referenced such sources in my testimony and/or attached Schedules and included copies or summaries in my Schedules and/or work papers.

SECTION II: OVERVIEW OF FPL FOUR-YEAR RATE PLAN PROPOSAL

Q. PLEASE PROVIDE A SUMMARY OF THE COMPANY'S PROPOSED RATE PLAN IN THIS CASE?

A. The FPL proposed Four-Year Rate Plan is addressed by a number of FPL witnesses, but the most complete summary appears in the direct testimony of FPL Witness Barrett at page 65 through page 69. The FPL Four-Year Rate Plan consists of the following key elements:

> FPL commits not to request any additional general,[1] base rate increase effective prior to January 1, 2026 (except those identified in this proceeding).[2]

[1] FPL uses the qualifier "general" here. I am aware that Section 366.076, Fla. Stat. authorizes something called "limited" proceedings to adjust rates. I will not opine on scope of non-general base rate proceedings authorized under this statute, but I would urge the Commission to evaluate whether this is an exception to the stay-out commitment FPL purports to make.

[2] Direct Testimony Witness Barrett at page 65 line 22 through page 66 line 1.

i) In exchange for this four-year stay out provision FPL requests the following:

A. January 1, 2022 base rate increase of $1,108,000,000,[3]

B. January 1, 2023 base rate increase of $607,000,000,[4]

C. January 1, 2024 base rate increase of $140,000,000,[5]

D. January 1 2025 base rate increase of $140,000,000.[6]

E. Commission approval of the requested Reserve Surplus Amortization ("RSAM") amount of $1.48 billion to be available to FPL for the 2022 through 2025 period or until the next general base rate change.[7] I discuss later, FPL may in fact delay the next rate increase and stay out longer given the enormous amount of revenue increase in this case and the substantial likelihood that the test year forecasts of sales and economic recovery are understated.

F. Approving the RSAM adjusted depreciation rates set forth in FPL Witness Ferguson Exhibit KF-3(B) creating the $1.48 billion Reserve Amount and the revenue requirement amounts set forth in items A and B above.[8] (Witness Ferguson asserts that the actual depreciation rates are approximately $200 million higher than the proposed RSAM depreciation rates in the four-year rate plan.)

[3] Direct Testimony FPL Witness Silagy at page 36 line 23.
[4] Direct Testimony Witness Silagy at page 37 line 1.
[5] Direct Testimony FPL Witness Cohen at page 33 line 15.
[6] Direct Testimony Witness Cohen at page 33 line 15.
[7] Direct Testimony Witness Barrett at page 66 lines 11 through line 14.
[8] Direct Testimony Witness Barrett at page 66 line 15 through page 20.

G. Approval of the Solar Base Rate Adjustment ("SoBRA") mechanism set forth in Witness Barrett's Exhibit REB-12 which supports two additional base rate increases of about $140 million each; the first SoBRA increase in 2024 and the second SoBRA increase in 2025.[9]

H. Approval of the accelerated amortization of the unprotected excess deferred income taxes (unprotected EDITs) that were to be amortized in 2026 and 2027 would instead be amortized in 2024 and 2025 as described by FPL Witness Bores.[10] The impact of the acceleration is to defer cash rate increases over the 2024 and 2025 period.[11] The impact of the deferral is about $163 million over the two years.[12]

I. Included in the above four-year rate plan components are the following items:

1. A 50-basis point increase to the requested ROE requirement of 11.0% up to 11.50% at a revenue requirement cost to consumers of about $183 million per year or over $732 million during the for-year rate plan;[13]

2. Expansion of the authorized equity return range of earnings from the original 10% to 12.0% with an 11.0% midpoint up to 10.5% to 12.5%. with an 11.50% midpoint;

[9] Direct Testimony Witness Barrett at page 66 line 21 through page 67 line 2.
[10] Direct Testimony FPL Witness Bores at page 10 line 1 through line 4.
[11] Direct Testimony Witness Bores at page 10 line 4 through line 5.
[12] Direct Testimony Witness Bores at page 41 line 5 through line 6.
[13] The annual revenue requirement impact of a 50-basis point adjustment to the requested equity return is provided in Schedule (DJL-2)

3. FPL proposes to retain other mechanisms in place such as the Storm Cost Recovery Mechanism ("SCRM") to assure revenue recovery to address unforeseen or unpredictable events.[14] Mechanisms such as the SCRM lower business risks for FPL.

To summarize, FPL is proposing to not file a general base rate increase over the four-year period 2022 through 2025 if FPL is allowed a year 2022 increase of $1.108 billion, a year 2023 increase of $607 million, a year 2024 increase of $140 million, and a year 2025 increase of $140 million. In other words, FPL will commit to not filing a general base rate increase for four years if the Commission will preapprove four annual increases totaling $1.995 billion over four years. Included in these $1.995 billions of rate increases between 2022 and 2025 is the authorization of an 11.0% equity return, where an 11.0% ROE is about 160 basis points above the current 9.4% authorized average ROE for the average electric utility operations in 2020.[15] FPL is certainly less risky than the average electric utility in the United States. OPC Witness Woolridge addresses this ROE issue in detail.

FPL further enhances the shareholder profit by requesting an additional 50 basis points of equity return to a level of 11.50%.[16] This 50-basis point inflator translates into another $136.432 million of added profit and an additional $183.027 of annual revenue requirement. Thus, the FPL first year revenue requirement includes significant

[14] Direct Testimony Witness Barrett at Exhibit REB-10, Page 1 of 1.
[15] Average ROE awarded by regulatory authorities to the average electric utility in 2020 per Edison Electric Institute Financial Data publication 4th quarter 2020.
[16] Direct Testimony Witness Barrett at page 49 lines 4 through line 7.

amounts of excess profits and when taxes are considered, substantial excess revenue requirement. Thus, the first-year rate increase of $1.108 billion includes a substantial amount of excess profit request.

The Company's proposed four-year rate plan includes yet another shareholder profit enhancement through the RSAM. Through the RSAM, FPL is able to generate an additional 100 basis points of shareholder profits up to a 12.50% equity return. As shown in Schedule DJL-2, FPL has employed the RSAM to generate top end earnings at 11.6% equity return each reporting month since July 2018 through the present. Thus, through RSAM earnings management an added 100 basis point of equity return which further increase FPL annual revenue requirements by $366.054 million.[17]

The end result is that the Company's proposed four-year rate plan is the pre-approval of four annual increases that produce excessive profits for FPL shareholders at the expense of customers. The Subsequent Year Adjustment ("SYA") is a second forecast further into the future designed to maintain the excess profit level again at the expense of customers.[18] In fact Witness Bores states: "[a]ssuming FPL's 2022 request is granted in full, the 2023 SYA reflects only the incremental revenue need in 2023 to achieve a projected ROE equal to the requested midpoint of 11.50%."[19] FPL's sole goal in the SYA is to maintain excess profits. The third and fourth year 2024 and 2025 increases for the SoBRA proposal allows for the targeted piecemeal rate increases for specific solar assets and ignore other cost decreases or revenue increases again at the expense of customers. Then on top of the four proposed rate increases between 2022 and 2025, the FPL proposed RSAM allows the Company to maximize earnings at a

[17] Calculated from Schedule (DJL-2) by doubling the 50-basis point adjustment quantification.
[18] Direct Testimony Witness Bores at, Page 35 line 20 through page 36, lines 1 through 5.
[19] Direct Testimony Witness Bores at, Page 36 lines 1 through 3.

substantial expense to future customers. As I discuss in the RSAM section of this testimony, historically FPL has used the RSAM to enhance shareholder returns causing customers to incur more costs in the future. Then, we have the proposed Inflator equity return which is not supported by a more complete review of FPL's historical performance.

The FPL proposed 4-year rate plan is not a good plan for customers and should be rejected. The FPL plan is based on earning excess profits at the expense of customers and then maximizing these excess profits to an even higher level through the RSAM which will result in putting hundreds of millions of dollars of added costs on future customers. The maximization of the excess profits is maintained over three additional years through more, uncertain forecasts in the guise of what FPL calls a SYA and additional piecemeal ratemaking adjustments called SoBRAs. The FPL four-year rate plan is not good or sound regulatory policy and the Company plan should be rejected by the Commission.

Q. PLEASE PROVIDE A SUMMARY OF YOUR RECOMMENDED ADJUSTMENTS IN THIS CASE?

A. Each issue is addressed in detail in the following pages, but a summary of the recommendations I make in this case are as follows:

(1) The test year in this case should be limited to the forecast 2022 test period. Thus, the proposed Subsequent Year Adjustment 2023 test year should be eliminated. The forecasting uncertainty surrounding the 2020 pandemic make estimates beyond 2022 substantially uncertain and not reliable for sound rate setting. As I discuss below, the FPL forecast of sales, customers, and load is based on an analysis

conducted in mid to late 2020. The analysis does not consider more rapid recovery and the influences of recent fiscal policy and some monetary initiatives. This recommendation does not threaten FPL's revenues or financials. If it turns out future increases are necessary FPL may file such requests at that time. Moreover, this approach to dealing with uncertain test year forecasts made during an economic crisis is exactly how this Commission handled the matter in Docket No. 20080677-EI when FPL requested multiple test year adjustments following the Great Recession.

(2) Consistent with the removal of the Subsequent Year Adjustment, I recommend that the two proposed SoBRA $140 million annual increases 2024 and 2025 be eliminated. In addition to the increased forecast uncertainty, there are fundamental fairness issues of targeting future increases while ignoring offsetting cost factors. Also like the Subsequent Test Year Adjustment, this Commission handled the matter of targeted future rate increases by eliminating them in Docket No. 20080677-EI when FPL requested multiple year rate increase adjustments following the Great Recession.

(3) Third, FPL's proposed RSAM proposal should be denied in total. The fundamental reason for denying FPL's request is that the proposal harms customers and FPL acknowledges this customer harm. Specifically, FPL proposes a $1.48 billion RSAM starting balance.[20] Now, when FPL amortizes the RSAM reserve amount such **amortization is recorded as a credit to depreciation expense and a corresponding debit to the accumulated depreciation reserve – an increase to**

[20] Direct Testimony FPL Witness Barrett at page 66 lines 11 through line 14.
[

rate base.[21] The Company employed this RSAM flexibility through the last base rate case settlement to maintain a high-end ROE of 11.60%.[22] Now, FPL proposes to employ the $1.48 billion RSAM for the next four years. But as Witness Bores acknowledges each time FPL credits depreciation expense to enhance shareholder profits to maximum levels – customers incur an increase to rate base (i.e. more cost obligations). This is wrong to take ratepayer depreciation payments and rather than reduce plant investment through higher levels of accumulated depreciation, instead boost shareholder profits.

To address RSAM and Theoretical Depreciation Reserve issues I have made the following recommendations:

a. OPC witness McCullar's Theoretical Reserve imbalance should be employed using the remaining life technique supported in Ms. McCullar's depreciation analysis as well as in that of Company's own depreciation Witness Ned Allis.

b. The expected year-end 2021 outstanding balance of RSAM reserve should remain as a component of depreciation reserve, not subject to amortization discretion, and be dealt with in the next FPL base rate case.

(4) Fourth, the FPL requested 50-basis point ROE incentive or surplus return should be rejected. The requested incentive is excessive adding about $183 million in annual revenue requirement.[23] The requested incentive is even more excessive when one considers all other incentives already in rates or further requested by FPL. I discuss this issue in detail below. For all these reasons, I recommend that the

[21] Direct Testimony FPL Witness Bores at page 31 lines 8 through line 10.
[22] Direct Testimony FPL Witness Bores at page 31 lines 10 through line 13, also see FPL's February 28, 2021 Earnings Surveillance Report at Attachment 1.
[23] Calculated as a 50-basis point equity adjustment from FPL's filed Schedule A where revenue requirement is grossed-up employing a 21% Federal Income Tax Rate.

proposed inflator or surplus profit be rejected.

SECTION III: TEST YEAR, SUBSEQUENT YEAR ADJUSTMENTS, AND FORECASTING ISSUES

Q. WHAT ISSUE(S) DO YOU ADDRESS IN THIS SECTION OF YOUR TESTIMONY?

A. In this section of my testimony, I address the essential part of FPL's four-year rate plan that being the multi-year approximately $2.0 billion of rate increases, of which $1.1 billion is through a forecasted 2022 test year, about $607 million more through what FPL calls a Subsequent Year Adjustment, and two more $140 million annual increases through a mechanism called the SoBRA. I explain the problems with forecasting rates far into the future, the unfairness of one-sided mechanisms, and the basic reason for one test period for setting rates. The key issue being addressed is that FPL has forecasted 5-years of data from 2021 through 2025 and ended up with about $1.995 billion of consumer rate increases for the period 2022 through 2025.

In evaluating all of the issues in FPL's request, the Commission should keep one overriding issue in mind "what is driving this requested $2.0 billion increase?" FPL as a vertically integrated electric utility has managed to earn one of the highest if not the highest equity return profits in the country of 11.60% every month since July 2018 to the present. What exactly is causing a sudden need for a $2.0 billion increase?

The simply answer is that there are substantial capital additions on the FPL system, but FPL's employing an overstated profit request is the driving factor causing a need for such a substantial rate change. A careful examination of this request shows

it is entirely driven by profit enhancement. That is profit enhancement beyond a fair, just, and reasonable profit level and leads to excessive rates.

Q. HOW DID FPL CALCULATE THE FUTURE REVENUE REQUIREMENTS FOR THE 2022 TEST YEAR, THE 2023 SUBSEQUENT YEAR ADJUSTMENT TEST YEAR, AND THE 2023 AND 2024 SOBRA MECHANISM ADJUSTMENT YEARS?

A The answer is starting with 2020 historical data in the midst of the COVID-19 pandemic and one of U.S. history's most severe and sudden economic downturns, FPL employed forecasts, more forecasts and even more forecasts to predict the future $2.0 billion in rate requirements for customers. Starting from the 2020 historical base line, FPL first made forecasts for estimating the year 2021, and then additional forecasts for estimating year 2022 (the first test year). Then FPL estimated a Subsequent Year Adjustment test year 2023. FPL then estimated 2024 and 2025 and layered in about $140 million of solar plant estimates for those years.

To get a sense of the FPL forecasting efforts one need look no further than Mr. Bores direct testimony where he points out that FPL and Gulf provided separate O&M expense and capital expenditure forecasts for the period 2021 through 2025.[24] In addition to these separate FPL and Gulf forecasts, estimates of merger synergy savings were developed on the assumption of legally combined FPL and Gulf operation.[25] These merger assumptions were worked into the final FPL and Gulf forecast estimates to arrive at a legally combined utility cost estimate. The major assumptions underlying

[24] FPL Direct Testimony Witness Bores at page 20, line 10 to 11.
[25] FPL Direct Testimony Witness Bores at page 20, line 11 to 21.

the forecasts are shown in the 22 pages that make up Schedule MFR F-8 attached to Mr. Bores testimony.[26] I should note that FPL Witness Park estimated future customers, energy, and demands by class in separate regression forecasts. The general assumptions and inputs to Mr. Park's analysis are also contained in MFR F-8. Also, Mr. Park is the witness responsible for the inflation factors employed in the models. The bottom line is that there is no factual dispute that the entirety of the $2.0 billion in proposed FPL rate increases is based on forecasts well into the future.

Q. IS THERE GOOD REASON TO HAVE CONCERN ABOUT THESE FORECASTS?

A. Absolutely. First, the starting point or the base line historical year of 2020 was a year full of economic turmoil, uncertainty, with major economic disruptions. A February 2021 report by the Congressional Budget Office concluded: "the 2020-2021 coronavirus pandemic caused severe economic disruptions last year as households, governments, and businesses adopted a variety of mandatory and voluntary measures-collectively referred to here as social distancing. The impact was focused on particular sectors of the economy, such as travel and hospitality . . . ."[27] Florida knows full well the impact of the disruptions to the economy surrounding the travel, leisure, and hospitality industries.

The Congressional Budget Office currently projects a stronger economy in its February 2021 forecast than it did in the third quarter 2020 forecast in large part because the economic downturn in 2020 was not as severe as expected and recovery

[26] FPL Direct Testimony Witness Bores at Exhibit SRB-6, pages 1 through 22.
[27] *An Overview of the Economic Outlook 2021 to 2031*, Congressional Budget Office, (February 2021) at 1.

was sooner and stronger than expected.[28] But the Congressional Budget Office points out that these current projections are "subject to an unusually high degree of uncertainty and that uncertainty stems from many sources, including the course of the pandemic, **the effectiveness of monetary and fiscal policies, and the response of global financial markets to substantial increases in public deficits and debt**."[29] Other forecasting concerns and uncertainty surround the impact of the pandemic on the economy over the longer term, including the impacts on productivity, the labor force, and technological innovation.[30]

There are many economic uncertainties never before experienced, but FPL seems to plow ahead with enormous rate increases all based on estimates – none of which directly consider recent monetary and or fiscal policy impacts. Further, this case is not just a forecasted test year, but involves **FIVE** future year forecasts 2021 through 2025. During times of increased uncertainties, it is generally not wise to estimate more years of rate increases. Forecasting a test year two years into the future is already subject to uncertainty, but forecasting multiple test years using an extremely volatile economic year such as 2020 for the base historic year is fraught with pitfalls. The Commission should have concerns in this environment with extended future test years, all piling on more and more rate increases.

Q. IS THERE ANY WAY TO EVALUATE THE QUALITY OF THE FPL REVENUE REQUIREMENT FORECASTS AT THIS TIME?

[28] *An Overview of the Economic Outlook 2021 to 2031*, Congressional Budget Office, (February 2021) at 4.
[29] *An Overview of the Economic Outlook 2021 to 2031*, Congressional Budget Office, (February 2021) at 4. (Emphasis added.)
[30] *An Overview of the Economic Outlook 2021 to 2031*, Congressional Budget Office, (February 2021) at 4.

A. Yes. First, one does need to wait until 2026 to see how close the forecasts came in relative to actuals. That could be an expensive and costly wait for customers. Instead, the Commission can exercise its judgement based on the facts and decide not to employ any rate adjustments beyond the 2022 forecasted test year.

This Commission has previously addressed similar forecasting uncertainties in Docket Nos. 20080677-EI and 20090130-EI, where FPL requested a $247 million increase in a Subsequent Year Adjustment beyond the 2010 forecasted test year. (See, Order No. PSC-10-0153-FOF-EI, issued March 17, 2010, in Docket Nos. 20080677-EI and 20090130-EI, In Re: Petition for Increase in Rates by Florida Power & Light Company, In Re: 2009 Depreciation and Dismantlement Study by Florida Power & Light at page 7).

In that case, after concluding that the Commission has legal authority to employ a forecasted test year and authority to authorize a Subsequent Year Adjustment, the Commission decided a Subsequent Year Adjustment and back-to-back increases was a bridge to far. (Order No. PSC-10-0153-FOF-EI at pages 9 - 11). Specifically, the Commission found that back-to-back rate increases should only be allowed in "extraordinary circumstances." (Order No. PSC-10-0153-FOF-EI at page 9). There are no extraordinary circumstances requiring FPL to request a Subsequent Year Adjustment in this case – instead FPL claims that the equity return earnings deteriorate following the 2022 test year and the purpose of the Subsequent Year Adjustment is to increase equity earnings.[31] This is exactly the same argument FPL made in Docket Nos. 20080677-EI and 20090130-EI. (Order No. PSC-10-0153-FOF-EI at page 9). The Commission soundly rejected FPL's Docket Nos. 20080677-EI and 20090130-EI

[31] FPL Direct Testimony Witness Bores at page35, lines 22 to 23 through. Page 36, lines 1 – 5.

Subsequent Year Adjustment request stating; "[t]he Company's ratepayers deserve a full investigation into the cause of FPL's claimed deterioration of its earnings." (Order No. PSC-10-0153-FOF-EI at page 10).

The Commission made two additional points on the merits of the FPL Subsequent Year Adjustment in Docket Nos. 20080677-EI and 20090130-EI that are relevant to the current case. First, the Commission pointed out that regulatory authorities that make use of forecasted test year ratemaking typically only look one year into the future. (Order No. PSC-10-0153-FOF-EI at page 10). This case also requests the Commission look into a future 2022 test year and then look out another year for the second test period basis for the Subsequent Year Adjustment. As the Commission noted in PSC-10-0153-FOF-EI at page 10 "[a]s one reaches farther into the future, predictions and projections of future economic conditions become less certain and more subject to the vagaries of changing variables." The current FPL Subsequent Year Adjustment for 2023 like FPL's prior case discussed above reaches farther into the future, predictions and projections of future economic conditions become less certain and more subject to the vagaries of changing variables.

Second, in Order No. PSC-10-0153-FOF-EI at page 10, the Commission pointed out that the economic environment when the test year projections were made was heavily influenced by the impact of the subprime mortgage crisis of 2008 – 2009. The Commission pointed out that it is certainly possible that FPL's claimed need for a Subsequent Year Adjustment could be offset by changes in sales growth, billing determinants, fiscal policy Stimulus Bill benefits and other cost-decreasing measures. (Order No. PSC-10-0153-FOF-EI at page 10) Finally in Order No. PSC-10-0153-FOF-EI at page 10, the Commission concluded "FPL's claim that it will need a rate increase

in 2011 simply is too speculative, and is hereby rejected."

The same is true in this case. The forecasts were made during 2020, down economic times and certainly do not include all the impacts of monetary and fiscal policy Stimulus Bill benefits that continue to have economic impacts in enhancing economic growth. On the monetary policy front the Federal Reserve Federal Open Market Committee ("FOMC") is committed to a policy of low inflation and full employment. Maintaining inflation controls requires the continued low federal funds rate along with continued quantitative easing efforts resulting in lower cost of capital for the immediate future.[32]

Q. HAVE YOU IDENTIFIED ANY FORECAST ASSUMPTIONS THAT MAY BE SUSPECT GIVEN ECONOMIC TURMOIL AND SUBSEQUENT ECONOMIC TURNAROUND?

A. I have not considered all modeling assumptions, but a review of the customer and energy forecast used in this case shows rather low or anemic growth over the 2021 through 2025 period.[33] The compound growth rate is less than 1.0% at about 0.79%.[34] The longer-term growth rate for the 2021 through 2068 period is also less than 1.0% at about 0.98%. A review of the recent forecasts from the U.S. Energy Information Administration ("EIA") for the South Atlantic region has about a 1.95% growth rate in energy consumption in the 2020 to 2022 period.[35] In terms of overall forecasts, the EIA

[32] See Federal Reserve FOMC Press Release (April 28, 2021) see www.federalreserve.gov/newsevents/pressreleases/monetary20210428a.htm
[33] FPL Direct Testimony Witness Sims at Exhibit bSRS-4, page 3 of 3 column 3.
[34] FPL Direct Testimony Witness Sims at Exhibit bSRS-4, page 3 of 3 column 3, CAGR for 2022 -2025.
[35] See *Short – Term Energy Outlook*, U.S. Energy Information Administration May 6, 2021 Forecast, Table 7b. US regional Electricity Retail Sales (S. Atlantic Region 2020 2022).

states that electricity consumption in the United States will increase by 2.2% in 2021 after falling 3.9% in 2020 and EIA forecasts industrial sales to increase by 3.3% in 2021.[36] FPL's current estimates do appear understated. So, FPL's conclusion of low, under 1.0% growth is an assumption that should be questioned.

