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FLORIDA PUBLIC UTILITIES COMPANY

DOCKET NO. 940620-GU

DIRECT AND REBUTTAL TESTIMONY OF PETE LESTER
ON BEHALF OF THE STAFF OF THE FLORIDA PUBLIC SERVICE COMMISSION
DIVISION OF AUDITING AND FINANCIAL ANALYSIS

FILED: MARCH 3, 1995

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FPSC-RECORDS/REPORTING

DIRECT TESTIMONY OF PETE LESTER

1 |
2 | Q. Please state your name and business address.

3 | A. My name is Pete Lester. My business address is 101 East Gaines Street,
4 | Tallahassee, Florida 32399-0865.

5 | Q. By whom are you employed and in what capacity?

6 | A. I am employed by the Florida Public Service Commission as an Economic
7 | Analyst in the Finance Section of the Division of Auditing and Financial
8 | Analysis.

9 | Q. Will you briefly summarize your educational background and regulatory
10 | experience?

11 | A. I received a Bachelor of Science degree in Finance from Florida State
12 | University in March 1978. In June 1980, I received a Masters of Business
13 | Administration degree also from Florida State University. In August 1980, I
14 | began work as a material price analyst for Avco Aerostructures, a major
15 | aerospace subcontractor located in Nashville, Tennessee. My responsibilities
16 | included preparing bids for subcontracts, analyzing price variances among
17 | vendors, pricing plan changes, and helping customer and government auditors.

18 | In September 1981, I joined the Staff of the Florida Public Service
19 | Commission as a staff analyst in the Division of Water and Wastewater. As an
20 | analyst, I was responsible for rate structure issues on file and suspend rate
21 | cases and for all finance, accounting, and rate structure issues for
22 | staff-assisted rate cases, overearnings investigations, and certificate cases.
23 | In addition, I was responsible for case coordination and scheduling,
24 | presenting staff positions to customers at customer meetings, responding to
25 | customer complaints, and conducting research projects.

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FPSC-RECORDS/REPORTING

1 In August 1990, I was promoted to an Economic Analyst position in the
2 Finance Section in the Division of Auditing and Financial Analysis. My
3 responsibilities include advising the Commission on the appropriate cost of
4 equity, capital structure, and overall cost of capital for utility companies
5 in rate cases and other Commission proceedings. I also analyze the effect
6 that statements of the Financial Accounting Standards Board have on utility
7 regulation in Florida.

8 Q. Are you a member of any professional associations?

9 A. Yes, I am a member of the National Society of Rate of Return Analysts
10 (NSRRA). I have been awarded the professional designation Certified Rate of
11 Return Analyst (CRRA) by the NSRRA. This designation is awarded based upon
12 education, experience and the successful completion of a written examination.

13 Q. Have you previously testified before the Commission?

14 A. Yes, I have. In addition, as a Commission staff member, I have
15 participated in many rate proceedings.

16 Q. What is the purpose of your testimony?

17 A. The purpose of my testimony is to recommend the appropriate cost of
18 common equity for Florida Public Utilities Company ("FPUC") to be used in
19 calculating a fair rate of return on rate base.

20 Q. Do you have exhibits that accompany your testimony?

21 A. Yes. Accompanying my testimony are Exhibits PHL-1 through PHL-11.
22 Exhibit PHL-1 is an index of the exhibits.

23 Q. What principles provide the legal framework for your determination of
24 the cost of equity?

25

1 A. The principles established by the Supreme Court of the United States in
2 Bluefield Waterworks and Improvement Company v. Public Service Commission of
3 West Virginia, 262 U.S. 679 (1923) and Federal Power Commission v. Hope
4 Natural Gas Company 320 U.S. 591 (1944). These cases provide the legal basis
5 for my analysis. The Supreme Court held in both the Hope and Bluefield
6 decisions that the return to the equity owner should be commensurate with
7 returns on investments in other enterprises having corresponding risks. Also,
8 the return should be sufficient to assure confidence in the financial
9 integrity of the enterprise so that it can maintain credit and attract
10 capital.

11 Q. Please define the cost of common equity.

12 A. The cost of common equity is the minimum rate of return necessary to
13 attract capital to a common equity investment. It is the minimum rate of
14 return that a stockholder considers acceptable, considering both the riskiness
15 of the investment and returns available on other investments.

16 Q. How does your cost of equity recommendation meet the basic legal
17 criteria of the Hope and Bluefield decisions?

18 A. My recommendation of the appropriate cost of equity for FPUC is based
19 upon an analysis of required returns for common equity investments with
20 comparable risk as determined through the direct application of capital market
21 valuation models to current financial data. I believe an analysis based upon
22 current stock prices, interest rates, and investor expectations satisfies the
23 comparable returns, capital attraction, and financial integrity guidelines
24 established in the Hope and Bluefield decisions for determining a fair and
25 reasonable rate of return on common equity.

1 Q. What do you recommend as the cost of common equity for FPUC?

2 A. Based upon the results of my analysis, I recommend that the cost of
3 equity for Florida Public Utilities Company is 11.20%.

4 Q. Would you describe the general approach you used to determine FPUC's
5 cost of equity?

6 A. I analyzed current economic conditions and trends, as well as industry
7 and company factors. I believe these factors and conditions affect the
8 capital markets. I then applied two generally accepted market-based rate of
9 return models to an index of comparable natural gas distribution companies.
10 The results of this analysis are the basis for my recommended cost of equity
11 for FPUC.

12 Q. What is your analysis of the current economic environment?

13 A. The economy is continuing to recover from the recession of 1990/1991.
14 Growth in gross domestic product (GDP), the total amount of goods and services
15 produced in the United States, and the unemployment rate are indicators of
16 current economic activity. GDP grew at an annual rate of 4.5% in the fourth
17 quarter of 1994, up from the 3.3% rate in the first quarter of 1