Another questionable assumption is FPL's assumed unemployment rate (Florida) for 2022 of 6.61% which is overstated.[37] A recent study by Goldman Sachs forecasts a jobs boom and unemployment rate of 4.1% by the end of 2021.[38] The Congressional Budget Office current 2021 and 2022 projections estimate unemployment at 4.9% in 2022 and 4.6 % in 2023, declining to 4.0% in the 2024-2025 period.[39] Further, based on the most current U.S. Bureau of Labor Statistics, the Florida unemployment rate is 4.8% well below FPL's forecast model assumption of 6.61%. This is a problem.

In summary there are valid concerns surrounding FPL's revenue requirement and billing determinants forecasts in this case. There should be significant concern regarding forecasts formulated in the midst of the 2020 COVID-19 pandemic and economic collapse during the second and third quarters of 2020. These forecasts are then employed through 2023 and incorporate an unacceptable level of uncertainty for setting future rates. Fundamental assumptions such as the Florida unemployment rate are factually incorrect and the anemic growth resulting from these uncertain estimates means fewer billing units and higher rates for all customers. It is just not necessary to rely on these uncertain estimates. The biggest concerns surround the increased

[36] *Short – Term Energy Outlook*, U.S. Energy Information Administration May 6, 2021 at page 1.
[37] See MFR Schedule F-8 at page 1, line 9.
[38] See Goldman Sachs forecasts a jobs boomwww.cnbc.com/2021/03/08/goldman-sachs.
[39] *An Overview of the Economic Outlook 2021 to 2031,* Congressional Budget Office, (February 2021) at 2.

uncertainty surrounding the FPL 2023 forecasts for the subsequent year adjustment. The forecast and proposed 2023 test year Subsequent Year Adjustment is not necessary and should be excluded from this case. If the 2022 test year turns out to be less than adequate in terms of future cost recovery, FPL can file for new and changed rates at that time. There is no evidence in this proceeding that indicates filing a new case if necessary is an undue burden on FPL or customers and may in fact be quite beneficial to customers given the uncertainty of the forecasting environment.

Q. HAVE YOU IDENTIFIED ANY FORECAST ISSUES THAT THE COMPANY CONSIDERED AS A RESULT OF THE YEAR 2020 ECONOMIC TURMOIL AND EXPECTED ECONOMIC TURNAROUND?

A. Several parts of Witness Park's testimony seem to address these topics. First, Mr. Park does state that the Great Recession (2007 – 2009) affected the Florida economy far greater than other parts of the United States.[40] He also points out that the Florida economy grew at a faster rate than the U.S. from 2016 through 2019 – then the pandemic hit.[41]

To make estimates in this case Mr. Park assumed a population growth estimate of about 1% versus the 2016 to 2019 historical 1.4%.[42] From the start, by employing lower population growth levels, Mr. Park's analyses failed to consider a more rapid rebound to pre-pandemic levels. Then Mr. Park readily acknowledges the impacts of COVID-19 to-date, and the projected recovery are captured in the forecasts.[43] The

[40] Direct Testimony Witness Park at page 8, line 1-2.
[41] Direct Testimony Witness Park at page 8, lines 7 - 8.
[42] Direct Testimony Witness Park at page 8, lines 19 - 22.
[43] Direct Testimony Witness Park at page 9, lines 8 - 9.

problem is that Mr. Park's forecasts do not have added data showing a quicker economic turn-around. Instead, Mr. Park's analysis employed economic projections for customer, energy sales and peak demand forecasts from IHS Markit's August 2020 economic forecast and the CPI projections are based on IHS Markit's May 2020 forecasts.[44] The pandemic and associated economic outlook has changed swiftly and dramatically over a short period of time and these dramatic changes have not been incorporated in Mr. Park's analyses.

To see the problem and results from Mr. Park's forecasting efforts on customer quantities one need look no further than the following table.

TABLE 1
FPL HISTORICAL AND FORECAST of CUSTOMER DATA[45]

YEAR	CUSTOMERS	ANNUAL PERCENT GROWTH
2013	5,065,000	
2014	5,151,000	1.7%
2015	5,223,000	1.4%
2016	5,293,000	1.3%
2017	5,361,000	1.3%
2018	5,426,000	1.2%
2019	5,526,000	1.8%
2020	5,608,000	1.5%
2021 FORECAST	5,664,000	0.998%
2022 FORECAST	5,718,000	0.993%
2023 FORECAST	5,785,000	1.172%

As can be seen in the table above, historical customer quantities grew historically at rates well above 1 percent. But Mr. Park employing his 2020 forecast along with

[44] Direct Testimony Witness Park at page 9, lines 11 - 13.
[45] Historical and forecast customer quantities from Witness Park Direct Testimony Exhibit JKP-3.

pandemic and economic collapse assumptions has changed those customer growth expectations to less than 1 percent. Only starting later in 2023 do we see customer growth climb above 1 percent. Mr. Park's failure to recognize a more rapid turn-around in the economy by using outdated data has led to these understated estimates.

Q. HAS FPL ALSO UNDERSTATED THE ENERGY SALES FORECAST?

A. Yes. I have developed an analysis of FPL's energy sales forecast in Table 3 below.

TABLE 2
FPL HISTORICAL AND FORECAST SALES DATA[46]

YEAR	DELIVERED SALES GWH'S[47]	COMPOUND GROWTH
2017	116,821	
2018	120,355	
2019	119,536	
2020	120,134	0.90%[48]
2022 FORECAST	122,083	0.80%[49]
2023 FORECAST	122,980	0.78%[50]

Like the customer forecast, the estimate of delivered sales grow at a lower rate than pre-pandemic levels. Again, Mr. Park has understated the future.

For all of the above reasons, the Commission should avoid looking beyond the 2022 forecasted test year. Use of Mr. Park's forecasts beyond 2022 only compound the understatement of sales and revenues all to the detriment of consumers. This is the approach this Commission took during the last economic crisis 2007 - 2009 and it should follow that approach in this case as well.

[46] Historical and forecast customer quantities from Witness Park Direct Testimony Exhibit JKP-3.
[47] Historical and forecast delivered sales quantities from Witness Park Direct Testimony Exhibit JKP-4.
[48] Compound growth rate for historical period 2017 – 2020.
[49] Compound growth rate for forecast period 2020 – 2022.
[50] Compound growth rate for forecast period 2020 – 2023.

SECTION IV: THE SOLAR BASE RATE ADJUSTMENT MECHANISM ("SoBRA)

Q. PLEASE ADDRESS THE 2024 AND 2025 RATE INCREASES UNDER THE FPL PROPOSED SOLAR BASE RATE ADJUSTMENT ("SOBRA") MECHANISM?

A. In this case the Company proposes to continue the SoBRA mechanism that has been in place as the result of the settlement of FPL's 2016 rate case.[51] The fact that a SoBRA mechanism was part of an overall Settlement in the 2016 FPL rate case should have no impact of this proceeding. Parties in a prior case engaged in the give and take of negotiation and ultimately agreed on a total package leading to the Settlement of the prior case. Now, proposals in this case must stand on their own merits -- not the fact that previous settlements included similar types of rate mechanisms.

As to the merits of the SoBRA mechanisms, FPL proposes to have rate increases of about $140 million per year in 2024 and 2025 to accommodate expected in-service dates of new solar facilities.[52] To achieve the expected $140 million revenue requirement, the rate increase will be implemented by adjusting the customer charge, demand charge and energy charge by an equal percentage to recover the revenue requirement approved. Also these revenue requirements are to be subject to true up.[53] The Company asserts that the SoBRA mechanism is similar to the Generation Base Rate Adjustments employed by the Commission in past cases.[54]

[51] See Order No. PSC-16-0560-AS-EI (December 15, 2016).
[52] FPL Direct Testimony Witness Cohen at page 33, lines 10 – 15.
[53] Direct Testimony Witness Cohen at page 34, lines 10 – 21.
[54] Direct Testimony Witness Cohen at page 35, lines 5 – 10.

Q. DO YOU AGREE WITH THE COMPANY'S SOBRA PROPOSAL AND $140 MILLION INCREASES FOR 2024 AND 2025?

A. The short answer is no. The proposed 2024 and 2025 SoBRA rate increases should be denied. First, I discussed above how the longer-term forecast are uncertain and the claimed need for the Subsequent Year Adjustment as well as these outer year SoBRA adjustments must be questioned. It is certainly possible that economic conditions, increased customer growth, increased electric sales, and lower capital costs will all tend to offset costs of power plants and/or other plant additions. Alternatively, if it turns out increases are necessary in 2024 and 2025, FPL can file a rate case and demonstrate the need for a rate change. The 2025 SoBRA estimates are four years down the road and the Company will have more current data and estimates at that time.

As to the FPL argument that the SoBRA mechanism is similar to the Generation Base Rate Adjustment ("GBRA") employed in past proceedings – such an analogy does not support the SoBRA in this case. For example, in FPL's Docket No. 080677-EI the Commission ruled; "We deny FPL's request to continue the GBRA mechanism. It is not possible for us to exercise as adequate a level of economic oversight within the context of a GBRA mechanism as we can exercise within the context of a traditional rate case proceeding." (See Order No. PSC-10-0153-FOF-EI at p. 16.). In that analysis, the Commission pointed out a concern for formalizing the GBRA process. The Commission also pointed out that a substantial portion of FPL's total revenue requirement (61% as of 2009) was already subject to pass through mechanisms and recovery clauses and another clause mechanism versus traditional rate cases may not provide any advantage or benefits. Since this time, the Storm Protection Plan mechanism to process capital improvements under the plan has been added which shifts

additional revenues from base rates to a clause mechanism.

It does not appear that the benefits of employing a SoBRA mechanism outweigh the risks to customers. FPL is in the best position to determine when a new revenue requirement proceeding is necessary. So, if economic recovery in 2024 and 2025 make a new rate case necessary FPL can file a case at that time. For all of the above reasons, I recommend that the Commission not adopt the proposed SoBRA mechanism.

SECTION V: RESERVE SURPLUS AMORTIZATION MECHANISM (RSAM)

Q. PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS RELATED TO FPL'S REQUEST FOR APPROVAL OF A RSAM.

A. FPL's request for a RSAM demonstrates the Company's over-reach for increased rates and revenues in this case to the detriment of the customers. First, FPL creates a $1.48 billion RSAM balance out of whole cloth that will likely drive future depreciation rates and customer rates to higher levels.[55] Second, FPL proposes to amortize the RSAM, at its sole discretion to maintain the FPL return on equity between 10.5% and 12.5%.[56] This provision of the RSAM should raise alarms when FPL needs a mechanism to assure the equity return earned will be maintained below an astounding 12.5%. This certainly indicates that FPL's request is overstated.

Third, the FPL RSAM proposal is actually a taking of customer assets to be used to enhance shareholder profits. FPL Witness Bores actually acknowledges this obvious taking of depreciation payments and turning that into increased rate base and

[55] Direct Testimony FPL Witness Barrett Exhibit REB-11, page 1 of 1, paragraph 2.
[56] Direct Testimony FPL Witness Barrett Exhibit REB-11, page 1 of 1, paragraph 4(a),(b),(c),(d),(e),(d),(e).

increased cost obligations.[57] Taking of consumer assets is unfair, unwarranted, and unjust. Fourth, historical evidence shows that FPL's RSAM proposal will lead to consistent excessive earnings levels. Fifth, the Company calculation of the RSAM is a substantial overstatement of the Theoretical Reserve which will likely increase customers future depreciation charges.

It is my recommendation that the proposed RSAM be denied. Instead, a more accurately calculated Theoretical Reserve as calculated in OPC witness Ms. McCullar's testimony should be employed in calculating the proposed remaining life depreciation rates ion this proceeding. Each of the five recommendations and final conclusion are explained below.

Q. PLEASE DESCRIBE AND EXPLAIN THE SOURCE OF THE RSAM'S RESERVE AMOUNT BALANCE OF $1.48 BILLION – WHAT IS IT AND WHERE DID IT COME FROM?

A. The Reserve Amount component of the RSAM amounts to $1.48 billion and represents what is called the Theoretical Reserve Imbalance. The Theoretical Reserve Imbalance is calculated as the difference between FPL's book accumulated depreciation, or book reserve, and the calculated accrued depreciation, or theoretical reserve.

Now, the "book reserve" referenced above is also known as the accumulated provision for depreciation, which reflects the running or historical total of recorded depreciation activity. This historical balance is equal to the historical depreciation accruals, less retirements and cost of removal, plus historical gross salvage. This

[57] Direct Testimony Witness Bores, page 31, lines 8 – 10.

historical book reserve of depreciation activity represents a reduction to the original cost of plant in the rate base calculation.

The Theoretical Reserve is an estimate of the book reserve or accumulated provision for depreciation described in the prior two sentences. The Theoretical Reserve is calculated based on the current plant balances and depreciation parameters (service life and net salvage estimates) at the current point in time. In other words, the Theoretical Reserve would be the reserve balance if current estimates of service life and net salvage materialize.

Now, the Theoretical Reserve is not based on actual recorded depreciation resulting from the application of approved depreciation rates. Instead, the Theoretical Reserve is an estimate at a point in time employing current depreciation parameters. For example, after completing his depreciation study, FPL witness Allis calculated the Theoretical Reserve Imbalance to be a negative $437 million.[58] This means if Mr. Allis' depreciation estimates are correct the current accumulated provision for depreciation is about $437 million short of where it needs to be given the estimate of theoretical reserve.[59] This implies future depreciation rates would need to increase if Mr. Allis' estimates are correct.

Q. GIVEN MR. ALLIS' DEPRECIATION STUDY RESULTS HOW DID THE THEORETICAL RESRVE BALANCE INCREASE TO $1.48 BILLION?

A. Mr. Allis' depreciation study and negative $437 million Theoretical Reserve estimate would not afford FPL the opportunity to implement the proposed RSAM. So, to

[58] See Direct Testimony Witness Allis at page 48, lines 24 – 26.
[59] See Direct Testimony Witness Allis at page 48, lines 24 – 26.

facilitate the RSAM request, FPL Witness Ferguson asked Witness Allis to "calculate several alternative parameters" to enable (increase) the Theoretical Reserve and RSAM balance.[60]

The resulting adjustments made by Witness Allis included;

i) Increase St. Lucie Nuclear plant life from 60 years to 80 years;

ii) Increase combined cycle generating plant lives from 40 years to 50 years;

iii) Increase solar plant lives from 30 years to 35 years;

iv) For transmission, distribution, and general functions adopt the lives and/ or net salvage from the FPL 2016 Rate Settlement or 2021 Allis depreciation study whichever results in longer lives or higher net salvage (i.e. whichever increases the Theoretical Reserve the most).[61]

The results of these cherry-picking adjustments caused annual depreciation expense to decrease $239 million in test year 2022 and $249 million for test year 2023.[62] The key result of Mr. Allis' altered analysis is to increase the Theoretical Reserve imbalance from a negative $437 million to a positive $1,480,000,000 for use in the proposed RSAM.[63]

Q. HOW DOES FPL PROPOSE TO EMPLOY THIS $1.480 BILLION THEORETICAL RESERVE?

[60] See Direct Testimony Witness Ferguson at page 14, lines 7 – 10.
[61] See Direct Testimony Witness Ferguson at page 14, lines 13 – 21, also see Exhibit KF-3(B).
[62] See Direct Testimony Witness Ferguson at page 17, lines 11 – 13.
[63] See Direct Testimony Witness Ferguson at Exhibit KB-3(B), page 47 of 47, column 4.

A. The Company proposes the establishment of an RSAM as part of the proposed four-year rate plan employing the same framework from the 2016 Settlement Agreement updated for the assumptions and projections in this current filing.[64] Mr. Barrett explains the RSAM as an accounting mechanism to address underlying changes in revenues and expenses in order to maintain the authorized equity return level.[65] These RSAM earnings are non-cash earnings to the Company so there are no additional tariff charges to the customer.[66] But, when the RSAM is used as a credit to depreciation it results in an increase in rate base (decrease to the accumulated provision) by an equal and offsetting amount.[67] Therefore, if this proposed $1.480 billion RSAM is approved and used by the Company for enhanced shareholder earnings, then in the next case, customers will have a rate base that is $1.48 billion higher. Customers pay dearly for enhanced shareholder earnings.

Q HOW HAS FPL EMPLOYED A SIMILAR RSAM FROM PAST CASES?

A. The Company was authorized an RSAM mechanism as part of the 2016 comprehensive settlement of that proceeding. I have included in Schedule DJL-2 the claimed historical equity return earned by month as reported in the FPL Earnings Surveillance Reports.[68] The 2016 Settlement proceeding started with a balance of $1,252,100,355.[69] It is expected that all but $340 million will be used by FPL by year end 2021.[70]

[64] See Direct Testimony Witness Barrett page 61, lines 14 – 18.
[65] See Direct Testimony Witness Barrett page 60, lines 3 – 6.
[66] See Direct Testimony Witness Barrett page 60, lines 11 – 14.
[67] See Direct Testimony Witness Barrett page 60, lines 11 – 14.
[68] Between October 2018 and the present FPL reported the maximum 11.60% ROE. From January 2017 through September 2018 the Company generally reported an 11.50% ROE with the lowest month at 11.15% in January 2018.
[69] See FPL February 2021 Earnings Surveillance Report Attachment 1 (1/1/17) Balance at Settlement.
[70] See Witness Barrett Direct Testimony Exhibit REB-11 page I at paragraph 2.

The prior 2016 Settlement was just that a comprehensive rate case settlement by the parties and it should not be used as precedent or any basis to normalize the RSAM as a rate making function. Parties to that 2016 Settlement Agreement engaged in give and take on issues and made an agreement on a comprehensive settlement package.

In this case, the Company proposes to employ the Theoretical Reserve balance of $1.480 much the same in this case to maintain a 12.50% top end of the proposed equity return range in this case. But the basis for the creation of the $1.480 billion RSAM balance is based on cherry-picking depreciation studies to arrive at the highest balance without regard to sound depreciation analysis.[71] Such an inflated balance is not reflective of any expert's opinion on depreciation, but rather reflects adjustments solely to drive the reserve to higher levels. Such an approach is not consistent with setting just and reasonable depreciation rates. Nor does this Company proposal look out for customer interests. Instead, the likely outcome is that FPL shareholders will report 12.50% equity returns each month and ratepayers will pay for this through a $1.48 billion increase in rate base.

Q. DO YOU HAVE ADDITIONAL CONCERNS WITH THE RSAM AS PROPOSED BY FPL?

A. Yes, I do. FPL is asking the Commission to approve the RSAM in the amount of $1.48 billion to be available to FPL for the 2022 through 2025 period or **until the next base rate change.**[72] The RSAM has allowed FPL to manage its earnings in a way that has allowed it to

[71] See Direct Testimony Witness Ferguson at page 14, lines 13 – 21, also see Exhibit KF-3(B).
[72] Direct Testimony Witness Barrett at page 66 lines 11 through line 14.

stay out for five years while earning at the top of its range. FPL may in fact delay the next rate increase and stay out longer given the enormous amount of revenue increase in this case and the substantial likelihood that the test year forecasts of sales and economic recovery are understated. If FPL has the RSAM mechanism that would allow them to manage their earnings level to keep them in the range without a termination point like in a Settlement, this could unintentionally limit the Commission and other parties ability to review FPL's rates in the future by creating a self-regulating mechanism. This could happen since rate proceedings are generally triggered because the Company is either over-earning or under-earning outside the Commission approved range. If the earnings are managed within the range, then no review would be triggered. The Commission should reject any mechanism where it could thwart the Commission's exercise of an adequate level of economic oversight that can be exercised using the context of a traditional rate case proceeding.

Q. HAVE YOU CONSIDERED AN ALTERNATIVE RESERVE AMOUNT AND AN ALTERNATIVE RESERVE TREATMENT BALANCING THE INTERESTS OF FPL'S CUSTOMERS?

A. Yes, OPC depreciation Witness Ms. McCullar calculated a Theoretical Reserve based on her depreciation recommendations. Witness McCullar's Theoretical Reserve analysis showing a Theoretical Reserve of $638 million. While the OPC calculated reserve is much smaller than FPL's $1.480 billion, the OPC reserve reflects the reality of sound depreciation practices. OPC employs the Theoretical Reserve as part of the remaining life depreciation rate calculation. For these reasons the OPC proposed reserve should be recognized by the Commission**.**

SECTION VI: THE FPL SURPLUS EQUITY RETURN INFLATOR (INCENTIVE ROE)

Q. PLEASE DESCRIBE THE IMPACT OF THE FPL PROPOSED SURPLUS ROE INFLATOR.

A. In this case Witness Barrett describes FPL Witness Coyne's ROE recommendation of 11.0% as "appropriate considering FPL's unique risk profile and the Company's commitment to a strong financial position . . ."[73] Then in the very next page Witness Barrett argues an 11.0% equity return is not enough and proceeds to argue for a 50-basis point adder (11.50% ROE) which he calls a "ROE Performance Incentive."[74] Mr. Barrett claims the 50-basis point equity return inflator is to compensate FPL for the Company's "superior value proposition" for customers and as an incentive to promote further efforts to improve the "customer value proposition."[75] Mr. Barrett is asking that the Commission to consider past performance as the basis for awarding the 50 basis point surplus ROE inflator.[76] Witness Barrett claims that "[a]cross almost every metric, FPL stands among the best in the industry delivering value for its customers . . .'[77]

Among the metrics described by Mr. Barrett are non-fuel O&M expenses, lower base rate revenue requirements associated with lower O&M expenses.[78] Mr. Barrett describes how FPL's fossil fuel heat rate is more than 30% better than the industry then

[73] Witness Barrett Direct Testimony at page 48, lines 7 -9.
[74] Witness Barrett Direct Testimony at page 49.
[75] Witness Barrett Direct Testimony at page 49, lines 5 - 7.
[76] Witness Barrett Direct Testimony at page 49, lines 13 – 23.
[77] Witness Barrett Direct Testimony at page 49, 16 - 18.
[78] Witness Barrett Direct Testimony at page 50, lines 13 – 21.

he goes on to tout FPL's reliability performance relative to the industry.[79] Mr. Barrett goes on to boast about FPL's emissions profile and avoided fuel costs along with additional awards received by FPL[80]

Mr. Barrett would have this Commission believe that the decisions made by FPL were always correct and always led to superb customer results and cost savings. Further, performance since the last settlement should be outstanding given the advantages FPL had during this period. Mr. Barrett fails to mention that during the period 2018 through the present, customers have been paying rates based on a 35% federal income tax rate rather than the statutory 21% tax rate as a result of the Tax Cut and Jobs Act of 2017 ("TCJA"). Rather, than lower income taxes by the 40% statutory decrease (35% to 21%) like most all utility operations across the country, FPL enjoyed these amounts as added profits at the expense of consumers. These excess tax earnings combined with the ability to alter monthly earnings through the RSAM provided the Company substantial opportunity to perform well financially. It is no wonder FPL has been a strong financial performer, after receiving many millions of pure profit enhancements FPL would be imprudent if it were not a financially strong utility.

Other items left out of Mr. Barrett's testimony are the poor decisions made by FPL that other parties had to challenge and the Florida Courts had to stop from going forward. For example, in Docket No. 140001 FPL proposed the "Woodford Project" a speculative investment in an Oklahoma gas reserve. While the Woodford project would have guaranteed profits to shareholders, customers would have been on the

[79] Witness Barrett Direct Testimony at page 51, lines 5 – 8, and page 52, lines 4 – 7.
[80] Witness Barrett Direct Testimony at page 52, lines 4 – 21.

hook for substantial costs in the hundreds of millions.[81] Ultimately, the Florida Supreme Court stopped this project.

Another costly practice by FPL was gas hedging. FPL lost billions that consumers ultimately paid in higher fuel costs, but this is never mentioned in Mr. Barrett's testimony. The bottom-line is that FPL does not always make the correct decision and FPL certainly doesn't always lower consumer costs. I have already pointed out in this case that FPL proposes an RSAM mechanism that is designed to enhance profits, but only after increasing consumer cost obligations by about $1.48 billion. These actions do not deserve a profit enhancement.

Q. DO YOU AGREE WITH FPL'S ARGUMENTS AND JUSTIFICATIONS FOR A SURPLUS EQUITY RETURN INFLATOR GIVEN FPL'S PAST PERFORMANCE?

A. No. Even accepting FPL's claims as totally accurate, which they are not, exceptional service should be the norm not something worthy of expanded profits. For example, customers settled the last rate proceeding and with FPL's settlement mechanisms like the RSAM and the retention of hundreds of millions of excess taxes it would be very difficult for FPL to perform poorly. Customers provided FPL every opportunity to succeed now FPL seeks to take added profits for the success that was handed to the Company.

Moreover, past rates did not contain terms and conditions that exceptional performance by FPL will lead to higher rates and shareholder profits in the future. Customers paid the legal tariff rate and that should be the end of the customer

[81] FPL's gas price forecast in the Woodford case was woefully overstated, leaving customers' rather than gas savings.to pay the Woodford costs.

obligations. FPL's historical management met the regulatory expectation of prudent management. If FPL wishes to deem prudent management as exceptional service, so be it, but that doesn't make FPL's performance worthy of added profits.

Customers pay through rates millions for FPL's capital investment. The efficient heat rate projects are paid for by customers. The FPL generation, transmission, and distribution infrastructure cost billions to build, millions to operate and maintain - all paid by customers through rates. Reliability and other efficiencies resulting from the electric infrastructure have been paid for by customers.

Mr. Barrett goes on to state that all utilities have access to the same technology, and access to the capital markets, but the human capital differentiates superior performance from average performance.[82] I agree the human capital and the leadership from the organization make a difference in the corporate culture and firm success. What Mr. Barrett fails to address is that the human capital FPL management and employees receive bonuses and other financial benefits through compensation packages paid by customers. Giving an added 50 basis points to shareholder returns will not change that fact or facilitate added success.

Q. WHAT IS THE ANNUAL REVENUE REQUIREMENT IMPACT OF THE FPL REQUESTED EQUITY RETURN SURPLUS INFLATOR?

A. The impact is substantial as I demonstrate in the following table. A 50-basis point reduction in equity return from the 11.50% request to 11.0% results in about a $183 million annual revenue requirement reduction. Given that FPL has proposed a four-

[82] FPL Witness Barrett Direct Testimony at page 49, lines 16 – 23.

year rate plan the FPL proposal costs customers about $732.1 million ($183,027 * 4 years). This equity return inflator or bonus proposal is an excessive over-reach by FPL.

In summary FPL's 50-basis point ROE inflator request should be rejected. FPL staff receive annual performance bonus and other benefits as part of the compensation package. FPL customers pay through rates for all costs that have led to efficiencies on the system.

Q. IS FPL REQUESTING OTHER INCENTIVE COMENSATION IN THIS CASE?

A. Yes. I described above the 50-basis point incentive request which would cost customers about $183,027,000 per year in added revenue requirements. Also, I already described how FPL proposes an RSAM mechanism which if historical practices are a guide would result in another 100 – basis points of equity return. The potential estimated cost of this incentive is about $370,000,000 in increased rate base investment to consumers per year.[83] Then we have FPL Witness Forrest's proposal to continue the Economy Sales, Economy Purchase Savings, Natural Gas Optimization, and Other Incentive Mechanisms.[84] This mechanism has provided FPL about $7.5 million annually.[85] These three requested mechanisms alone cost consumers about $560.5 million in revenues.[86]

[83] Calculated as $1.480 billion/ 4 years = $370 million per year as added rate base which is ultimately included in future rates.
[84] FPL Witness Forrest Direct Testimony at Exhibit SAF-1, page 1 of 1.
[85] FPL Witness Forrest Direct Testimony at Exhibit SAF-1, page 1 of 1.
[86] It should be noted that the RSAM costs are future costs.

It is my understanding that FPL employees (what Mr. Barrett calls human capital) have about $100 million of annual incentive compensation built in the proposed rates. So, it would appear FPL is requesting something on the order of $660.5 million of annual incentive compensation costs. This obviously translates into $2.642 billion over the four-year rate plan. This ROE Inflator by any measure or metric is an over-reach that must be denied.

SECTION VII: FPL FINANCIAL INTEGRITY AND CREDIT RATING METRICS

Q. WHAT IS THE SIGNIFICANCE OF FINANCIAL INTEGRITY AND CREDIT RATING METRICS?

A. Financial integrity is essential for creditworthiness. More specifically, credit ratings and underlying credit metrics are necessary measures and determinants of creditworthiness of a Company's debt borrowing. The Company's creditworthiness, as reflected in credit ratings, will directly affect the Company's ability to attract capital at reasonable a cost and prevailing market conditions. The lower the credit rating, the higher will be the associated cost of borrowing. Customers in the end pay these higher costs in rates. Rating agencies ultimately evaluate a specific firm's cash flows and overall credit metrics and ultimately assign a credit rating to each specific company. In evaluating the specific credit rating to assign a company these rating agencies ultimately evaluate a company's ability to pay the contractual interest on borrowings and ultimately the principal balance of the borrowing when due.

Q. WHAT RATING AGENCIES RATE FPL'S DEBT?

A. FPL's debt is rated by the three main rating agencies; Standard & Poor's ("S&P"), Moody's Investor Services ("Moody's"), and Fitch Ratings ("Fitch"). The final determination and assignment of a credit rating by these rating agencies is premised on several credit metrics that evaluate cash flow and amount of leverage and interest obligations. These leverage and interest obligations consist of direct contractual requirements and imputed amounts based on leases and/or purchase power obligations.

Q. WHAT ARE FPL'S CURRENT CREDIT RATINGS?

A. The credit ratings of FPL and NextEra are outline in the following Table 4.

Table 4
Credit Ratings FPL & NextEra

	FPL			NextEra		
	S&P[87]	Moody's[88]	Fitch[89]	S&P[90]	Moody's[91]	Fitch[92]
Credit Rating	A	A1	A	A-	Baa1	A-
Outlook	STABLE	STABLE	STABLE	STABLE	STABLE	STABLE

All these credit ratings are well above the minimum for investment grade (where investment grade is above Baa3 for Moody's or BBB- for S&P or Fitch) and this allows the Company to access capital markets on reasonable terms. FPL ratings are consistently above NextEra ratings by at least one ratings notch and in the case of Moody's, three ratings notches. Maintaining investment grade rating is most important given most institutional investors (such as many banks, insurance companies, pension funds, endowments, mutual funds, or other institutions) are not permitted to invest in non-investment grade securities.

[87] S&P 1/15/21.
[88] Moody's 8/25/20.
[89] Fitch 12/22/20.
[90] S&P 1/26/21.
[91] Moody's 1/26/21.
[92] Fitch 12/20/20.

Q. WHAT FACTORS DO THE CREDIT RATING AGENCIES CONSIDER TO ESTABLISH A COMPANY'S CREDIT RATING?

A. Credit rating agencies base credit ratings on a number of qualitative and quantitative factors. For a utility company one major qualitative factor is the quality of the regulatory environment including the ability to earn the authorized returns. Quantitative considerations typically address cash flow and leverage financial metrics. Generally, the three main rating agencies employ similar quantitative evaluations, but all three have subtle differences in calculating cash flow metrics. A primary consideration by all rating agencies is the assessment and evaluation of a company's ability to pay interest and principal obligations in a timely manner. Also, the amount of margin available in these payments is an important consideration.

Q. WHAT DO THE CURRENT RATING AGENCY CREDIT REPORTS CONCLUDE WITH REGARD TO FPL'S RISKS AND CREDIT QUALITY?

A. An early 2021 credit report from S&P states the following with regard to FPL;

i. We believe there is a strong economic basis for NEE to preserve FPL's credit strength reflecting FPL's low-risk, profitable, and regulated business model FPL is also a significant portion of NEE, reflecting more than 60% of the consolidated company's EBITDA.[93]

ii. S&P Global Ratings' stable outlook on FPL is consistent with its stable outlook on parent NEE and its expectations that FPL's stand-alone financial measures will not materially weaken.[94]

Similarly, the Fitch Ratings of FPL stated the following:

iii. Fitch does not expect the coronavirus pandemic to have a material impact on FPL's operations and access to capital. Fitch pointed out that FPL's uncollectible expenses could rise but should remain manageable

[93] S&P 1/15/21 at page 3.
[94] S&P 1/15/21 at page 3.

pointing out that during the 2008 - 2009 financial crisis uncollectible revenues as a percentage of revenues were approximately 0.2%.[95]

iv. Fitch forecast of FPL's credit metrics estimates the Company's credit metrics remaining robust over the 2020 – 2022 period. Fitch expects the Company's Funds From Operations (FFO) relative to leverage to be in the 2.9x to 3.2x range and FFO to interest to be in the 8.5x to 9.0x range.[96]

Overall, FPL is viewed by rating agencies as strong financially operating in a favorable regulatory environment

Q. IN YOUR OPINION WILL FPL MAINTAIN A STRONG AND FAVORABLE CREDIT RATING UNDER THE ALTERNATIVE CAPITAL STRUCTURE AND CAPITAL COST RECOMMENDATIONS IN THIS CASE?

A. Yes. I evaluated FPL financial metrics under the OPC ROE 8.75% recommendation along with a 55%/45% equity debt capital structure. As expected, FPL's financial metrics decline under the OPC proposal, but the reduction in the cash flow metrics does not impair the Company's financial integrity. For example, FPL collects substantial revenues under clause mechanisms, the collection of these revenues are not impacted by FPL financials. The remaining revenues provide sufficient cash flows to maintain FPL's financials. I have included these financial metric calculations in my attached Schedule (DJL-3).

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

[95] See Fitch Ratings Florida Power & Light Company at page 1 (December 22, 2020).
[96] See Fitch Ratings Florida Power & Light Company at page 2 (December 22, 2020).

(Whereupon, prefiled direct testimony of Ralph Smith was inserted.)

DIRECT TESTIMONY

OF

RALPH SMITH

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 20210015-EI

I. INTRODUCTION

Q. WHAT IS YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS?

A. My name is Ralph Smith. I am a Certified Public Accountant licensed in the State of Michigan and a senior regulatory consultant at the firm Larkin & Associates, PLLC, Certified Public Accountants, with offices at 15728 Farmington Road, Livonia, Michigan, 48154.

Q. PLEASE DESCRIBE THE FIRM LARKIN & ASSOCIATES, PLLC.

A. Larkin & Associates, PLLC, ("Larkin") is a Certified Public Accounting and Regulatory Consulting Firm. The firm performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorneys general, etc.). Larkin has extensive experience in the utility regulatory field as expert witnesses in over 600 regulatory proceedings, including numerous electric, water and wastewater, gas and telephone utility cases.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION?

A. Yes, I have testified before the Florida Public Service Commission ("FPSC" or "Commission") previously. I have also testified before several other state regulatory commissions.

Q. HAVE YOU PREPARED AN EXHIBIT DESCRIBING YOUR QUALIFICATIONS AND EXPERIENCE?

A. Yes. I have attached Exhibit RCS-1, which is a summary of my regulatory experience and qualifications.

Q. ON WHOSE BEHALF ARE YOU APPEARING?

A. Larkin & Associates, PLLC, was retained by the Florida Office of Public Counsel ("OPC") to review the rate request of Florida Power & Light Company ("FPL" or "Company"). Accordingly, I am appearing on behalf of the Citizens of the State of Florida ("Citizens").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I am presenting OPC's overall recommended revenue requirement in this case. I also sponsor some of the OPC's recommended adjustments to the Company's proposed rate base and operating income.

Q. WHAT EXHIBITS HAVE YOU ATTACHED TO YOUR TESTIMONY?

A. I have attached the following exhibits:

RCS-1, Qualifications Appendix
RCS-2, Revenue Requirement and Adjustment Schedules for 2022 Test Year
RCS-3, Revenue Requirement and Adjustment Schedules for 2022 Subsequent Year
RCS-4, Demonstration of the Lack of Need for a Reserve Surplus Amortization Mechanism Excluding Storm Write-Off.
RCS-5, Florida Power and Light Company Earned Return on Equity History

Q. ARE ANY ADDITIONAL WITNESSES APPEARING ON BEHALF OF THE FLORIDA OFFICE OF PUBLIC COUNSEL IN THIS CASE?

A. Yes. Roxie McCullar addresses FPL's request for new depreciation and amortization rates. William Dunkel addresses FPL's dismantlement cost. Kevin O'Donnell's testimony addresses the appropriate capital structure for purposes of determining the revenue requirement of FPL in this case and FPL's proposed asset optimization incentive mechanism. Dr. Randall Woolridge presents Citizens' recommended return on equity ("ROE") in this case based on OPC's recommended capital structure and in the event the Commission adopts FPL's proposed capital structure. Daniel Lawton addresses FPL's request for Commission adoption of prior settlement provisions such as the Reserve Surplus Amortization Mechanism ("RSAM") and ROE inflator.

Q. AS A PRELIMINARY MATTER, FPL HAS PROPOSED WHAT IT EFFECTIVELY CALLS A FOUR-YEAR PLAN THAT HAS SEVERAL ELEMENTS THAT FPL HAS CHARACTERIZED AS ESSENTIAL TO ANY COMMITMENT THAT IT WILL MAKE TO NOT FILE FOR ADDITIONAL GENERAL BASE RATE RELIEF DURING THE 2022-2025 FOUR-YEAR

PERIOD. HOW ARE YOU TREATING THIS ASPECT OF THE COMPANY'S FILING IN THIS CASE?

A. I am effectively disregarding it. I am addressing this case as a conventional rate case that is based on my understanding that across the country and in Florida regulatory commissions are required to established cost-based rates. To the extent that the proposed FPL rate plan has as a fundamental core element -- the Reserve Surplus Amortization Mechanism ("RSAM") -- I believe that the rate plan would not constitute cost-based ratemaking if ordered by the Commission. I discuss the RSAM as a threshold issue and have concluded that it is bad regulatory policy and should be rejected.

Accordingly, throughout my testimony my adjustments and policy recommendations are based on FPL's case on a non-RSAM basis.

II. RESERVE SURPLUS AMORTIZATION MECHANISM

Q. WHAT HAS FPL PROPOSED FOR A DEPRECIATION RESERVE SURPLUS AMORTIZATION MECHANISM ("RSAM")?

A. FPL's RSAM proposal is summarized on Exhibit REB-11 and various aspects of the Company's RSAM proposal are sprinkled throughout in the Direct Testimony of a number of the Company's witnesses.

Q. **HOW HAS FPL UTILIZED THE RSAM SINCE THE FUNCTIONAL EQUIVALENT OF IT WAS FIRST ESTABLISHED IN 2010?**

A. Since an RSAM was first implemented in November of 2010 and continuing through today FPL used it with one minor exception to effectively earn as if its rates had been set at or very near the top of the maximum point in the range of reasonableness. Together, Exhibits

RCS-4 and RCS-5 attached to my testimony presents a summary of FPL's earned ROE history.

Q. HOW HAS THE RSAM FUNCTIONED IN THE FOUR-YEAR PLUS PERIOD (2017 THROUGH MARCH 2021)?

A. The RSAM has functioned in a manner to enable the Company to target and "manage" its earnings to achieve earnings above the mid-point in every month of the 2017 through 2021 (year-to-date) four-year plus period and at or near the high end of the allowed earnings range in several months, as reported on the Company's ESRs.

Q. WHAT IS THE NORMAL FUNCTION OF A UTILITY'S DEPRECIATION RESERVE SURPLUS?

A. As explained in the testimony of Witnesses Dunkel and McCullar, the normal function of a depreciation reserve surplus is to reduce prospective depreciation rates that are determined under the remaining life method. In the remaining life method, the numerator is: Plant – Accumulated Depreciation +/- Net Salvage. The denominator is the estimated remaining years of useful life. Thus, the higher the amount in Accumulated Depreciation, including any portion of the Accumulated Depreciation balance that is determined to be surplus, reduces future depreciation accruals. authorized depreciation rates and reflecting depreciation expense for a regulated public utility using the remaining life method effectively matches the recovery of the cost of the consumption of the assets (plus or minus net salvage) over time with those who benefit from the service provided by the assets. This is consistent with cost-based ratemaking.

Q. IS THAT HOW FPL HAS BEEN USING THE DEPRECIATION RESERVE SURPLUS?

A. No. Instead of using the portion of the Accumulated Depreciation balance that is determined to be surplus to reduce future depreciation accruals, FPL has been using that surplus to "manage" its earnings, enabling the Company to earn above the mid-point of its return range for every month during the four-year period 2017 through 2020 as well as in the months of January through March 2021, and to earn at or near the very high-end of its authorized earnings range in several months during that period. This is not a "normal" application of a utility depreciation reserve surplus, nor, as Witness McCullar explains, is it consistent with established utility industry definitions applicable to depreciation.

Q. WHAT HAVE YOU DETERMINED FROM YOUR REVIEW OF THE COMPANY'S REQUEST TO CONTINUE UTILIZATION OF THE RESERVE SURPLUS AMORTIZATION MECHANISM?

A. The RSAM is not required. The mechanism is simply a tool for the Company to be able to adjust its earnings to reflect a level of desired earnings. It has historically been used by the Company to achieve earnings results at or near the top end of the ROE range instead of the ROE mid-point. To evaluate the necessity of the RSAM, the application of amounts from the reserve surplus and the impact on the Company's earnings during the four calendar years 2017 through 2020, along with the first three months of 2021, were analyzed. The analysis is reflected on Exhibit RCS-4.

Q. WHAT IS THE BASIS FOR YOUR STATEMENT THAT THE COMPANY WAS ABLE TO ADJUST ITS EARNINGS TO REFLECT A DESIRED LEVEL OF EARNINGS?

A. This concept was allowed in paragraph 12 of the 2016 settlement agreement found in Order No. PSC-2016-0560 at p. 25 where:

> the amounts to be amortized in each year of the Term [were] left to FPL's discretion subject to the following conditions: (i) the amount that FPL may amortize during the Term shall not be less than the actual amount of depreciation reserve surplus remaining at the end of 2016; (ii) for any surveillance reports submitted by FPL during the Minimum Term on which its ROE (measured on an FPSC actual, adjusted basis) would otherwise fall below 9.6%, FPL must amortize at least the amount of the available Reserve Amount necessary to maintain in each such 12-month period an ROE of at least 9.6% (measured on an FPSC actual, adjusted basis); and (iii) FPL may not amortize the Reserve Amount in an amount that results in FPL achieving an ROE greater than 11.6% (measured on an FPSC actual, adjusted basis) in any such 12-month period as measured by surveillance reports submitted by FPL.

I do not dispute that FPL (apart from apparent excess earnings above the top of the range) was within its right to manage its achieved earnings to show these very high returns as provided by a negotiated agreement; however, as discussed below, this past practice of using a depreciation reserve surplus to manage earnings results should not continue.

Q. WOULD YOU EXPLAIN THE PURPOSE UNDERLYING YOUR ANALYSIS?

A. Yes. The overall purpose of the analysis is to demonstrate that there has been no ratemaking need for use of the depreciation reserve surplus under the current settlement agreement. The analysis looks at FPL's use of the depreciation reserve surplus in relation to achieved earnings measured against the ratesetting mid-point of 10.55%. This approach is conservative since it does not look at what is needed to keep the company above the bottom of the range of reasonableness. Such an analysis would likely be more appropriate as it would ensure that the Company was not in jeopardy of earning below the range of reasonableness and in need of filing a rate case. FPL's primary RSAM Witness Barrett has

testified in this case that anywhere within the Commission-established range is reasonable.[1]

Q. PLEASE DESCRIBE YOUR ANALYSIS.

A. First, the starting point for the analysis is the Company's own reporting in the Earnings Surveillance Report ("ESR") and presents the credit balance of the reserve surplus as a positive amount. The Company's reported achieved ROE from its ESRs is shown in column A of Exhibit RCS-4.

The activity affecting the depreciation reserve surplus, as reported by the Company in its ESRs, is shown in column B. The negative amounts in column B represent debits (or charges) against the depreciation reserve, showing how the Company tapped the reserve and increased rate base to keep its earnings at or near the top end of the ROE range. The positive amounts in column B, as reported in the Company's ESRs, show increases to the reserve surplus associated with the Company having calculated earnings that would otherwise have been above the top end of the earnings band.

The information in columns A, B, G, H, I, J and K are from FPL's Earnings Surveillance Reports.

Column C reflects OPC's analytical adjustments to reverse the debits to the depreciation reserve that were made by FPL to increase the Company's achieved net operating income to reflect a higher rate of return in those various respective ESR reports

[1] June 11, 2021 deposition of Robert A. Barrett at 49-50.

where the return was below the Company's predetermined target level but above the mid-point.

Column D reflects the OPC's adjusted reserve balance (for analytical purposes) based on the beginning balance and adjusted to illustrate the effect of excess earnings in months where the actual earnings exceeded the Company's predetermined target ROE or the high point of the earnings range. When FPL's earnings for the 12-month period reported on the Company's ESRs were above the Company's predetermined target ROE or high end of the earnings range, column D shows how the depreciation reserve surplus would be adjusted by FPL to limit earnings by debiting depreciation expense and crediting the depreciation reserve such that the earnings were limited to no more than the Company's predetermined target ROE or the top of the earnings range. No analytical adjustment was made for these amounts that were reported on the Company's ESRs as being restored to the reserve in order to account for and effectively limit earnings that were above the predetermined target ROE or top-end of the earnings range to the top end of the range.

For analytical purposes, Column E adjusts the illustrative excess earnings (above the Company's predetermined target or 11.6%) amount out of the reserve.

Column F is the result that shows that the reserve excess was not required to meet the rate-setting point of 10.55% ROE for the calendar years 2017 through 2020 and for the first three months of 2021. As mentioned above, columns G, H, I, J and K, each present information as reported by FPL in its ESRs.

L shows the net-of-tax adjusted earnings results, based on the analytical adjustments described above.

Columns M, N and O indicate by "yes" or "no" whether the adjusted earnings results shown in column L were (1) above the midpoint return (listed in column J), (2) below the midpoint return, or (3) above the high-point return (i.e., the return maximum listed in column K), respectively.

Q. WHAT DOES YOUR ANALYSIS SHOW WITH RESPECT TO THE ADJUSTED ACHIEVED RETURNS AS IT RELATED TO THE MID-POINT (OR RATE-SETTING POINT)?

A. Simply put, FPL did not need to tap into the depreciation reserve excess to reach the rate-setting mid-point of its allowed return. This phenomenon is shown on Exhibit RCS-4 in Columns L-O which illustrate the lack of need for the reserve. Column L shows the calculated rate of return related to each ESR period, had the reserve excess not been utilized for the indicated periods. Using the net-of-tax OPC-adjusted achieved earnings in column L and comparing that adjusted return with the mid-point and high-end allowed returns from the Company's ESRs that are shown in columns J and K, columns M, N and O summarize, respectively, for each period whether the adjusted achieved return is over the mid-point, under the mid-point, or over the high-end return level. These columns show that during the years 2017 through 2020 (and January through March 2021) FPL's earnings without using the reserve always exceeded the mid-point rate of return, and in several months, FPL exceeded its high point of rate of return.

Because during the four-year period 2017 through 2020 the Company's rate of return was never less than the midpoint return without using the reserve, there is no defensible need for the depreciation reserve surplus to be utilized to adjust earnings. The reserve was almost exclusively used to maximize shareholder returns in the form of earnings above the rate-setting mid-point, boosting the earnings up to or near the high point.

Q. WOULD YOU PROVIDE AN EXPLANATION OF HOW THE ADJUSTMENTS YOU MADE IMPACTED THE RATE OF RETURN IN VARIOUS MONTHS?

A. Yes. As shown on Exhibit RCS-4, line 4, the Company charged the reserve $125,223,511 and in turn credited pre-tax income by that amount in order to increase its earned rate of return for the twelve-month period reported on its ESR for January 2017. This accounting treatment, as it is called, is explained on page 60, lines 1-8 of the Direct Testimony of Witness. Barrett.

This use by the Company of the $125,223,511 amount from the reserve surplus resulted in a rate of return on rate base of 6.60% being reported on the Company's ESR (as shown on line 4, in column I) and an ROE of 11.5% (as shown in column A).[2]

The OPC analysis shown on Exhibit RCS-4, on line 4, reverses the Company's $125,223,511 reserve excess amount in column C. The resulting rate of return on rate base is reflected in column L. The achieved rate of return on rate base absent the Company adjustment is 6.35% as shown on line 4, in column L. The actual achieved return on rate base of 6.35% exceeds the 6.17% midpoint return on rate base as reported by FPL in its

[2] In deposition testimony, FPL witnesses Ferguson and Barrett confirmed that this was the pre-established target ROE for 2017. June 7, 2021 Deposition of Keith Ferguson at pp. 40-41; June 11, 2021 Deposition of Robert A. Barrett at pp. 81-82.

ESR. This shows that no adjustment to net operating income was needed to maintain a healthy achieved return at the rate-setting point of 10.55%.

Q. IF THE ACTUAL RETURN EXCEEDED THE MIDPOINT RETURN ON RATE BASE, THEN WHY WOULD AN ADJUSTMENT HAVE BEEN MADE BY FPL?

A. The Company's predetermined target rate of return was either at or as close as possible to the high point of the allowed range of the rate of return on rate base. In other words, the Company's predetermined target earnings were not at the midpoint, but were instead at the high point. FPL has admitted that they use the RSAM to achieve the ROE target.[3] Column A of Exhibit RCS-4, which reproduces the achieved ROEs shown on FPL's ESRs, shows that the Company achieved this goal almost all of the time in terms of the ROE component of the achieved return. As shown on line 4, in the specific example from the Company's January 2017 ESR, the adjusted achieved of 6.60% (shown in column I) is close to the maximum return of 6.65% (shown in column J).

Q. WHY IS USING THE DEPRECIATION RESERVE SURPLUS TO MAKE ADJUSTMENTS TO THE COMPANY'S EARNINGS AN ISSUE?

A. A utility is allowed the opportunity to earn a level of earnings when rates are established, not a guaranteed return. By allowing the Company to adjust earnings upward when actual earnings already exceed both the low point and the midpoint of the earnings range is essentially allowing the Company to reflect a guaranteed level of return. This maneuver, were it not part of the give-and-take of a settlement agreement, would otherwise appear to

[3] June 11, 2021 Deposition testimony of Robert Barrett at p. 43 and June 7, 2021 Deposition testimony of Keith Ferguson at p.84

clearly violate the basic principle of rate making established in *Hope* and *Bluefield.*[4] The earnings range set by the Commission around the rate-setting mid-point is the established fair, just and reasonable return; therefore, no adjustment should be needed when actual earnings fall within this range. My point is that, while I recognize that reflecting achieved earnings consistently at or near the top of the range was allowed under the language of the current settlement, the application of an RSAM is not needed under circumstances where the Commission itself establishes cost-based rates for a utility in a rate case.

Q. PLEASE EXPLAIN THE ADJUSTMENTS IN COLUMN C FOR CREDITS TO THE RESERVE?

A. Credits to the depreciation reserve surplus, which increase the available surplus amount, are made by FPL because the Company's earnings for the period reported in its ESRs have exceeded the high point of the allowed return range that was established by the Commission. By crediting (i.e., increasing) the depreciation reserve surplus, the Company is keeping the reported and adjusted achieved return at or near the high point of the return range, which reduces the possible requirement to return the excess earnings to ratepayers. As an illustrative example, as shown on Exhibit RCS-4, line 7, column L, the April 2017 ESR adjusted actual earnings were 6.65% which exceeds the allowed high point of 6.64% (listed in column M). As shown by the "yes" in column O, for several of the 12-month periods covered in the Company's ESRs, the achieved return exceeded the top end of the allowed return range.

[4] *Bluefield Water Works and Improvement Co. v. Public Service Comm'n*. 262 U.S. 679 (1923); and the *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Q. ARE THERE ANY EXCEPTIONS IN YOUR ANALYSIS IN RECALCULATING THE ACTUAL ACHIEVED RETURN AS SHOWN IN COLUMN L?

A. Yes. In December 2017, the reserve was charged with costs associated with Hurricane Irma. The $1,148,303,252 charge was limited to the balance in the depreciation reserve surplus at the time. FPL reported an achieved (and exceptionally healthy) ROE of 11.08% and a rate base return for 2017 of 6.32% (as shown in on Exhibit RCS-4, column I, on line 15) that was well above the midpoint return of 6.09% (which is shown in column J). This achieved result was not adjusted even though the charge to the depreciation reserve surplus for that storm was reversed in this analysis since the achieved return was well above the rate-setting mid-point. The cost incurred for Hurricane Irma could have been recovered through a surcharge or by applying the income tax savings that the Company has been realizing from TCJA impacts that was largely credited to the depreciation reserve surplus. The analysis assumed that the storm costs that the Company incurred for Hurricane Irma and other storms would be recovered from customers from one of the above-noted methods, and not charged against the depreciation reserve surplus, so there should not have been any impact on the net operating income number in the calculation of the return for the year 2017 and there would have been no need to charge the reserve surplus the $1.148 billion amount.

Q. IN YOUR OPINION BASED ON YOUR EXPERIENCE, IS CHARGING A DEPRECIATION RESERVE AN APPROPRIATE METHOD TO "PAY" FOR HURRICANE RECOVERY COSTS?

A. No. I think FPL said it best in 2009 when it argued against such accounting gimmicks when they:

> [A]rgued that a short amortization of the reserve surplus would have "the direct and unavoidable effect of rapidly increasing rate base, the required return on rate base, and future depreciation expense - all of which will have to be borne by future customers."

Order No. PSC-2010-0153-EI at p. 81. This is an accurate description of the "mortgaging" of the future by using the depreciation reserve to pay for costs for which current customers have historically been responsible. Charging hurricane recovery costs to the depreciation reserve should not be allowed in the future. Discontinuing the use of earnings-enhancing depreciation reserve surplus mechanisms in the future will help ensure that this does not happen again.

Q. WHY DID YOUR ANALYSIS REVERSE THE CREDIT TO THE RESERVE IN COLUMN E?

A. The reversal is done because while overearning may have been reported in the monthly reports during the year, it is my understanding of the ESR process that the end of the calendar year (December) result is the ultimate determinate as to whether the company is overearning. Excess earnings must be recorded as credits to the reserve or otherwise disposed of at least on a calendar year basis. For example, for the calendar year 2017, the actual calculated achieved return was 6.32%, as shown in column L, on line 15.[5] That is below the high end of the earnings range of 6.56% for calendar year 2017 (shown on line 15, in column K), so the depreciation reserve surplus balance would not be increased for the 2017 calendar year results. Since the actual calendar 2017 earnings are within the allowed range, an upward adjustment to 2017 earnings, such as by applying amounts from the depreciation reserve surplus, was not necessary. Thus, after excluding the impact related to applying the depreciation reserve surplus amounts in 2017 to Hurricane Irma

[5] The 6.32% earned return for 2017 is also shown on line 15 in column I as the return reported by FPL on its ESR.

costs, the 2017 earnings would be within the allowed earnings range, and the reserve surplus would not be neither drawn down nor increased, based on the 2017 results.

As shown on Exhibit RCS-4, the circumstances are different for calendar 2018 when the Company's actual achieved return of 6.90% (shown in column L, on line 29) exceeded the high point the allowed earnings range of 6.70% (from FPL's ESR, as shown on Exhibit RCS-4, on line 29, in column K). Based on the calendar year 2018, the reserve would require a credit adjustment, increasing the reserve, to account for the 0.20% difference represented by the 2018 earnings above the top end of the authorized earnings range.[6]

Q. WHAT CONCLUSIONS DO YOU REACH FROM THIS ANALYSIS?

A. The analysis shown on Exhibit RCS-4 demonstrates that while allowed for the years 2010 through 2020, the access to the Depreciation Reserve Surplus amounts was not needed for any purpose other than to allow FPL to reflect earnings at or close to the top of the ROE range. Exhibit RCS-5 shows that as far back as 2010, FPL's track record has been to utilize the Reserve Surplus Amount and similar RSAMs to accomplish the same type of earnings result. In my opinion**,** the RSAM has been used to enrich FPL's shareholders at the expense of future customers. Over the past 11 years FPL has used calculated reserve surplus amounts to consistently achieve earnings at or very near the top of the authorized range.

[6] While the amounts further demonstrate the lack of need to use the Reserve Amount, I have not proposed that anything can or should be done about the $98,506,091 and $86,995,377 shown on lines 31 and 45 of Schedule RCS-4, Page 1. These amounts in column F of Exhibit RCS-4 on lines 31 and 45 represent orphaned overearnings (above 11.6%) that could not be credited to the capped Reserve Amount of $1,252,100,355.

Q. IS THERE A CONCERN THAT, AS PROPOSED BY FPL IN THE CURRENT RATE CASE, THE RSAM COULD EFFECTIVELY ALLOW FPL TO EARN AT THE HIGH END OF THE COMPANY'S PROPOSED ROE RANGE?

A. Yes. Although the Company has proposed to calculate the revenue requirement for the 2022 future test year and the 2023 subsequent year using an 11.5% return on equity (and the Company's proposed capital structure, which has a common equity ratio of 59.6% as discussed in the testimony of OPC witness O'Donnell), I am advised that the 11.5% proposed by FPL would effectively be a mid-point, and the high end of the Company's proposed ROE range would be 100 basis points higher, at 12.5%. For 2022, the revenue requirement impact of 100 basis points on equity (at FPL's 59.6% equity ratio) is approximately $360 million. To the extent that that FPL is effectively asking the Commission to authorize the use of the RSAM so that the Company can achieve earnings at the top end of the Company's proposed ROE range of 12.5%, this is simply unreasonable. Given is decade-long ability to use the RSAM mechanisms to achieve earnings at or very near the top of the range, it would seem likely that the same would be true for at least the next four years if the Company's proposed RSAM in its proposed four-year plan were to be approved.

Q. WHAT IS THE OPC RECOMMENDING THE COMMISSION DO WITH AN RSAM GOING FORWARD?

A. For purposes of setting rates for 2022 and beyond, the Commission should not approve a mechanism whose sole purpose is to effectively set rates to allow the Company to earn at the top of the range.

Q. WHAT IS YOUR CONCLUSION ABOUT HOW THE RSAM PROPOSAL SHOULD BE TREATED IN A DETERMINATION OF FPL'S RATES BY THE COMMISSION IN THE CURRENT RATE CASE?

A. For purposes of setting rates for 2022 and beyond, as stated above, the Commission should reject FPL's RSAM. To the extent that there is a depreciation reserve surplus associated with the new depreciation rates that are being recommended by OPC witness McCullar, that reserve surplus should not be set aside as a means for the Company to use to target and manage its earnings to the top end of an earnings range. Rather, any depreciation reserve surplus under industry standard, cost-based remaining life depreciation practices will reduce future depreciation expense under the remaining life depreciation method, as recommended by Witness McCullar. In summary, the Company's RSAM proposal in the current case should be rejected.

III. FPL REQUESTED REVENUE INCREASES

Q. WHAT ARE THE REVENUE ADJUSTMENTS THAT THE COMPANY IS PROPOSING?

A. The Company is proposing four revenue adjustments over the 2022 through 2025 four-year period. The Company's major requests are the following: (1) a general base revenue adjustment of approximately $1.108 million effective in January 2022; (2) a subsequent year adjustment of approximately $607 million effective in January 2023 ("2023 SYA"); (3) a Solar Base Rate Adjustment ("SoBRA") mechanism that would authorize FPL to recover costs associated with the installation and operation of up to an aggregate of 1,788 megawatts ("MW") of solar generation in 2024 and 2025. As components of its four-year plan, FPL is also proposing: (4) a mechanism to address the possibility that changes to corporate tax laws might be enacted under the new presidential administration; (5) the

continuation of a form of the RSAM that was allowed as part of FPL's 2016 rate case settlement; (6) the continuation of the storm cost recovery mechanism that was approved as part of FPL's 2016 rate case settlement; (7) extension and expansion of the asset optimization incentive mechanism that was approved in the 2016 rate case settlement (8) and the authority to accelerate amortization of unprotected excess accumulated deferred income taxes ("EADIT") resulting from the 2017 Tax Cuts and Jobs Act ("TCJA").[7]

Q. FPL IS REQUESTING A BASE RATE INCREASE TO BE EFFECTIVE JANUARY 1, 2022, A SUBSEQUENT YEAR INCREASE FOR JANUARY 1, 2023, AND A SOLAR BASE RATE ADJUSTMENT MECHANISM IN 2024 AND 2025, TO RECOVER COSTS ASSOCIATED WITH THE INSTALLATION AND OPERATION OF UP TO AN AGGREGATE OF 1,788 MW. WILL YOU BE ADDRESSING EACH OF FPL'S FOUR REQUESTED INCREASES TO BASE RATES?

A. Yes. In this testimony, I first address the base rate increase that FPL has proposed to be effective January 1, 2022 ("January 2022 Base Rates"). I then address the proposed base rate adjustment for the Company's requested January 2023 Subsequent Year Increase and the Company's requested SoBRA mechanism for the recovery of costs associated with the installation and operation of up to an aggregate of 1,788 MW of new solar generation for 2024 and 2025.

Q. FPL IS ALSO REQUESTING A MECHANISM TO ADDRESS POSSIBLE CHANGES TO CORPORATE TAX LAWS THAT MAY BE ENACTED UNDER

[7] See, FPL's petition at page 2.

PRESIDENT BIDEN'S ADMINISTRATION, THE CONTINUATION OF THE RSAM, THE CONTINUATION OF THE STORM COST RECOVERY MECHANISM APPROVED AS PART OF THE COMPANY'S 2016 RATE SETTLEMENT, THE EXTENSION AND EXPANSION OF THE ASSET OPTIMIZATION INCENTIVE MECHANISM AND THE AUTHORITY TO ACCELERATE AMORTIZATION OF UNPROTECTED EADIT RESULTING FROM THE TCJA. WILL YOU BE ADDRESSING EACH OF THESE REQUESTS?

A. No. I will be addressing most, but not all of those FPL proposals. I will be addressing FPL's requested mechanism to address possible changes to corporate tax laws that may be enacted under President Biden's administration, the continuation of the RSAM as already discussed in my testimony, the continuation of the storm cost recovery mechanism approved as part of the Company's 2016 rate settlement, and the Company's requested authority to accelerate amortization of unprotected EADIT resulting from the TCJA. Another OPC witness, Mr. Kevin O'Donnell is addressing the Company's request concerning the extension and expansion of the asset optimization incentive mechanism.

IV. ORGANIZATION OF TESTIMONY

Q. HOW ARE THE DISCUSSIONS THAT ARE BEING ADDRESSED IN YOUR TESTIMONY ORGANIZED?

A. As noted above, in Section II, I have presented a threshold analysis of FPL's RSAM and demonstrate how it has been utilized by the Company to achieve adjusted earnings at or near the high end of its authorized earnings range, why it is not needed, and why its use for continued earnings manipulation purposes should be rejected prospectively in the ratemaking process. To re-cap and to emphasize this point Exhibit RCS-4 presents an

analysis of the RSAM using information from FPL's Earnings Surveillance Reports ("ESRs") for the four calendar years, 2017 through 2020, and the first three months of 2021. For the lagging 12-months reported in every single month of this period, FPL earned above the midpoint of the earnings range and in the majority of (24 out of 39) months was at or close to the extreme top end of the earnings band. As shown on Exhibit RCS-4 and RCS-5 together, for the calendar years 2010 through 2020, and 2021 (year-to-date), FPL earned at the top of the earnings band in 9 of the 11 periods. In 2013, FPL effectively earned at the 11.0% midpoint (10.96), which it had previously established as its target earning point. This was approximately $90 million below the top of the range of 11.5% for the calendar year 2013. In 2017, FPL chose to earn 11.08% instead of its target of 11.5%. For all intents and purposes FPL had the ability to achieve earnings at or near the top of the range for 11 years which demonstrates that historically the RSAM mechanisms have allowed FPL to earn at near the top of the range for the past 11 years. This practice of using a calculated depreciation reserve surplus to manipulate earnings should be discontinued.

The remainder of my testimony is organized as follows:

In Section V, I present the overall financial summary for the base rate change to be effective January 1, 2022, showing the revenue requirement excess for the 2022 test year recommended by Citizens. Exhibit RCS-2 presents the schedules and calculations in support of the 2022 base rate revenue requirement.

In Section VI, I discuss certain corrections that FPL has identified to its filing that affect the revenue requirement.

In Section VII, I then discuss my proposed adjustments which impact the January 2022 Base Rates, including how the new depreciation rates (and resulting expense) recommended by Witness McCullar and the Dismantlement expense recommended by Witness Dunkel have been reflected. Where an adjustment affects both 2022 and 2023, I discuss the impact on both projected test years in Section VII.

As an element of Section VII, I address FPL's request to accelerate amortization of unprotected EADIT resulting from the TCJA.

In Section VIII, I address the Company's proposed January 2023 Subsequent Year Increase. Within this section, I present the OPC revenue requirement recommendation associated with the 2023 increase requested by FPL. The January 2023 revenue requirement calculations and adjustments impacting these calculations are presented in Exhibit RCS-3. Put another way, Exhibit RCS-3 presents the calculations affecting the 2023 base rate revenue requirement.

In Section IX, I address the Company's request for the SoBRA rate increases for 2024 and 2025 solar generating plant additions.

In Section X, I address the Company's proposal for a mechanism to address possible changes to corporate tax laws that may be enacted before the Company's next base rate case.

In Section XI, I address the Company's proposal to continue the storm cost recovery mechanism approved as part of the Company's 2016 rate case settlement.

As noted above, my testimony does not address the asset optimization incentive mechanism, which will be addressed by Witness Kevin O'Donnell

V. OVERALL FINANCIAL SUMMARY – JANUARY 2022 BASE RATE CHANGE

Q. WHAT IS THE JANUARY 2022 BASE RATE REVENUE REQUIREMENT DEFICIENCY OR EXCESS FOR FLORIDA POWER & LIGHT COMPANY?

A. As shown on Exhibit RCS-2, Schedule A, the OPC's recommended adjustments in this case result in a recommended revenue reduction for FPL in January 2022 of approximately $70.901 million. This is $1.355 billion less than the base rate revenue increase of $1.284 billion requested by FPL in its application under the "without RSAM" alternative.[8]

Q. PLEASE DISCUSS THE EXHIBIT YOU PREPARED IN SUPPORT OF YOUR TESTIMONY AS IT PERTAINS TO THE JANUARY 2022 BASE RATE CHANGE.

A. Exhibit RCS-2, totaling 46 pages, consists of Summary Schedules A, A-1, B, B.1, C, C.1 and D and Adjustment Schedules B-1 through B-4 and C-1 through C-6.

Q. WHAT IS SHOWN ON SCHEDULE A, PAGE 1, OF EXHIBIT RCS-2?

[8] FPL has also presented a "with RSAM" alternative, under which FPL is requesting a 2022 base rate revenue increase of $1.108 billion. See the Direct Testimony of FPL Witness Bores at page 23 for a summary. The OPC is strongly recommending against continuation of an RSAM on a going-forward basis for FPL. Consequently, the OPC's base rate revenue requirement calculations are presented on the "without RSAM" basis. I address the Company's historic RSAM results and explain why it is not needed and should not be approved for continuation in Section II of my testimony.

A. Schedule A, page 1, presents the revenue requirement calculation for the January 2022 Base Rate change, giving effect to all of the adjustments I am recommending in this testimony, along with the impacts of the recommendations made by OPC Witnesses McCullar, Dunkel, O'Donnell, Lawton, and Woolridge.

Q. WHAT IS SHOWN ON SCHEDULE A, PAGE 2, OF EXHIBIT RCS-2?

A. Schedule A, page 2, presents a reconciliation of the revenue requirement calculation for the January 2022 revenue reduction showing the estimated impacts of OPC recommendations.

Q. WHAT IS SHOWN ON SCHEDULE A-1?

A. Schedule A-1 shows the gross revenue conversion factor ("GRCF"), which is used to convert net operating income into equivalent revenue requirement amounts. As shown there, FPL's original application used a GRCF, which FPL refers to as the Net Operating Income Multiplier, of 1.34153. FPL corrections adjusted the GRCF to 1.34143. As shown on Schedule A-1, in column E, I have used the FPL corrected GRCF of 1.34143 in my revenue requirement calculations. My use of the FPL corrected GRCF of 1.34143 is also shown on Exhibit RCS-2, Schedule A, page 1, column E, line 7.

Q. WHAT IS SHOWN ON SCHEDULE B?

A. Schedule B presents OPC's adjusted rate base that incorporates each of the adjustments impacting rate base that are recommended by OPC Witnesses in this case.

Q. WHAT IS SHOWN ON SCHEDULE B.1?

A. Schedule B.1 presents each of the adjustments impacting rate base that are recommended by OPC Witnesses in this case.

Q. WHAT IS SHOWN ON SCHEDULE C OF EXHIBIT RCS-2?

A. OPC's adjusted net operating income is shown on Schedule C. This incorporates each of the adjustments impacting net operating income that are recommended by OPC Witnesses in this case. The OPC's adjusted results for net operating income are shown on Schedule C in column F.

Q. WHAT IS SHOWN ON SCHEDULE C.1 OF EXHIBIT RCS-2?

A. Schedule C.1 summarizes each of the adjustments impacting net operating income that are recommended by OPC Witnesses in this case.

Q. WOULD YOU PLEASE DISCUSS SCHEDULE D?

A. Schedule D presents Citizens' recommended capital structure and overall rate of return, based on the revisions to FPL's proposed debt-to-equity ratio recommended by Witness O'Donnell and the ROE recommended by Witness Woolridge. The capital structure ratios for debt and common equity are based on the ratios recommended by Mr. O'Donnell. On Schedule D, I have applied the adjustments to the capital structure necessary to synchronize Citizens' recommended capital structure to the adjusted jurisdictional rate base. On Schedule D, I applied Dr. Woolridge's recommended ROE, resulting in OPC's overall recommended rate of return of 5.29%.

VI. INCORPORATION OF FPL IDENTIFIED ADJUSTMENTS AND CORRECTIONS

Q. HAS FPL IDENTIFIED CERTAIN ADJUSTMENTS AND CORRECTIONS TO ITS ORIGINALLY FILED APPLICATION?

A. Yes. In filings made on May 7, 2021 and May 21, 2021, FPL identified corrections and adjustments to its filing.

Q. AFTER FILING ITS MFRS, HAS FPL IDENTIFIED ANY ERRORS OR CORRECTIONS TO ITS FILING?

A. Yes. FPL so far has filed two notices of Identified Adjustments that impact the requested revenue requirement as detailed below. I have included FPL's Identified Adjustments in my testimony.

A. FPL'S MAY 7, 2021 NOTICE OF IDENTIFIED ADJUSTMENTS

Q. ON MAY 7, 2021, FPL FILED A NOTICE OF IDENTIFIED ADJUSTMENTS. WHAT DID THAT CONTAIN?

A. FPL's May 7, 2021 Notice of Identified Adjustments provided descriptions and estimated revenue requirement impacts for the corrections and adjustments that FPL had identified up to that point. FPL explained in its May 7, 2021 Notice that: "the adjustments, if made, would net to an approximate net $27 million decrease in FPL's overall requested revenue requirement increase for the 2022 Test Year and an approximate $2 million decrease in FPL's requested revenue increase for the 2023 Subsequent Year, which assumes FPL is granted its full revenue increase for 2022." FPL stated further in its Notice that it would include all adjustments identified on Attachment 1 to its Notice in an exhibit of adjustments that it will file with rebuttal testimony, along with any other adjustments that may be

identified between now and then. FPL indicates further that it had included similar exhibits with the rebuttal testimony of FPL witnesses in its 2009, 2012 and 2016 rate cases.

Q. WHAT ADJUSTMENTS WERE IDENTIFIED IN FPL'S MAY 7, 2021 NOTICE?

A. FPL's May 7, 2021 Notice in Attachment 1, pages 3 and 4 of 8 (the without RSAM version) identified 30 items that impact the revenue requirement, which are briefly summarized below using FPL's short-hand descriptors:

1) **SolarNow**. Remove of all SolarNow costs, expenses, and revenues from FPL's calculation of revenue requirements, as required in Order No. 2020-0508-TRF-EI, issued on December 18, 2020. Due to time constraints between the preparation of this case and the issuance of the Order, FPL was unable to incorporate these adjustments into the MFRs.

2) **Distribution Facility Charges**. Add revenue credit related to the Gulf Distribution Facility revenues for Florida Public Utilities and Blountstown, which was inadvertently excluded from revenue requirements due to an application of a jurisdictional factor of zero.

3) **Income Tax Payable - Refund**. Revise federal income tax payable, which is reflected as a debit balance in rate base, to incorporate an estimated refund expected in September 2021 which was omitted from the forecast.

4) **Income Tax Payable - FCG**. Remove income tax receivable (reflected as a debit in a payable) from Florida City Gas (a non-electric regulated entity consolidated with FPL) which was incorrectly included in the forecast.

5) **Deferred Income Tax Expense** Revise deferred income tax expense for the following items that were calculated incorrectly:

   a. Generation of ITC (reclassification between FERC Acct 410.1 and 411.4 which have different separation factors).

   b. Florida Net Operating Loss and storm fund earnings (reclass from ATL to BTL).

6) **Miscellaneous Service Fees**. Increase miscellaneous service fee revenues to reflect current approved service charges instead of proposed lower service charges, which were incorrectly entered into the rate case forecast.

7) **Deferred Pension Debit**. Reduce Deferred Pension debit by enhanced early retirement programs which was omitted from the forecast.

8) **Deferred Debit – SFAS 158**. Revise the separation factor applied to the Misc Deferred Debit SFAS 158 to be the same as the related SFAS 158 liability.

9) **Uncollectible Accounts Expense**. Revise the uncollectible accounts expense calculation utilizing the correct revenue forecast. Also impacts the bad debt rate used in the calculation of the NOI multiplier. Revised bad debt rates for 2022 and 2023 are 0.072% and 0.066%, respectively.

10) **Public Relations Expenses**. Decrease public relations expenses included in the forecast, which was overstated.

11) **Asset Retirements**. Remove inadvertent forecasted interim retirements and related depreciation associated with retired generation plants.

12) **Intangible Plant Amortization**. Revise intangible plant amortization due to incorrect amortization rate applied to certain intangible plant.

13) **Miscellaneous Other Power Generation Expenses**. Remove inadvertent duplicative expenses associated with West County Energy Center.

14) **St. Lucie Participation Agreement Reimbursements Allocation**. Revise allocation of St. Lucie Participation Agreement reimbursements to the proper FERC accounts, which resulted in a change to jurisdictional amounts.

15) **SPP Pole Inspection Distribution Program.** Revise SPP Pole Inspection forecast, which was understated by approximately $0.8 million in each of the forecasted periods. This revision has no impact on FPL's requested base rate increase because the Company is requesting to move recovery of these expenses from base to clause starting January 1, 2022.

16) **Dismantlement Jurisdictional Factors.** Revise incorrect separation factors applied to dismantlement cash activity.

17) **EVolution Pilot Program.** Remove incremental capital costs associated with FPL's EVolution pilot program, which were inadvertently included in the rate case forecast.

18) **EVolution Pilot Program.** Revise an incorrect depreciation rate and jurisdictional separation factor applied to a portion of the EVolution pilot program assets.

19) **EVolution Pilot Program.** Total. This has the total of the Company's corrections related to the Evolution Pilot Program.

20) **Gain from Disposition of Utility Plant.** Remove gain related to a mitigation sale in 2023, which is expected to occur after 2023.

21) **Deferred Debit – LTSA.** Revise the credit amount for the Deferred Debit - Long-Term Service Agreement, which was incorrectly forecasted.

22) **Co Adj – Dismantlement Accrual.** Revise the Dismantlement Study and associated dismantlement Company adjustment for the following:[9]

a. Crist 8 was inadvertently classified as steam production instead of other production.

b. Useful life of synchronous condenser- other production was inadvertently reflected as 44 years instead of 41 years.

c. Revisions were made to scrap and labor assumptions to incorporate a more optimal disposal location/method and mix of labor resources, resulting in a reduction in total net dismantlement costs.

23) **Co Adj – Dismantlement Reserve Transfers.** Revise the Company adjustment to transfer dismantlement reserves between units due to the revised Dismantlement study as described above.

24) **Co Adj – Dismantlement Base to Clause.** Revise the Company adjustment to move the Scherer coal ash dismantlement reserve and

[9] FPL inadvertently excluded Smith Unit 3 from its dismantlement study filed in this proceeding. FPL is not adjusting its proposed dismantlement accrual to add an accrual for Smith Unit 3 and instead will address dismantlement costs for that unit in its next dismantlement study.

accrual from base to ECRC due to the revised Dismantlement Study as described above.

25) **Co Adj – SPP – Transmission Inspection Program.** Revise Company adjustment to move SPP transmission inspection program from base to clause. A portion of capital expenditures related to this program were inadvertently omitted from the Company adjustment.

26) **FPSC Adj – SPPCRC – IT Costs.** Revise FPSC adjustment to include information technology costs associated with the Storm Protection Plan Cost Recovery Clause (SPPCRC) which were inadvertently omitted from the FPSC adjustment.

27) **FPSC Adj – Executive Compensation.** Increase executive compensation FPSC adjustment, which was understated.

28) **Capital Structure Impacts**. FPL identified the following three adjustments as impacting on its proposed Capital Structure.

29) **Solar Now.** FPL identified specific adjustments for Solar Now for the following Capital Structure elements

a. ITC Specific Adjustment
b. ADIT Specific Adjustment
c. Debt and Equity Specific Adjustments
d. Total Adjustment

30) **FPL-ES – ADIT.** Remove ADIT balances associated with FPL-Energy Services (an unregulated entity consolidated with FPL), which were not uniquely identified in the forecast and therefore had not been removed from ADIT in capital structure. Adjustment is the addition of ADIT in 2022 of $395K and reduction in ADIT of $107K in 2023, with offsetting pro-rata adjustments to other capital structure components in each period.

31) **Pro-Rata Adjustments.** Represents total rate base identified adjustments less other capital structure adjustments in this section.

Q. HOW HAVE YOU INCORPORATED THOSE ADJUSTMENTS IDENTIFIED BY FPL IN ITS MAY 7, 2021 NOTICE INTO THE CALCULATION OF THE REVENUE REQUIREMENT?

A. As noted above, the Notice filed by FPL on May 7, 2021 provided estimated revenue requirement impacts of its identified corrections and adjustments, and included limited detail on rate base or net operating income impacts. In Excel workpapers, FPL provided additional details showing the impacts on key rate base and net operating income components of its Identified Adjustments. I have utilized the information provided by FPL in response to that discovery to incorporate many FPL-identified adjustments to FPL's originally filed rate base and net operating income.

Q. WHAT DID FPL IDENTIFY AS THE 2022 TEST YEAR RATE BASE AND NET OPERATING INCOME IMPACTS (WITHOUT RSAM) THAT RESULT FROM ITS MAY 7, 2021 NOTICE OF IDENTIFIED ADJUSTMENTS?

A. As shown on Attachment 1, pages 3-4 of 6, of FPL's May 7, 2021 Notice of Identified Adjustments, the net result of the Company's corrections was to decrease combined 2022 rate base by $66.103 million and to increase 2022 net operating income by $15.562 million.

Q. HOW DID YOU INCORPORATE THE 2022 RATE BASE IMPACT OF FPL'S MAY 7, 2021 CORRECTIONS?

A. On Exhibit RCS-2, Schedule B, I have incorporated the 2022 rate base impact of FPL's May 7, 2021 corrections in column B. As noted above, those corrections reduced FPL's 2022 rate base by $66.103 million.

Q. HOW DID YOU INCORPORATE THE 2022 NET OPERATING INCOME IMPACT OF FPL'S MAY 7, 2021 CORRECTIONS?

A. On Exhibit RCS-2, Schedule C, I have incorporated the 2022 net operating income impact of FPL's May 7, 2021 corrections in column B. Those FPL corrections increased 2022 net operating income by $15.562 million.

Q. WHAT DID FPL IDENTIFY AS THE 2023 SUBSEQUENT YEAR RATE BASE AND NET OPERATING INCOME IMPACTS (WITHOUT RSAM) THAT RESULT FROM ITS MAY 7, 2021 NOTICE OF IDENTIFIED ADJUSTMENTS?

A. As shown on Attachment 1, pages 3-4 of 6, of FPL's May 7, 2021 Notice of Identified Adjustments, the net result of the Company's corrections was to decrease combined 2023 subsequent year rate base by $89.738 million and to increase 2023 net operating income by $15.228 million. On Exhibit RCS-3, Schedules B and C, I have reflected the impact on 2023 rate base and net operating income of FPL identified adjustments on the 2023 forecasted subsequent year, respectively, in column B, on each of those schedules, rate base and net operating income. I also address the 2023 SYA revenue requirement in Section VIII of my testimony.

Q. PLEASE EXPLAIN HOW YOU HAVE REFLECTED THE FPL MAY 7, 2021 CORRECTIONS AFFECTING THE 2022 RATE BASE AND NET OPERATING INCOME.

A. As noted above, on Exhibit RCS-2, Schedule B, which shows 2022 forecasted rate base, I have reflected the adjustments to rate base identified in FPL's May 7, 2022 Notice (using the without RSAM version) in column B. As noted above, those corrections reduced FPL's 2022 rate base by $66.103 million.

Similarly, on Exhibit RCS-2, Schedule C, which shows 2022 forecasted net operating income, I have reflected the adjustments to net operating income that were identified in FPL's May 7, 2021 Notice (using the Company's without RSAM adjustments) in column B. Those FPL corrections increased 2022 net operating income by $15.562 million.

Q. HOW HAVE YOU INCORPORATED FPL'S CHANGES TO THE GROSS REVENUE CONVERSION FACTOR (GRCF) AT THIS TIME?

A. As shown on Exhibit RCS-2, Schedule A-1, I have incorporated the impact of FPL's corrections on the GRCF, in column B. As corrected, the Company-proposed GRCF is 1.34143, as shown on Schedule A-1, in column D. As shown on Schedule A-1, in column E, I have used that same Company-corrected GRCF of 1.34143.

Q. HOW HAVE YOU INCORPORATED FPL'S CHANGES TO THE CAPITAL STRUCTURE AT THIS TIME?

A. As shown on Exhibit RCS-2, Schedule D, the reconciliation of the capital structure to the adjusted rate base includes the OPC rate base adjustments and the FPL identified rate base correction amounts. The FPL corrections submitted on May 7, 2021 are shown on Schedule D in column B. The FPL corrections submitted on May 21, 2021 are shown in column C. As described elsewhere in my testimony, Witness O'Donnell is recommending a different capital structure than FPL has proposed. The capital structure, cost rates, and overall cost of capital used to compute the revenue requirement for the 2022 forecasted test year is shown on Exhibit RCS-2, Schedule D.

Q. HAVE YOU INCORPORATED THE IMPACTS OF FPL'S MAY 7, 2021 NOTICE ON 2023 SUBSEQUENT YEAR RATE BASE AND NET OPERATING INCOME IN A SIMILAR MANNER?

A. Yes. I have reflected the impacts on the 2023 subsequent test year in a similar manner. Specifically, on Exhibit RCS-3, Schedule B, which shows 2023 subsequent year rate base. I have reflected the adjustments to rate base identified in FPL's May 7, 2021 Notice in column B.

On Exhibit RCS-3, Schedule C, which shows 2023 subsequent year net operating income, I have reflected the adjustments to net operating income that were identified in FPL's May 7, 2021 Notice in column B.

B. FPL'S MAY 21, 2021 NOTICE OF IDENTIFIED ADJUSTMENTS

Q. HAS FPL FILED A SECOND NOTICE OF IDENTIFIED ADJUSTMENTS?

A. Yes. On May 21, 2021, FPL filed a Second Notice of Identified Adjustments. Similar to its May 7, 2021 Notice, in its May 21, 2021 Second Notice, FPL states they will include the adjustments identified on Attachment 1 to its Second Notice in an exhibit of adjustments that it will file with rebuttal testimony, along with any other adjustments that may be identified between now and then.

Q. WHAT ADJUSTMENTS WERE INCLUDED IN THAT SECOND NOTICE?

A. FPL's Second Notice identified the following three adjustments, along with FPL's short-hand descriptors:

> 1) **Separation Factor Revisions to Filed Case**. Remove the adjustment to the E203 Peaking Energy allocator for stratified contracts as this adjustment is only needed for stratified demand allocators which resulted in revisions to multiple separation factors.

2) **Separation Factor Revisions to 1st NOIA**. Revise identified adjustments reflected in FPL's notice of identified adjustments filed on May 7, 2021 to incorporate revised separation factors discussed above.

3-10) **Separation Factor Revisions to Filed Case**. FPL updated capital structure components related to separation factor revisions.

11-14) **Separation Factor Revisions to 1st NOIA.** SolarNow – Revisions to separation factors were applied to the SolarNow capital structure adjustments but those are small enough that they do not appear due to rounding.

FPL-ES-ADIT – Revisions to separation factors applied to the FPL-ES capital structure adjustment but those are small enough that they do not appear due to rounding.

Revisions to pro-rata capital structure adjustments related to rate base identified adjustments above.

Q. WHAT DID FPL IDENTIFY AS THE 2022 TEST YEAR RATE BASE AND NET OPERATING INCOME IMPACTS (WITHOUT RSAM) THAT RESULT FROM ITS MAY 21, 2021 NOTICE OF IDENTIFIED ADJUSTMENTS?

A. As shown on Attachment 1, page 2 of 4, of FPL's May 21, 2021 Notice of Identified Adjustments, the net result of the Company's corrections was to increase combined 2022 rate base by $48,000 and to decrease 2022 net operating income by $34,000.

Q. WHAT DID FPL IDENTIFY AS THE 2023 SUBSEQUENT YEAR RATE BASE AND NET OPERATING INCOME IMPACTS (WITHOUT RSAM) THAT RESULT FROM ITS MAY 21, 2021 NOTICE OF IDENTIFIED ADJUSTMENTS?

A. As shown on Attachment 1, page 2 of 4, of FPL's May 21, 2021 Notice of Identified Adjustments, the net result of the Company's corrections was to increase combined 2023 subsequent year rate base by $35,000 and to decrease 2022 net operating income by $23,000.

Q. HOW HAVE YOU INCORPORATED THE ADJUSTMENTS AND CORRECTIONS NOTED BY FPL IN ITS MAY 21, 2021 SECOND NOTICE OF IDENTIFIED ADJUSTMENTS IN THE REVENUE REQUIREMENT DETERMINATION?

A. I have incorporated those May 21, 2021 FPL adjustments in a similar manner to FPL's May 7, 2021 adjustments. An Excel file containing detail of the additional FPL-identified adjustments was obtained and that FPL-provided information was used to incorporate the rate base and net operating impact of those adjustments into the revenue requirement determination in the following manner.

On Exhibit RCS-2, Schedule B, which shows 2022 forecasted rate base, I have reflected the adjustments to rate base identified in FPL's May 21, 2021 Second Notice in column C.

Similarly, on Exhibit RCS-2, Schedule C, which shows 2022 forecasted net operating income, I have reflected the adjustments to net operating income that were identified in FPL's May 21, 2021 Second Notice in column C.

On Exhibit RCS-2, Schedule D, which shows the 2022 capital structure, I show the FPL adjustments from its May 21, 2021 Second Notice in column C.

As shown on Exhibit RCS-2, Schedule A-1, in column C, FPL's May 21, 2021 Second Notice of Identified Adjustments did not have any notable impact on the 2022 GRCF.

Q. HAVE YOU REFLECTED THE IMPACTS OF FPL'S MAY 21, 2021 SECOND NOTICE OF ADJUSTMENTS ON THE 2023 SUBSEQUENT YEAR IN A SIMILAR MANNER?

A. Yes. I have reflected the impacts on the 2023 subsequent test year in a similar manner. Specifically, on Exhibit RCS-3, Schedule B, which shows 2023 forecasted rate base, I have reflected the adjustments to rate base identified in FPL's May 21, 2021 Notice in column C.

Similarly, on Exhibit RCS-3, Schedule C, which shows 2023 subsequent year net operating income, I have reflected the adjustments to net operating income that were identified in FPL's May 21, 2021 Second Notice in column C.

On Exhibit RCS-3, Schedule D, which shows the 2023 capital structure, I show the FPL adjustments from its May 21, 2021 Second Notice in column C.

As shown on Exhibit RCS-3, Schedule A-1, in column C, FPL's May 21, 2021 Second Notice of Identified Adjustments did not have any notable impact on the 2023 GRCF.

Q. BY INCORPORATING THE RESULTS OF FPL'S NOTICES OF ADJUSTMENT INTO YOUR SCHEDULES ARE YOU MAKING ANY TYPE OF DETERMINATION ABOUT THE ACCURACY OF THE ADJUSTMENTS OR THE ITEMS OR BALANCES THAT WERE ADJUSTED OR CORRECTED?

A. No. Due to the timing of the filing I am accepting them but I am not offering my opinion as to the accuracy or prudence of the costs in the adjustments or of those balances that were adjusted.

Q. DID FPL FILE A THIRD NOTICE OF IDENTIFIED ADJUSTMENTS?

A. Not yet.

VII. RECOMMENDED ADJUSTMENTS TO RATE BASE AND NET OPERATING INCOME

Q. WOULD YOU PLEASE DISCUSS EACH OF THE ADJUSTMENTS THAT YOU, AND OTHER OPC WITNESSES, ARE RECOMMENDING THAT AFFECT THE RATE BASE AND NET OPERATING INCOME IN FPL'S FILING?

A. Yes, I will address each adjustment below.

A. RATE BASE ADJUSTMENTS

Q. ON WHAT SCHEDULES IN EXHIBIT RCS-2 AND RCS-3 DO YOU SHOW RATE BASE ADJUSTMENTS?

A. Exhibit RCS-2 shows rate base adjustments for the 2022 forecasted test year on Schedule B-1 through B-4. Similarly, Exhibit RCS-3 shows rate base adjustments for the 2023 subsequent year on Schedules B-1 through B-4.

Accumulated Depreciation - Depreciation Expense - New Depreciation Rates

Q. PLEASE EXPLAIN THE ADJUSTMENT TO ACCUMULATED DEPRECIATION EXPENSE FOR NEW DEPRECIATION RATES.

A. As shown on Exhibit RCS-2, Schedule B-1, average rate base for the 2022 forecasted test year is increased by $74.438 million for the impact of the new depreciation rates being recommended by Witness McCullar. Her recommendation for new depreciation rates results in lower 2022 depreciation expense (without RSAM) than FPL's proposal. Thus, a

lower amount of average 2022 accumulated depreciation results from her depreciation rate recommendation. The 2022 rate base impact was calculated by taking one-half (average year impact) of Ms. McCullar's depreciation expense impact, using the jurisdictional amount. The impact of her recommendation on 2022 depreciation expense is discussed further in conjunction with the related adjustment to operating expense.

Accumulated Depreciation - Dismantlement Expense

Q. PLEASE EXPLAIN THE ADJUSTMENT TO ACCUMULATED DEPRECIATION EXPENSE FOR NEW DEPRECIATION RATES.

A. As shown on Exhibit RCS-2, Schedule B-2, average rate base for the 2022 forecasted test year is increased by $8.136 million for the impact of the dismantlement expense being recommended by Witness Dunkel. Mr. Dunkel's recommendation for dismantlement expense results in lower 2022 accumulation of dismantlement accruals into the accumulated depreciation account than FPL's proposal. Thus, a lower amount of average 2022 accumulated depreciation results from Mr. Dunkel's dismantlement expense recommendation. The 2022 rate base impact was calculated by taking one-half (average year impact) of Mr. Dunkel's dismantlement expense impact, using the jurisdictional amount. The impact of his recommendation on 2022 dismantlement expense is discussed further in conjunction with the related adjustment to operating expense.

Unamortized Rate Case Expense

Q. PLEASE EXPLAIN THE COMPANY'S ADJUSTMENT TO RATE CASE EXPENSE.

A. As discussed in the direct testimony of Company witness Fuentes, FPL has estimated rate case expenses totaling $5.170 million, which it proposes to amortize over a four-year

period beginning in 2022. In its originally application, apparently FPL forgot to reflect the impact on the 2022 test year of its proposed four-year amortization on rate base, but in its May 7, 2021 Notice of Identified Adjustments, FPL submitted a correction showing a reduction to 2022 rate base of $646,000 related to the 2022 amortization impact.

As shown on MFR Schedule C-10, using the four-year amortization period, FPL proposes to include $1.292 million for test year rate case expense amortization. In addition, as shown on supporting information for MFR Schedule B-2, FPL proposes to include the 13-month average unamortized balance of rate case expense associated with this proceeding of $5.170 million (before FPL's correction) in the working capital component of its proposed 2022 test year rate base. After FPL's correction, the $5.170 million rate base amount for unamortized rate case expense proposed by the Company in its original application was reduced by $646,000 to reflect the average impact of the Company's proposed 2022 amortization.

Q. HAS THE COMPANY INCLUDED THE PROJECTED TEST YEAR BALANCE OF UNAMORTIZED RATE CASE EXPENSE IN ITS WORKING CAPITAL REQUEST IN THIS CASE?

A. Yes. As noted above, the working capital component of rate base for the 2022 test year includes $5.170 million for FPL's projected unamortized rate case expense associated with this case, before FPL's May 7, 2021 correction and $4.523 million after FPL's correction.

Q. SHOULD FPL BE PERMITTED TO INCREASE RATE BASE FOR THE UNAMORTIZED RATE CASE EXPENSE BALANCE?

A. No, it should not. The Commission has disallowed the inclusion of unamortized rate case expense in working capital in several prior decisions. This long-standing Commission policy was reaffirmed in Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, involving Progress Energy Florida. At pages 71 - 72 of that Order, the Commission stated the following with regard to unamortized rate case expense:

> We have a long-standing policy in electric and gas rate cases of excluding unamortized rate expense from working capital, as demonstrated in a number of prior cases. The rationale for this position was that ratepayers and shareholders should share the cost of a rate case: i.e., the cost of the rate case would be included in the O&M expenses, but the unamortized portion would be removed from working capital. It espouses the belief that customers should not be required to pay a return on funds expended to increase their rates.
>
> While this is the approach that has been used in electric and gas cases, water and wastewater cases have included unamortized rate case expense in working capital. The difference stems from a statutory requirement that water and wastewater rates be reduced at the end of the amortization period (Section 367.0816,F.S.). While unamortized rate case expense is not allowed to earn a return in working capital for electric and gas companies, it is offset by the fact that rates are not reduced after the amortization period ends.
>
> We agree with the long-standing policy that the cost of the rate case should be shared, and therefore find that the unamortized rate case expense amount of $2,787,000 shall be removed from working capital. (footnote omitted)

In a footnote on page 71 of the Order, the Commission identified the following cases that confirm and validate its long-standing policy of excluding the unamortized rate case expense from working capital in electric and gas cases:

> Order No. 23573, issued October 3, 1990, in Docket No. 891345-EI, In re: Application of Gulf Power Company for a rate increase; Order No. PSC-09-0283-FOF-EI, issued April 30, 2009, in Docket No. 080317-EI, In re: Petition for rate increase by Tampa Electric Company; Order No. PSC-09-0375-PAA-GU, issued May 27, 2009, in Docket No. PSC-09-0375-PAA-GU, In re: Petition for rate increase by Florida Public Utilities Company.

In addition, in Order No. PSC-10-0153-FOF-EI, which was issued pursuant to FPL's last litigated rate case in Docket No. 080677-EI, at page 164, the Commission stated in part:

> We do not agree with the Company that the unamortized balance of rate case expense should be included in rate base. Historically, the unamortized balance of rate case expense has been excluded from rate base to reflect a sharing of the rate case cost between the ratepayers and the shareholders. Rate case expenses are recovered from ratepayers through the amortization process as a cost of doing business in a regulated environment. However, the unamortized balance of rate case expense has been excluded from rate base to reflect that an increase in rates is a benefit to the shareholders. (footnote omitted)

This policy was also affirmed in Commission Order No. PSC-12-0179-FOF-EI, issued April 3, 2012, in Docket No. 110138-EI, involving Gulf Power Company, where the Commission stated at pages 30 and 31:

> [W]e have a long-standing practice in electric and gas rate cases of excluding unamortized rate case expense from working capital, as demonstrated in a number of prior cases. The rationale for this position is that ratepayers and shareholders should share the cost of a rate case; i.e., the cost of the rate case would be included in O&M expense, but the unamortized portion would be removed from working capital. This practice underscores the belief that customers should not be required to pay a return on funds spent to increase their rates.
>
> * * *
>
> For the foregoing reasons, we find that the unamortized rate case expense of $2,450,000 shall be removed from working capital consistent with our long-standing practice.

In a footnote on page 30 of the Gulf Power Order, the Commission identified the same cases referenced in the footnote of the Progress Energy Florida Order discussed above.

Q. ARE YOU AWARE OF ANY CASES IN WHICH A PORTION OF A UTILITY RATE CASE EXPENSE WAS ALLOWED TO BE INCLUDED IN RATE BASE?

A. Yes. As an example, in Order No. PSC-08-0327-FOF-EI, issued on May 19, 2008, that allowed Florida Public Utilities Company ("FPUC") to include one half of their unamortized rate case expense balance in working capital. However, the Commission specifically stated, in that cited FPUC rate case[10] that "[t]he inclusion of unamortized rate case expense in working capital in FPUC's case is an exception to our long-standing policy." FPUC has had that exception since 1993. Id. at 22. In that FPUC order, the Commission also explained that "[w]hile unamortized rate case expense is not allowed to earn a return in working capital for electric and gas companies, it is offset by the fact that rates are not reduced after the amortization period ends." Id. at p. 21. Consequently, this does not support a change in the Commission's long-standing policy of disallowing rate case expense in rate base.

Q. DO YOU RECOMMEND THAT THE UNAMORTIZED RATE CASE EXPENSE BE EXCLUDED FROM RATE BASE IN THIS CASE?

A. Yes, I recommend that the Commission follow its long-standing policy in electric cases of not allowing inclusion of the unamortized rate case expense in rate base. Consistent with the Commission's findings in the Progress Energy Florida base rate cases, and the Gulf Power Company base rate case cited above, and FPL's 2010 rate case, it would be unfair for customers to pay a return on the costs incurred by the Company in this case when these are being used to increase customer rates. On Exhibit RCS-2, Schedule B-3, I have

[10] Order No. PSC-09-0375-PAA-GU, issued May 27, 2009, in Docket No. 080366-GU, In re: Petition for Rate Increase by Florida Public Utilities Company at pages 21-22

removed the Company's updated amount for the unamortized balance of rate case expense from working capital in this case, thus reducing rate base by $4.523 million.

Q. IS THERE A SIMILAR RATE BASE ADJUSTMENT FOR THE 2023 SUBSEQUENT YEAR?

A. Yes. As shown on Exhibit RCS-3, Schedule B-3, FPL's requested amount of $3.231 million for unamortized rate case expense is removed from the 2023 subsequent year rate base. It would also be appropriate to adjust the 2023 capital structure for related ADIT.

Payment to JEA to Induce JEA Agreement with Early Retirement of Plant Scherer Unit 4

Q. PLEASE DISCUSS FPL'S PROPOSAL FOR THE EARLY RETIREMENT OF PLANT SCHERER UNIT 4.

A. Plant Scherer is a generating unit located in Georgia which is operated for FPL and JEA by Georgia Power Company ("GPC" or "Georgia Power"). FPL has indicated it will be retiring Scherer Unit 4 effective January 1, 2022. FPL has presented calculations purporting to show the Cumulative Present Value of Revenue Requirement ("CPVRR") benefit that would be realized with the retirement of Scherer Unit 4.

FPL owns a 76% interest in Scherer Unit 4, and JEA owns the other approximately 24%. FPL's proposed revenue requirement for the costs to retire Scherer Unit 4 include a payment of $100 million to JEA which is described as necessary to induce JEA to agree with moving up the retirement date to January 2022 and to enable JEA to pay off debt related to its ownership in the plant. FPL appears to be justifying its request that its ratepayers provide the funds for the JEA payoff on the basis of its calculated CPVRR

savings. FPL claims that there are $583 million of CPVRR savings associated with the Scherer Unit 4 retirement. (FPL Witness Bores Direct Testimony at p. 42).

FPL requests that its $100 million payment to JEA be recorded as a regulatory asset and amortized over a ten-year period. It seems dubious that FPL ratepayers should pay any amounts related to JEA's ownership in Scherer Unit 4.

It is my position that FPL's justification for charging FPL ratepayers for a payment to JEA falls short of meeting its burden to show that this payment was in the best interest of the FPL ratepayers. FPL has not provided clear and convincing evidence that the touted customer benefits of closure could not have been achieved without making the payment to JEA and then charging it to FPL's ratepayers even though JEA (rather than FPL's customers) would presumably be receiving JEA's share of the assumed benefits from early retirement that FPL has presented. Moreover, FPL has had ongoing business relationships with JEA and was recently a bidder in a process established to sell the electric utility assets of JEA. FPL indicates that it expects to make up for the capacity lost by the Scherer Unit 4 early retirement by gas-fueled generation and solar. (Witness Bores Direct Testimony at p. 43). FPL indicates that it included the cost of those generation upgrades in its CPVRR analysis related to the Scherer Unit 4 early retirement.

It may also be of interest to note that while FPL claims that Scherer is inefficient and expensive to maintain compared to the rest of FPL's generating fleet, it does provide fuel diversity. Additionally, Georgia Power, the operator of Scherer, claimed in its last Integrated Resource Plan case that Scherer Unit 3 was the most modern and efficient generating unit its coal-fueled generating fleet. Maintaining fuel diversity was cited by Georgia Power as a significant benefit associated with its unit, Scherer Unit 3. The early

retirement of Plant Scherer Unit 4 will significantly diminish FPL's fuel diversity and will expose FPL's ratepayers to higher costs from natural gas price increases. If FPL's projected fuel cost savings for the Scherer Unit 4 do not materialize as projected by FPL, this would expose FPL ratepayers to higher costs and could make the early closure of that unit into a net present value cost to FPL's ratepayers. This is an additional reason for removing the FPL inducement payment to JEA from rate base and operating expenses.

Q. HAS GEORGIA POWER COMPANY, THE OPERATOR OF PLANT SCHERER, TOUTED THE BENEFITS OF THAT PLANT IN ITS MOST RECENTLY FILED INTEGRATED RESOURCE PLAN?

A. Yes. Georgia Power Company's filed 2019 Integrated Resource Plan, Docket No. 42310, highlighted some of the benefits of Plant Scherer including fuel diversity, fuel cost stability, and the fact that Plant Scherer was the newest and most economical coal-fueled generating plant within the Georgia Power Company generating fleet.

Q. YOU MENTIONED THAT EARLY RETIREMENT OF PLANT SCHERER UNIT 4 WOULD SIGNIFICANTLY DECREASE FPL'S FUEL DIVERSITY AND COULD SUBJECT FPL RATEPAYERS TO FUEL COSTS INCREASES. WHAT AMOUNT OF ASSUMED CPVRR BENEFIT DOES FPL SHOW RELATING TO FUEL COST SAVINGS?

A. On FPL's Exhibit SRB-11, the Company's CPVRR analysis for Scherer Unit 4 assumes fuel savings in the amount of $1.025 billion. Without those assumed fuel savings, the Company's claimed net CPVRR results would change from the $583 million favorable result to an unfavorable result of $442 million.

Q. SHOULD THE $100 MILLION PAYMENT FROM FPL TO JEA TO INDUCE THE EARLY RETIREMENT OF SCHERER UNIT 4 BE CHARGED TO FPL'S RATEPAYERS?

A. No. As a part of its failure to meet its burden of proof, FPL did not demonstrate that FPL's ratepayers ever obtained benefit from the portion of Plant Scherer Unit 4 that FPL did not own (i.e., from the portion of Plant Scherer Unit 4 capacity that was owned by JEA). Consequently, FPL ratepayers should not be required to pay the cost of an inducement for JEA to agree with the early retirement of the portion of Plant Scherer that is owned by JEA and not owned by FPL. It is also not clear that FPL has provided testimony that, in lieu of giving JEA $100 million, it adequately explored sale of the unit to Georgia Power, who seemed to hold the plant's efficiencies in much higher regard than FPL did.

Q. WHAT ADJUSTMENTS SHOULD BE MADE TO ELIMINATE THE $100 MILLION PAYMENT TO JEA SO THAT IT DOES NOT GET CHARGED TO FPL'S RATEPAYERS?

A. As shown on Exhibit RCS-2, Schedule B-5, the regulatory asset that FPL proposes related to the $100 million payment to JEA should be removed from rate base. Additionally, FPL's proposed amortization related to the payment should be removed from 2022 operating expenses.

Q. WHAT AMOUNT SHOULD BE REMOVED FROM RATE BASE?

A. As shown on Exhibit RCS-2, Schedule B-5, the $84.493 rate base amount related to FPL's $100 million Scherer unit 4 retirement inducement payment should be removed from jurisdictional rate base. The corresponding jurisdictional adjustment reduces 2022 rate base by $84.493 million.

Plant Held For Future Use in Rate Base

Q. PLEASE EXPLAIN THE LEVEL OF PLANT HELD FOR FUTURE USE THAT FPL HAS REFLECTED IN ITS 13-MONTH AVERAGE RATE BASE.

A. As shown on MFR Schedule B-1, FPL shows Plant Held For Future Use ("PHFFU") of $395,124,000 on a total Company 13-month average basis. FPL provided a breakout of this amount by category in MFR Schedule B-15, which is reproduced in the table below:

	13 Month Avg.	2022 Test Year
	2022 Test Year	Jurisdictional
Description	Amount	Amount
Other Production Future Use	$ 285,307,000	$ 273,353,000
Transmission Future Use	$ 35,674,000	$ 32,348,000
Distribution Future Use	$ 33,306,000	$ 33,306,000
General Plant Future Use	$ 40,838,000	$ 39,571,000
Total PHFFU	$ 395,125,000	$ 378,578,000

Q. HAS FPL REMOVED ANY PHFFU FROM RATE BASE?

A. Yes. FPL removed the $10.969 million for costs related to a portion of the North Escambia property (jurisdictional amount of $10.629 million) per Order No. PSC-12-0179-FOF-EI from rate base. Per a footnote on MFR Schedule B-15, FPL had assumed that $28.5 million of Hendry County land would be utilized for solar; however, it was later determined that only $11 million would be utilized. FPL claims that this change had no effect on total retail rate base and will have no impact on its proposed base rate increase. At this point this claim may need to be further explored in discovery and my testimony would be subject to revision based on the outcome of additional discovery responses.

Q. ARE THERE CONCERNS REGARDING WHETHER EVERY PROPERTY BEING HELD FOR FUTURE USE THAT IS INCLUDED IN FPL'S 2022 TEST

YEAR PHFFU BALANCE SHOULD BE INCLUDED IN RATE BASE IN THIS PROCEEDING?

A. Yes. Upon reviewing the detail associated with the Company's requested level of PHFFU provided in response to OPC's 7th Set of Interrogatories, Interrogatory No. 210, and in OPC's 1st Request For Production of Documents, POD No. 36 Supplemental, I observed that several items are designated with a target commercial operating date ("Target COD") of "TBD" (indicating "to be determined") do not have a definite, specific estimated in-service date, thus, FPL has not met its burden to demonstrate when those parcels are expected to be used. The "TBD" designated PHFFU parcels amount to $310.017 million on a total Company basis for the 2022 test year, or $297.028 million after jurisdictional allocation. I also reviewed information for PHFFU presented in FPL's 2020 FERC Form 1. The Company's FERC Form 1 presentation on PHFFU does show anticipated in-service dates for each item of PHFFU. Based on the FERC Form 1 information, it appears that the PHFFU is anticipated to be placed into service during the next 10 years. Consequently, I have not recommended removal of any additional items of PHFFU beyond those that the Company has already removed at this time. However, I would recommend that PHFFU items with a "TBD" designation be removed unless the Company can reconcile the "TBD" designation with the anticipated in-service dates that it has reported in its FERC Form 1 for PHFFU.

Q. DOES THE COMMISSION HAVE A STANDARD THAT IT HAS APPLIED TO DETERMINE WHETHER SPECIFIC FUTURE USE PROPERTIES SHOULD BE INCLUDED IN RATE BASE?

A. Yes. The relevant statute states: "The commission shall investigate and determine the actual legitimate costs of the property of each utility company, actually used and useful in

the public service, and … the net investment of each public utility company in such property which value, as determined by the commission, shall be used for ratemaking purposes and shall be the money honestly and prudently invested by the public utility company in such property used and useful in serving the public..." Section 366.06, Florida Statutes. (Emphasis added.)

Property being held for future use that does not have an anticipated use date is not used and useful in providing service to ratepayers. Thus, it is not reasonable to expect ratepayers to pay a return on the costs of that property held for future use on an annual recurring basis.

FPL offered a standard in the 2012 rate case, Docket No. 20120015-EI that is useful and can be followed since they agree to it. As addressed in his rebuttal testimony in FPL's 2012 rate case, former PSC Commissioner Terry Deason offered the following as a standard at page 14, lines 1 to 11:

> The Commission's standard is one of reasonableness or what amount of PHFU is reasonably needed to cost-effectively provide reliable service to existing and future customers. Applying this standard requires a review of specific properties to determine whether their acquisition and retention are reasonable to provide service over an adequate planning horizon. The Commission's reasonableness standard cannot be determined by arbitrary and rigid time limitations on the properties' ultimate use. To do so would be contrary to Commission policy and ultimately work to the disadvantage of utilities' customers.

Q. HAS FPL IN THIS DOCKET MADE ANY SHOWING THAT THE SPECIFIC PROPERTIES ARE REASONABLY NEEDED TO COST-EFFECTIVELY PROVIDE RELIABLE SERVICE TO EXISTING AND FUTURE CUSTOMERS OR WHAT TIMEFRAME IS AN ADEQUATE PLANNING HORIZON?

A. No, it has not. The detail that was provided in the response to OPC POD No. 36 Supplemental listed several properties under the Transmission and Distribution Future Use categories, where the expected in-service dates are "to be determined" or TBD. A "TBD" designation does not appear to meet the standard of rate base inclusion for PHFFU. FPL has made no showing why the projects with no expected use date are cost-effectively providing, or reasonably needed to provide, electric service. For property for which the Company has no specific year identified for being in-service to provide electric utility service, i.e., properties where the Company has "TBD" in the in-service date column, such criteria has not been met. The Company has not demonstrated that such parcels of land held for future use are reasonably needed to provide reliable service to existing customers. Customers should not be required to continue to provide FPL with a rate base return, including shareholder profits, on these projects when FPL has failed to show why and when these properties are going to be needed.

Q. WHAT COSTS DID FPL ASSIGN TO PHFFU SITES WITH EXPECTED IN-SERVICE DATES THAT THE COMPANY HAS NOT DETERMINED?

A. A description of the PHFFU sites and their associated costs, suggests that the total cost is $310.017 million on a 13-month average basis (per FPL response to OPC Interrogatory No. 210).

Q. PLEASE SUMMARIZE YOUR RECOMMENDATION FOR PHFFU FOR THE 2022 FUTURE TEST YEAR RATE BASE.

A. As described above, FPL's response to OPC Interrogatory No. 210 shows PHFFU in the 2022 future test year in the amount of $310.017 million total ($297.028 million jurisdictional) for sites with TBD in-service dates. Ratepayers should not be required to

pay a return to FPL's shareholders for the costs of sites that do not have an expected in-service date because it is not used and useful to current customers and has not been demonstrated to be reasonably needed to serve current or future customers within the period encompassed by the rate plan or an alternative period, such as ten years. FPL has not demonstrated that such PHFFU projects with a "to be determined" target commercial operation date will be used to provide electric service within a reasonable timeframe in the future. However, based on my review of the Company's PHFFU information that has been presented in its 2020 FERC Form 1, which does show anticipated in-service dates for each PHFFU items to be occurring within a 10-year period. I have tentatively refrained from removal of any additional items of PHFFU beyond those that the Company has already removed at this time. However, I would recommend removal of PHFFU items with a "TBD" designation unless the Company can meet its burden to reconcile the "TBD" designation with the anticipated in-service dates that it has reported in its FERC Form 1 for PHFFU.

Q. DO SIMILAR CONCERNS APPLY TO PHFFU IN THE 2023 SUBSEQUENT YEAR RATE BASE?

A. Yes. For the 2023 subsequent year, the jurisdictional adjustment amount of PHFFU items with a "TBD" in-service designation is approximately $296.336 million on a jurisdictional basis.

Construction Work in Progress

Q. HAS FPL INCLUDED CONSTRUCTION WORK IN PROGRESS ("CWIP") IN ITS RATE BASE REQUEST?

A. Yes. For the 2022 test year, MFR Schedule B-1 shows that $1,725,318,000 has been included in rate base for CWIP.

Q. SHOULD THE COMMISSION ALLOW THE NON-INTEREST-BEARING CWIP TO BE INCLUDED IN RATE BASE AS PROPOSED BY FPL?

A. No. It is my opinion that CWIP should not be afforded rate base treatment. CWIP, by its very nature, is plant that is not completed and is not providing service to customers. More specifically, and in reference to this proceeding, CWIP is not used or useful in delivering electricity to FPL's customers. Under the ratemaking process, utilities are permitted to earn a return on the assets that are used and useful in providing service to a utility's customers. Assets that are still undergoing construction clearly are not used in providing service to customers during the construction period. Because of this, the ratemaking process in some jurisdictions excludes CWIP from rate base, requiring that assets be classified as used and useful in serving customers prior to earning a return on those assets being recovered from ratepayers. Therefore, as a general regulatory principle, CWIP should be excluded from rate base and from costs being charged to customers until such time as it is providing service to those customers.

I am aware that the Commission has consistently allowed the inclusion of non-interest-bearing CWIP projects for electric utilities in rate base. This understanding is based in part on the Commission's Order No. PSC-12-0179-FOF-EI, issued April 3, 2012, in Docket No. 110138-EI in a Gulf Power Company general rate case proceeding. In that order, at page 20, the Commission indicated that: "the inclusion of CWIP (not eligible for AFUDC) in rate base is consistent with our practice." In acknowledgement of the Commission's practice and its recent affirmation thereof, I have not removed the non-

interest-bearing CWIP from rate base for purposes of determining OPC's recommended revenue requirement in this case. However, the fact that the removal has not been reflected in OPC's revenue requirement calculations in this case should not be interpreted to mean that my opinion or OPC's position on this issue has changed, or that OPC will not pursue this important policy issue in this rate case or future proceedings.

B. NET OPERATING INCOME ADJUSTMENTS

Q. ON WHAT SCHEDULES DO YOU PRESENT NET OPERATING INCOME ADJUSTMENTS?

A. On Exhibit RCS-2, for the 2022 forecast test year, adjustments to operating expenses that affect net operating income are presented on Schedules C-1 through C-6.

Similarly, on Exhibit RCS-3, for the 2023 subsequent year, adjustments to operating expenses and revenues that affect net operating income are presented on Schedules C-1 through C-6. Exhibit RCS-3 also has a Schedule E, which shows the revenue adjustment for the 2023 subsequent year resulting from the 2022 test year adjustments.

Depreciation Expense - New Depreciation Rates

Q. PLEASE EXPLAIN THE ADJUSTMENT TO DEPRECIATION EXPENSE FOR NEW DEPRECIATION RATES.

A. The amounts on Exhibit RCS-2, Schedule C-1, in columns A, B and C were supplied to me by Witness McCullar who is recommending new depreciation rates that differ from those proposed by FPL. Ms. McCullar shows that FPL's proposed depreciation rates applied to FPL's Test Year 2022 Plant produces annual depreciation expense accruals of

approximately $2.039 billion, as summarized in column A of Schedule C-1, based on the Company's "without RSAM" depreciation rates. In comparison, her recommended new depreciation rates produce annual depreciation accruals of approximately $1.906 billion, as summarized on Schedule C-1 in column B. As shown on Schedule C-1 in column C, Ms. McCullar's recommended new depreciation rates for FPL produce annual depreciation expense for 2022 that is $154.83 million less than the annual depreciation accruals computed by FPL (without RSAM). The 2022 depreciation expense amounts and adjustments provided to me by Ms. McCullar were on a Total Company basis, so in order to derive the corresponding jurisdictional expense adjustments, on Schedule C-1, I applied jurisdictional factors for each functional category in column D, to derive the corresponding jurisdictional expense adjustment amounts that are shown in column E. As shown on Exhibit RCS-2, Schedule C-1, in column E, jurisdictional depreciation expense for 2022 is reduced by $148.875 million.

Q. IS THERE A CORRESPONDING RATE BASE ADJUSTMENT RELATED TO THE ADJUSTMENT FOR THE NEW DEPRECIATION RATES FOR FPL?

A. Yes. As shown on Exhibit RCS-2, Schedule B-1, there is a related adjustment which decreases accumulated depreciation (and increases rate base). The impacts on 2022 rate base were derived by taking one-half of the annual jurisdictional depreciation expense adjustment from Schedule C-1.

Q. WAS THE ADJUSTMENT TO DEPRECIATION EXPENSE FOR THE 2023 SUBSEQUENT YEAR DERIVED IN A SIMILAR MANNER?

A. Yes. The adjustment to depreciation expense for the 2023 subsequent year was derived in a similar manner, as shown on Exhibit RCS-3, Schedule C-1. The amounts in columns A,

B and C, showing FPL's proposed depreciation expense (without RSAM), Ms. McCullar's recommended depreciation expense for 2023, and her resultant adjustment, respectively, were provided to me by Witness McCullar. To derive the corresponding adjustment to jurisdictional depreciation expense, I applied the jurisdictional factors shown on Exhibit RCS-3, Schedule C-1, in column D, to Ms. McCullar's depreciation adjustment amounts in column C, to produce the jurisdictional depreciation expense adjustment shown in column E. As shown there, FPL's requested 2023 depreciation expense for base rate inclusion (without RSAM) is reduced by approximately $157.845 million on a jurisdictional basis.

Q. IS THERE A RELATED IMPACT ON 2023 SUBSEQUENT YEAR RATE BASE?

A. Yes. As shown on Exhibit RCS-3, Schedule B-1, page 2, the related impact on 2023 subsequent year rate base is comprised of two components: (1) one-half of the 2023 jurisdictional depreciation rates expense adjustment, (2) a full year of the 2022 jurisdictional depreciation expense adjustment.

Dismantlement Expense

Q. HOW DID YOU REFLECT THE ADJUSTMENT FOR DISMANTLEMENT EXPENSE THAT IS BEING RECOMMENDED BY WITNESS DUNKEL?

A. This is reflected on Exhibit RCS-2, Schedule C-2. Witness Dunkel is recommending a different amount for dismantlement expense than the Company. Mr. Dunkel supplied me with the dismantlement expense amounts shown in column A of Schedule C-2, for the adjustment to reduce the Company's proposed dismantlement expense for 2022 by $17.033 million. Since he adjusted the total Company dismantlement expense amount, I applied the jurisdictional factor shown in column B to derive the jurisdictional expense adjustment

amount for dismantlement expense shown in column C, which reduces 2022 test year jurisdictional expense by $16.271 million.

Q. IS THERE A CORRESPONDING RATE BASE ADJUSTMENT RELATED TO THE ADJUSTMENT FOR DISMANTLEMENT EXPENSE?

A. Yes. As shown on Exhibit RCS-2, Schedule B-2, and discussed above, there is a related adjustment which decreases accumulated depreciation (and increases rate base). The impacts on 2022 rate base were derived by taking one-half of the annual jurisdictional dismantlement expense adjustment from Schedule C-2.

Q. WAS THE ADJUSTMENT TO DISMANTLEMENT EXPENSE FOR THE 2023 SUBSEQUENT YEAR DERIVED IN A SIMILAR MANNER?

A. Yes. The adjustment to depreciation expense for the 2023 subsequent was derived in a similar manner, as shown on Exhibit RCS-3, Schedule C-2. The amounts in columns A for FPL's 2023 dismantlement expense and the OPC recommended amount and the OPC adjustment were provided to me by Witness Dunkel. To derive the corresponding adjustment to jurisdictional depreciation expense, I applied the jurisdictional factors shown in column B, to the total Company amounts I received from Mr. Dunkel, which are shown in column A. The jurisdictional dismantlement expense adjustment is shown.in column C and reduces 2023 expense by $16.271 million on a jurisdictional basis.

Q. IS THERE A RELATED IMPACT ON 2023 SUBSEQUENT YEAR RATE BASE?

A. Yes. As shown on Exhibit RCS-3, Schedule B-2, page 2, the related impact on 2023 subsequent year rate base is comprised of two components: (1) one-half of the 2023

jurisdictional dismantlement expense adjustment, (2) a full year of the 2022 jurisdictional dismantlement expense adjustment.

Q. WERE YOU ABLE TO INTEGRATE THE DISMANTLEMENT RECOMMENDATION WITH THE COMPANY'S ANNOUNCED FILING ADJUSTMENTS?

A. Yes. Four of FPL's May 7, 2021 Notice adjustments (items 16, 22, 23, and 24) affect dismantlement costs that were reflected in the Company's 2022 and 2023 revenue requirements. Upon request, Mr. Dunkel conformed his recommended dismantlement expense adjustment to take into account those FPL corrections.

Directors and Officers Liability Expense

Q. PLEASE EXPLAIN THE ADJUSTMENT FOR DIRECTORS AND OFFICERS LIABILITY EXPENSE.

A. This adjustment reduces jurisdictional D&O Liability ("DOL") insurance expense by the amount shown on Exhibit RCS-2, Schedule C-3, to reflect an allocation to shareholders for half of the cost of the D&O insurance. DOL insurance protects shareholders from the decisions they made when they hired the Company's Board of Directors and the Board of Directors in turn hired the officers of the Company. There is no question that DOL insurance, which FPL has elected to purchase, is primarily for the benefit of shareholders. Since shareholders are the primary beneficiary, they should be responsible for the costs associated with acquiring this coverage. The Company will inevitably argue that the cost is a necessary expense which protects ratepayers. Nevertheless, the cost of the premiums associated with acquiring DOL insurance, while considered to be a necessary business expense by many, is in reality a necessary business expense designed to protect

shareholders from their past decisions. Notwithstanding that shareholders are the primary beneficiary, I am recommending that this business expense be shared equally between shareholders and rate payers.

Q. HAS THIS ISSUE IN PREVIOUS RATE CASES IN FLORIDA?

A. Yes. This issue was addressed in the Gulf Power Company rate case[11] In that case, the Commission determined that the cost for DOL insurance should be shared equally between shareholders and ratepayers. In the Progress Energy Florida ("PEF") case[12], the Commission allowed PEF to place one half the cost of DOL insurance in test year expenses noting that other jurisdictions make an adjustment for DOL insurance and that the Commission has disallowed DOL insurance in wastewater cases.

Q. WHAT IF THE COMMISSION HAD NOT DISALLOWED HALF THE COST IN THE GULF AND PEF DOCKETS, WHAT WOULD YOU THEN RECOMMEND IN THIS CASE?

A. I would still be recommending to the Commission that there be either a complete disallowance or at the very least an equal sharing, because the cost associated with DOL insurance benefits shareholders first and foremost. Unlike an unregulated entity, criteria exist for recovery of costs, such as prudence and benefit. The benefit of DOL insurance is the protection shareholders receive from directors' and officers' imprudent decision making. The benefit of this insurance clearly inures primarily to shareholders; some of whom generally are the parties initiating any suit against the directors and officers. The

[11] See, Order No. PSC-12-0179-FOF-EI, issued April 3, 2012, Docket No. 11-0138-EI, In re: Petition for increase by Gulf Power Company, at p. 101.
[12] See, Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, In re: Petition for increase in rates by Progress Energy Florida, Inc. at p. 99.

Commission's decisions on this question in the Gulf Power and PEF rate case dockets were fair, and those decisions should be followed in this Docket.

Scherer Unit 4 Retirement Inducement Payment to JEA – Amortization Expense

Q. PLEASE EXPLAIN THE ADJUSTMENT TO REMOVE THE AMORTIZATION EXPENSE ASSOCIATED WITH THE PAYMENT BY FPL TO JEA TO INDUCE JEA TO AGREE TO AN EARLY RETIREMENT OF PLANT SCHERER UNIT 4.

A. The adjustment shown on Exhibit RCS-2, Schedule C-4 removes the amortization in the 2022 forecasted test year associated with the $100 million payment by FPL to JEA to induce JEA to agree with the early retirement of Plant Scherer Unit 4. I discuss and recommend the disallowance of the recovery of this cost above. FPL has an approximately 76% ownership interest in Plant Scherer unit 4 and JEA has the remaining approximately 24% interest in that generating plant.

Q. WHAT ESTIMATED USEFUL LIFE FOR SCHERER UNIT 4 IS REFLECTED IN THE COMPANY'S CURRENT DEPRECIATION RATES?

A. FPL's current depreciation rates are based on parameters which include an assumed estimated retirement date for Plant Scherer unit 4 of June 2052.

Q. IS THE ANNOUNCED EARLY RETIREMENT DATE ESSENTIALLY MOVING UP THE RETIREMENT DATE FOR PLANT SCHERER UNIT 4 BY 30.5 YEARS?

A. Yes. As noted above, the previously assumed estimated retirement date for Plant Scherer unit 4 of June 2052 has been used in the development of FPL's current depreciation rates for that plant. Moving the retirement date up to January 1, 2022 essentially moves up the retirement date for Scherer Unit 4 by over 30 years.

Q. HAVE THERE BEEN PROBLEMS WITH THE OPERATION OF PLANT SCHERER?

A. Not to my knowledge. Indeed, the operator of Plant Scherer, Georgia Power Company has indicated that the unit GPC owns at that generating station is the most modern and efficient coal-fueled generating unit in GPC's generating fleet.

Q. WILL THE EARLY RETIREMENT BY FPL OF PLANT SCHERER UNIT 4 REDUCE FPL'S FUEL DIVERSITY?

A. Yes. The early retirement by FPL of Plant Scherer Unit 4 will reduce FPL's fuel diversity and thus could subject FPL's ratepayers to higher fuel costs if natural gas price volatility returns and natural gas prices escalate more rapidly than the prices of coal that would have been burned at Scherer Unit 4.

Q. IF THE FUEL COST SAVINGS PROJECTED BY FPL RELATED TO THE EARLY RETIREMENT OF PLANT SCHERER UNIT 4 DO NOT MATERIALIZE WOULD THERE STILL BE A CUMULATIVE NET PRESENT VALUE BENEFIT?

A. No, it appears not. FPL's claimed CPVRR benefit for the early retirement of Scherer Unit 4 of $583 million assumes a net fuel savings amount of $1.025 billion. If that fuel savings amount does not materialize, other things being equal, the claimed CPVRR benefit would be a CPVRR detriment of approximately $442 million ($1.025 billion less $583 million.).

Q. IF THAT CLAIMED BENEFIT WERE TO ACTUALLY OCCUR, WOULD JEA, AS OWNER OF 24 PERCENT OF THE PLANT, RECEIVE AT LEAST SOME OF THOSE BENEFITS?

A. Presumably if the benefits claimed by FPL for the early retirement of Plant Scherer unit 4 were to actually occur, a portion roughly commensurate with JEA's ownership, such as the claimed fuel cost savings, would inure to JEA. Thus, it would be unreasonable for FPL's ratepayers to subsidize the early retirement of Scherer Unit 4 by paying for the JEA inducement payment when JEA and its customers would be obtaining potentially tens, if not more than $100 million of benefit from that early retirement, and none of the benefits to JEA will be enjoyed by FPL ratepayers.

Q. PLEASE SUMMARIZE YOUR RECOMMENDED ADJUSTMENT FOR THE JEA SCHERER UNIT 4 EARLY RETIREMENT INDUCEMENT PAYMENT AMORTIZATION EXPENSE.

A. As shown on Exhibit RCS-2, Schedule C-4, removal of the amortization expense for the JEA Scherer Unit 4 early retirement inducement payment, reduces 2022 test year amortization expense by $8.794 million.

Rate Case Expense

Q. HAVE YOU REFLECTED AN ADJUSTMENT TO FPL'S PROPOSED RATE CASE EXPENSE AT THIS TIME?

A. No. This issue is under evaluation. There are concerns that the complexity of FPL's filing, with two forecasted test years and an additional proposed "SoBRA" rate adjustment for 2024 and 2025, has increased rate case expense. These costs are not reasonable and should not be borne by ratepayers.

Vegetation Management Expense and Storm Protection Plan

Q. WERE COSTS ASSOCIATED WITH VEGETATION MANAGEMENT AND THE STORM PROTECTION PLAN REVIEWED?

A. Yes. Because the Company is allowed separate recovery of costs associated with the approved Storm Protection Plan ("SPP") the costs are to be excluded from the current rate request. FPL excluded SPP costs as part of the Company adjustments on MFR C-1 and MFR C-3.

Q. ARE THERE ANY CONCERNS WITH THE SPP COSTS AND THE EXCLUSION OF THOSE COSTS IN THE FILING?

A. Yes, there is some concern based on the detailed support included with the detail supplied for MFR C-3 and the response to discovery. The detail support labeled "2022 Company Adjustments without RSAM" included a summary (FPL Bates Stamps No. 025813) of the SPP costs with a comparison to the costs included in the SPP filing. The summary of costs was verified to the Company adjustments in the rate filing. The concern is that the comparison indicates the SPP filing included $3.143 million more costs than what was excluded from the 2022 test year rate request. The detail indicated that $2,430,000 for Feeder Hardening and $800,000 for Distribution PIP were not included as part of the rate case adjustment. The Company should explain why the rate case adjustment did not remove the $3,230,000 included as part of the SPP filing.

Q. YOU INDICATED THAT A RESPONSE TO DISCOVERY ALSO RAISED SOME CONCERN. WHAT RESPONSE ARE YOU REFERRING TO?

A. The second supplemental response to OPC Interrogatory No. 79 indicated that distribution vegetation management costs for 2022 charged to O&M expense is $64.9 million. The detail support in FPL Bates Stamps No. 025813 identified $62,117,916 as cost excluded for distribution overhead lines. The difference of $2.8 million needs to be explained by FPL.

Q. ARE YOU RECOMMENDING AN ADJUSTMENT FOR THE VEGETATION MANAGEMENT AND SPP COST?

A. Yes. Unless FPL provides sufficient justification for the differences described, I am recommending that an adjustment to be made to remove vegetation expense from the operating expenses being used to set FPL's base rate revenue requirement of $3.230 million be made. The reduction to jurisdictional expense is $3.178 million, as shown on Exhibit RCS-2, Schedule C-5.

Interest Synchronization

Q. WHAT IS THE PURPOSE OF YOUR 2022 TEST YEAR INTEREST SYNCHRONIZATION ADJUSTMENT ON EXHIBIT RCS-2, SCHEDULE C-6?

A. The interest synchronization adjustment allows the adjusted rate base and cost of debt to coincide with the income tax calculation. Since interest expense is deductible for income tax purposes, any revisions to the rate base or to the weighted cost of debt will impact the test year income tax expense. OPC's proposed rate base and weighted cost of debt differ from the Company's proposed amounts. Thus, OPC's recommended interest deduction for determining the 2022 test year income tax expense will differ from the interest deduction used by FPL in its filing. Consequently, OPC's recommended debt ratio increase in this

case will lead to a greater interest deduction in the income tax calculation, which will in turn result in a reduction to income tax expense.

Q. IS THERE A SIMILAR INTEREST SYNCHRONIZATION ADJUSTMENT FOR THE 2023 SUBSEQUENT YEAR?

A. Yes. The similar interest synchronization adjustment for the 2023 test year is shown on Exhibit RCS-3, Schedule C-6.

Income Tax Expense Impacts of Adjustments to Operating Revenue and Expenses

Q. HAVE YOU ADJUSTED 2022 TEST YEAR INCOME TAX EXPENSE TO REFLECT THE IMPACT OF THE ADJUSTMENTS SPONSORED BY CITIZENS' WITNESSES TO NET OPERATING INCOME?

A. Yes. On Exhibit RCS-2, Schedule C.1, I calculate the impact of federal and state income tax expenses resulting from the recommended adjustments to operating expenses. The result is carried forward to the Net Operating Income Summary on Exhibit RCS-2, Schedule C.

Q. IS THERE A SIMILAR ADJUSTMENT FOR 2023?

A. Yes. The similar adjustments for 2023 for the impacts on income tax expense are shown on Exhibit RCS-3, Schedule C.1.

Incentive Compensation – Executive Compensation

Q. HAVE YOU ANALYZED FPL'S REQUEST FOR INCENTIVE COMPENSATION FOR THE TEST YEAR 2022?

A. Yes, I have. The Company MFR Schedule C-2, Test Year Consolidated (without RSAM) – Support indicates that $47,858,907 of what is labeled as "Executive Compensation" was excluded from the 2022 test year. According to the testimony of Company Witness Kathleen Slattery: "FPL has excluded from its expense request the portions of executive and non-executive incentive compensation that were excluded by the 2010 Rate Order, Order No. PSC-10-10153-FOF-EI."[13]

Q. ARE THERE ANY CONCERNS WITH WHETHER THE ADJUSTMENT MADE IN THIS FILING WAS AS DESCRIBED?

A. Yes, there is concern. The Commission's Order PSC-10-10153-FOF-EI excluded 100% of what was defined as executive compensation and 50% of what was identified as non-executive incentive compensation after first adjusting the level of compensation from an above target ratio to the target ratio. As I stated earlier, the specifics of the calculation have been requested to determine whether the Company's adjustment for incentive compensation in the current rate case is consistent with the adjustment in the 2010 Order. The concern is that in the 2010 case the ratio adjustments for executive and non-executive compensation was $12,226,189 and $2,122,947, respectively. The exclusion of the 100% of executive incentive compensation was $30,565,472 and the adjustment for non-executive compensation was $3,538,246.[14] The total of the adjustments is $48,452,854. The total requested in the 2010 rate case based on the definitions applied would be $51,991,100. That means that approximately 93.2% was excluded by the commission in Docket Nos. 080677-EI and 090130-EI. The question at hand is how could $48,452,854 be excluded then, and only $47,858,907 has been excluded in the current filing, which is the

[13] Direct Testimony of Kathleen Slattery at page 15, lines 17-20.
[14] Order No. PSC-10-0153-FOF-EI at pages 147 to 150.

estimated cost 11 years later. The OPC has pursued discovery concerning FPL's executive compensation adjustment and is anticipating receipt of some responses, such as to OPC set 15 after testimony is finalized. It is my opinion that the amount to be excluded for incentive compensation should be consistent with the decision in the 2010 order. I will reserve the right to recommend additional adjustment in this category based on the results of discovery.

Incentive Program Related to Construction Project Performance

Q. HAS THE COMPANY INCLUDED O&M EXPENSE IN THE 2022 FORECAST TEST YEAR AND 2023 SUBSEQUENT YEAR FOR AN INCENTIVE PROGRAM THAT IS RELATED TO CONSTRUCTION PROJECT PERFORMANCE?

A. Yes, as indicated in the Company's confidential responses to OPC Interrogatory No. 246 and OPC Production of Document, Request No. 48, Supplemental Attachment 6. Because this incentive is related to construction project performance, I am recommending that for ratemaking purposes the amounts identified in FPL's confidential response to OPC Interrogatory No. 246 be treated as construction project costs and removed from O&M expense in the 2022 test year and 2023 subsequent year. Due to the challenges presented by FPL's designation of related information as confidential or highly sensitive I have not reflected this adjustment on Exhibits RCS-2 or RCS-3.

Acceleration of Unprotected EADIT Amortization

Q. WHAT IS THE COMPANY PROPOSING FOR ACCELERATION OF UNPROTECTED EADIT AMORTIZATION?

A. At page 41 of his Direct Testimony, FPL Witness Bores states that FPL is seeking to accelerate $163 million in 2024 and 2025, with $81.3 million of such amortization in each year. Unprotected EADIT amortization is not subject to IRS normalization rules.

Q. SHOULD THAT COMPANY PROPOSAL BE ACCEPTED?

A. No. I agree with Mr. Bores that the Commission has the discretion to establish any amortization period for unprotected EADIT that the Commission deems appropriate, and could therefore approve either FPL's proposed amortization or a different amortization, as part of this rate case. If FPL's unprotected EADIT is going to receive an accelerated amortization in this rate case, and if there is any remaining revenue deficiency for 2022 or 2023, I recommend that the $163 million be amortized in 2022 and 2023 (rather than in 2024 and 2025) to offset any remaining revenue deficiency in those years so that unprotected EADIT is used to offset revenue requirements in 2022 or 2023 and provide rate stability in those years, rather than have it applied in 2024 and 2025 to enhance FPL's earnings in those years.

Q. HAVE YOU MADE AN ADJUSTMENT TO REFLECT ACCELERATED AMORTIZATION OF UNPROTECTED EADIT IN THE 2022 FORECASTED TEST YEAR OR THE 2023 SUBSEQUENT YEAR AT THIS TIME?

A. No. As shown on Exhibit RCS-2, Schedule A, without any accelerated amortization in 2022 of unprotected EADIT, a revenue excess of $70.9 million for the 2022 forecasted test year has been calculated. Thus, based on those results, there is no need to apply an accelerated unprotected EADIT amortization in 2022 for rate stability purposes.

On Exhibit RCS-3, Schedule A, for the 2023 subsequent year, I show a revenue deficiency of $528.6 million, without any accelerated amortization of unprotected EADIT. Applying the unprotected EADIT amount identified by FPL of $163 million against the 2023 subsequent year revenue deficiency could help mitigate the impact of a 2023 increase on ratepayers.

Q. IF THE ACCELERATED AMORTIZATION OF THESE UNPROTECTED EADIT AMOUNTS IS NOT NEEDED FOR RATE STABILITY FOR THE YEARS 2022 OR 2023, WHAT IS YOUR RECOMMENDATION REGARDING THESE DEFERRED TAX CREDITS?

A. I recommend that the credits remain in the capital structure as a cost-free source of capital unless the Commission determines that there is a positive revenue requirement for those years and if so that the Commission offset such a revenue requirement up to the extent of those unprotected EADIT balances.

VIII. OVERALL FINANCIAL SUMMARY – JANUARY 2023 SUBSEQUENT YEAR RATE CHANGE

Q. ARE YOUR SCHEDULES IN EXHIBIT RCS-3 FOR THE 2023 SUBSEQUENT TEST YEAR ORGANIZED IN A SIMILAR MANNER TO YOUR ABOVE-DESCRIBED PRESENTATION IN EXHIBIT RCS-2 FOR THE 2022 TEST YEAR?

A. Yes.

Q. HAVE YOU INCLUDED A SCHEDULE IN EXHIBIT RCS-3 TO REFLECT THE IMPACT ON 2023 SUBSEQUENT YEAR REVENUE ASSOCIATED WITH THE ADJUSTMENT TO THE 2022 REVENUE REQUIREMENT?

A. Yes. Exhibit RCS-3 includes Schedule E which reflects the impact on the 2023 subsequent year of the 2022 test year revenue requirement adjustment, adjusted for growth in 2023.

Q. WHAT IS THE JANUARY 2023 BASE RATE REVENUE REQUIREMENT DEFICIENCY OR EXCESS FOR FLORIDA POWER & LIGHT COMPANY (AND GULF POWER COMPANY) COMBINED?

A. As shown on Exhibit RCS-3, Schedule A, line 8, column E, the OPC's recommended adjustments in this case result in a recommended revenue deficiency for FPL/Gulf combined in January 2023 of approximately $457.2 million. The revenue increase requested by FPL for the 2023 subsequent year is presented in the Company's filing as a $1.920 billion revenue deficiency, as I have reproduced on Exhibit RCS-3, Schedule A, line 8, column A. The OPC amount is $1.435 billion lower than FPL's, as shown on Exhibit RCS-3, Schedule A, line 8, in column F.

The 2023 subsequent year revenue deficiency is also impacted by the revenue increase (or decrease) that has been calculated for the 2022 forecasted test year. The amounts of the 2022 revenue deficiency calculated by FPL and the 2022 revenue excess I have calculated on behalf of the OPC, with growth from 2022 to 2023, are shown on Exhibit RCS-3, line 9. After factoring in the impact of the 2022 test year revenue excess, with growth to 2023, as shown on Schedule A, line 9, in column E, the adjusted revenue deficiency of $528.6 million is shown on line 10 in column E. Compared with FPL's adjusted amount of approximately $600 million of revenue deficiency for 2023 (after the full impact of the 2022 rate increase requested by the Company), line 10, column F, shows the difference of $70.436 million.

In summary, the OPC's calculated revenue deficiency for the 2023 subsequent year of approximately $457.2 million is $1.434 billion lower than FPL's corrected 2023 amount

of $1.892 billion. This comparison is shown on Exhibit RCS-3, Schedule A, page 1, line 8.

In comparison with the Company's approximately $600 million additional revenue deficiency amount for the 2023 subsequent year, the OPC's adjusted results show a 2023 revenue deficiency of $528.6 million, which is approximately $70.4 million lower than FPL's additional 2023 revenue increase amount. This comparison is shown on Exhibit RCS-3, Schedule A, page 1, line 10. This deficiency is calculated assuming that the information from two years out can provide a reasonable basis for establishing rates. As discussed below this is not a reasonable assumption.

Q. BY CALCULATING A REVENUE DEFICIENCY FOR 2023 AS YOU HAVE DESCRIBED, IS IT YOUR OPINION THAT FPL HAS JUSTIFIED OR IS OTHERWISE ENTITLED TO A RATE INCREASE IN THAT AMOUNT?

A. No. My presentation of a 2023 revenue deficiency is based on the forecasts and assumptions offered by FPL. It is my opinion as well of that of OPC Witness Lawton that the subsequent year is inherently unreliable for rate setting purposes and that the Commission should deny relief at this time for 2023.

Q: DO YOU BELIEVE THAT THE 2023 SUBSEQUENT YEAR REQUEST IS NECESSARY OR GOOD POLICY?

A. No, I do not think that a subsequent test year is necessary or good policy. The test year is supposed to be representative of rates on a going-forward basis. If the test year is chosen appropriately, there should be no reason for another rate adjustment so shortly after original test year. As the Commission noted in Order No. PSC-10-0153-FOF-EI, at page 9, "[i]f

the test year is truly representative of the future, then the utility should earn a return within the allowed range for at least the first 12 months of new rates." As the Commission noted, these types of back-to-back rate cases deprive the Commission and ratepayers of twelve months of actual economic data and operating history of the Company. Id. The Commission further stated that "[w]e believe that back-to-back rate increases should be allowed only in extraordinary circumstances." Id. The Company has shown no extraordinary need for the subsequent test year. In fact, OPC's recommendation is for a reduction of approximately $70.9 million based on the 2022 test year (approximately $71.4 million with growth in 2023).

IX. SOBRA STEP INCREASES – 2024 AND 2025

Q. COULD YOU PLEASE BRIEFLY DESCRIBE FPL'S REQUEST AS IT PERTAINS TO THE PROPOSED ADDITIONAL BASE RATE REVENUE REQUIREMENT INCREASES FOR 2024 AND 2025?

A. FPL proposes a solar base rate adjustment ("SoBRA") mechanism for solar generating facilities projected to be placed into service during 2024 and 2025. The Company's SoBRA mechanism is summarized on FPL Exhibit REB-12 and is discussed in the Company's Direct Testimony, including the testimony of FPL Witness Barrett at pages 67-68.

Q. DO YOU HAVE A PRIMARY RECOMMENDATION AS TO WHETHER THE COMMISSION SHOULD APPROVE FPL'S REQUESTED SOBRA INCREASES IN THE CURRENT FPL RATE CASE?

A. Yes. I recommend that the FPL-proposed SoBRA base rate revenue increases not be approved at this time. This is primarily because of my previous recommendations

addressed in my testimony reflecting a revenue excess for 2022. I am also skeptical of the accuracy and reasonableness of FPL's 2024-2025 projections, given that they are three and four years further out in the future.

Q. IF THE COMMISSION WERE TO APPROVE BASE RATE INCREASES FOR 2024 AND 2025 FOR SOLAR PLANT ADDITIONS, HOW SHOULD THE CAPITAL STRUCTURE FOR 2024 AND 2025 BE DERIVED?

A. If the 2024 and 2025 step increases for solar plant additions are going to be considered, contrary to OPC's recommendations, the applicable rate of return that the Commission will apply to the projected rate base should be based on OPC's overall recommended 2022 rate of return. In Order No. PSC-09-0283-FOF-EI, issued April 30, 2009, the Commission applied its authorized overall rate of return it found appropriate for determining the base rate increase for Tampa Electric Company in its calculation of the January 1, 2010 step increase associated with five combustion turbine units being placed into service. This is demonstrated at pages 138 and 139 of the Order, on Schedules 5 and 6.

Next, I recommend that the projected amount of rate base and operating costs associated with the 2024 and 2025 solar generating plant projects be updated based on more recent forecasts, which should be presented by FPL in 2023 prior to approval of any additional base rate increases related to such solar projects.

Additionally, I recommend that the any start-up costs included in FPL's projections of SoBRA base rate revenue requirement increases be removed so that base rates established at the time of the proposed step increases would be based on normalized costs and exclude one-time non-recurring charges.

Q. YOU STATED THAT THE PROJECTED AMOUNT OF RATE BASE AND OPERATING COSTS ASSOCIATED WITH THE 2024 AND 2025 SOLAR GENERATING PROJECTS SHOULD BE UPDATED BASED ON MORE RECENT FORECASTS. PLEASE EXPLAIN.

A. In 2023, prior to approval of any limited purpose step increases in FPL's base rates related to projected solar generating plant additions in 2024, updated estimates should be presented by FPL. This would apply only if the Commission determines that additional base rate increases in 2024 and 2025 for new solar generating plant additions are needed. OPC's primary recommendation, as noted above, is that the Commission reject the 2024 and 2025 SoBRA step increases because OPC shows a revenue excess for 2022. While OPC's adjustments to 2023 test year show a revenue deficiency, forecasting out two years is inherently inaccurate and is bad policy for the reasons discussed above. Further, FPL has not demonstrated that a 2024 or 2025 base rate increase would be necessary to keep FPL from falling below the low point of its authorized ROE range. Approval of projected 2024 of 2025 base rate increases would be premature.

X. FPL PROPOSED MECHANISM TO ADDRESS FEDERAL INCOME TAX CHANGES

Q. HAS FPL PROPOSED A MECHANISM TO ADDRESS POTENTIAL CHANGES IN FEDERAL INCOME TAXES BEFORE ITS NEXT BASE RATE CASE?

A. Yes. As explained in the Direct Testimony of Witness Bores, the Company is proposing a mechanism to address potential changes in federal income tax law. FPL proposes that the impact of any change in tax law be handled through an adjustment to its base rates. FPL proposes that within 90 days of the enactment of the new tax law, FPL will submit the calculation of the required change in its base rates to the Commission for review. FPL

indicates that under no instance would FPL defer incremental income tax expense for 2021 or request the tax-related base rate adjustment be implemented prior to January 1, 2022. FPL notes that during the period of its four-year plan, legislation could result in increasing the federal corporate income tax rate from the current 21% to something higher. Witness Bores' Direct Testimony at pages 44-47 describes the Company's proposal to adjust rates for income tax changes. At page 46, Mr. Bores states that:

> [f]or the time period between enactment of the new tax law and implementation of new tax-adjusted base rates, FPL will defer the impact of new tax law to the balance sheet for collection through the Capacity Clause in the subsequent year. Any difference between actual income tax expense and the amount of the 2022 or 2023 base rate increase will be recorded in net operating income and reflected in FPL's earnings surveillance reports for all periods.

FPL proposes to flow back (or collect) unprotected ADIT resulting from tax law changes over a ten-year period. (Witness Bores Direct Testimony at pp. 46-47).

FPL suggests that, if there is a tax law change, it would prepare two sets of updated MFR schedules A-1, B-1 and C-1 and D-1a for both the 2022 test year and for the 2023 SYA that reflects the Commission's final rate order. FPL would prepare those MFR schedules in two ways: (1) utilizing current tax law under the Tax Cuts and Jobs Act ("TCJA") and (2) applying the new tax law. FPL states that the difference in revenue requirements between the two sets of MFR schedules would demonstrate the difference resulting from the new tax law and would be the amount that FPL proposes to utilize as an adjustment to base rates for both 2022 and 2023. For 2024 and 2025, FPL proposes no adjustment to base rates consistent with its four-year proposal.

If a new tax law is enacted after 2023, FPL proposes to update the 2023 MFRs reflecting the Commission's final base rate order and the impacts of the new tax law. In

that situation, FPL proposes, for the time period between enactment of the new tax law and implementation of new tax-adjusted base rates, FPL proposes to defer the impact of tax law changes on its balance sheet for collection through the Capacity Clause in the subsequent year. For any differences between actual income tax expense and the amount of the 2022 or 2023 base rate increase, FPL states that will be recorded in net operating income and reflected in FPL's earnings surveillance reports for all periods.

For deferred income taxes, FPL proposes that any deficient or excess accumulated deferred income taxes ("ADIT") that arise would be deferred as a regulatory asset or liability on its balance sheet and included within FPL's capital structure. FPL proposes to follow new tax law specifications for the treatment of protected excess ADIT ("EADIT"), and to amortize unprotected EADIT over a 10-year period, which Mr. Bores states is consistent with FPL's treatment under the TCJA and Order No. PSC-2019-0225-FOF-EL. FPL has also proposed that it be allowed to use accelerated amortization of its unprotected EADIT in 2024 and 2025. I have addressed FPL's proposal for accelerated unprotected EADIT amortization in 2024 and 2025 above, and have recommended that it be rejected. If the Commission does not accept FPL's proposed rate consolidation with Gulf, FPL proposes to make separate calculations for FPL and Gulf.

Q. SHOULD FPL'S PROPOSED TAX LAW CHANGE MECHANISM BE ADOPTED AS PROPOSED BY FPL?

A. No. It is my understanding that in the most recent (2017) Gulf Power rate case, the Commission has ruled that federal corporate income tax rate changes that are part of proposals and not actually in the law are too speculative for even considering in a pending rate case. Instead, a separate docket is the appropriate vehicle for considering any impact

of an income tax rate change. Specifically, the Commission ruled that the issue is "premature and not ripe for consideration at this time. Should federal tax changes occur in the future, the issue may be addressed at the appropriate time in a separate proceeding."[15] Additionally, unlike other Florida regulated utilities, FPL did not flow back the savings associated with the TCJA to ratepayers. Rather, FPL has used TCJA savings to replenish its depreciation reserve excess and to apply amounts from the replenished depreciation reserve excess to obtain earnings above the mid-point and in several months at the top end of the allowed earnings range – all for the benefit of shareholders. Thus, the base rate change mechanism for potential new tax law changes proposed by FPL should not be adopted.

Q. IS IT CLEAR WHAT A NEW TAX LAW WILL DO?

A. No. As recognized by the Commission's policy, it is entirely speculative at this point. It has been reported that a preliminary proposal has been floated by the Biden administration to raise the federal corporate income tax rate, currently at 21% under the TCJA, to 28%. There have then been subsequent reports of a "minimum" corporate tax of 15%. As new proposed federal income tax legislation is being developed, there may be other provisions that favor development of clean energy by providing tax credits, tax deductions or other incentives. Currently, it is very unclear what a new federal tax law will do, or whether it will even be enacted. In any event such speculation cannot be entertained in accord with the Commission's policy.

[15] See, Order No. PSC-2017-0099-PHO-EI at pp. 107-108.

Q. IF SIGNIFICANT NEW FEDERAL INCOME TAX LEGISLATION IS ENACTED DURING THE PENDENCY OF FPL'S CURRENT RATE CASE, HOW SHOULD FPL REPORT THE IMPACTS OF SIGNIFICANT CHANGES THAT COULD RESULT FROM POTENTIAL FEDERAL INCOME TAX LAW REVISIONS?

A. If significant tax law changes occur during the pendency of FPL's current rate case, FPL should update its MFRs for the 2022 test year and the 2023 SYA, and the rate case schedule should be suspended so that parties will have adequate time to review and address such changes.

Q. IF SIGNIFICANT NEW FEDERAL INCOME TAX LEGISLATION IS ENACTED AFTER A FINAL COMMISSION ORDER IN THE CURRENT FPL RATE CASE, HOW SHOULD FPL REPORT THE IMPACTS OF SIGNIFICANT CHANGES THAT COULD RESULT FROM POTENTIAL FEDERAL INCOME TAX LAW REVISIONS?

A. If the significant tax law changes occur after a final Commission Order in FPL's current base rate case, FPL should report the impacts on its ESRs. FPL should comply with requirements in any new tax law concerning the treatment of protected EADIT. FPL should report the amount of unprotected EADIT, including supporting details. Only if and to the extent FPL's earnings, as reported in its ESRs would, after full amortization of any RSAM-related Reserve Amount if authorized over the objection of the OPC), fall below the bottom end of the allowed earnings range should any base rate adjustment be considered. FPL should have the option of filing a new rate case for new base rates. A limited proceeding to address impacts from new federal income tax legislation that might be enacted may also be available depending on proximity to end of rate case.

Q. IF SIGNIFICANT FEDERAL INCOME TAX LEGISLATION IS PASSED, WOULD THAT TEND TO AFFECT ALL FLORIDA REGULATED UTILITIES, NOT JUST FPL?

A. Yes. If significant new federal income tax legislation is passed, such as a change in federal corporate income tax rate, it would likely affect all regulated Florida utilities, not just FPL, thus, there may be a need for a generic proceeding to consider the impacts not only on FPL, but also on the other affected utilities that are regulated by the Commission. If such a proceeding were opened, that would likely be the appropriate "separate proceeding" the Gulf Power order directed all parties to, for consideration of tax law changes on underearning utilities.

XI. STORM COST RECOVERY MECHANISM

Q. PLEASE DISCUSS THE COMPANY'S PROPOSAL FOR A STORM COST RECOVERY MECHANISM.

A. FPL proposes to continue a storm cost recovery mechanism ("SCRM") that it indicates was approved as part of the Company's 2016 rate case settlement. Witness Barrett addresses the Company's proposed mechanism in his Direct Testimony starting at page 56 and continuing through page 59. FPL proposes storm cost reserve replenishment to $150 million, subject to a $4/1,000 kWh cap per calendar year, subject to FPL requesting an increase in the cap if FPL incurs in excess of $800 million of storm recovery costs that qualify for recovery in a given calendar year. The terms of FPL's proposed SCRM are detailed on Exhibit REB-10.

Q. DOES MR. BARRETT EXPLAIN HOW ITS PROPOSED SCRM WOULD IMPACT THE CURRENT GULF POWER COMPANY SURCHARGE FOR HURRICANE SALLY COSTS?

A. At page 57 of his Direct Testimony, Mr. Barrett explains that:

> If the Commission approves the Company's petition to combine rates, the current Gulf surcharge for Hurricane Sally will cease when all approved deferred storm costs have been recovered exclusive of any replenishment of Gulf's storm reserve. If the Commission does not approve the Company's petition to combine rates, the Hurricane Sally surcharge will continue until Gulf's reserve is replenished in accordance with its current settlement agreement.

Q. HOW HAS FPL RECOVERED STORM COSTS?

A. FPL indicates that it incurred approximately $1.3 billion in storm costs related to Hurricane Irma. FPL applied TCJA related savings and the Excess Depreciation Reserve amount to "amortize" $1,148,303,252 of those costs. FPL has also applied TCJA related savings to replenish its Excess Depreciation Reserve Amount using the current RSAM. In December FPL applied an amount of approximately $265.4 million for recovery of the cost of Dorian and Other Storms.

Q. HAS MR. BARRETT INDICATED WHAT THE FPL AND GULF STORM RESERVE BALANCES ARE?

A. At page 58 of his Direct Testimony, Mr. Barrett indicates that as of December 31, 2020, FPL has a funded storm reserve of $115 million for FPL and zero for Gulf.

Q. WHAT ARE THE POTENTIAL ADVANTAGES OF SECURITIZING LARGE AMOUNTS FOR COSTS THAT ARE INCURRED TO RESTORE ELECTRIC SERVICE AFTER MAJOR STORMS, SUCH AS NAMED HURRICANES?

A. Securitization of large amounts of storm restoration costs could, depending on the structure and financing costs, potentially result in significant financing cost savings to ratepayers, versus other forms of storm costs recovery, such as those incorporating a rate base/rate of return that includes a common equity return with an income tax gross up.

Q. SHOULD FPL'S PROPOSED STORM COST RECOVERY MECHANISM BE APPROVED AS PROPOSED BY THE COMPANY?

A. No, not as proposed by FPL. FPL should continue to have access to a customer surcharge mechanism (and/or to Company-proposed securitization) for significant storm costs that are in excess of its funded reserve. However, as discussed in Section II of my testimony, under no circumstance should FPL be allowed to ever again charge storm recovery costs against the depreciation reserve surplus or to use an RSAM for recovery of storm costs or for purposes of manipulating its earnings.

Q. DOES THIS COMPLETE YOUR DIRECT TESTIMONY?

A. Yes, it does.

(Transcript continues in sequence in Volume 7.)

CERTIFICATE OF REPORTER

STATE OF FLORIDA)
COUNTY OF LEON)

I, DEBRA KRICK, Court Reporter, do hereby certify that the foregoing proceeding was heard at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorney or counsel connected with the action, nor am I financially interested in the action.

DATED this 21st day of September, 2021.

DEBRA R. KRICK
NOTARY PUBLIC
COMMISSION #HH31926
EXPIRES AUGUST 13, 2024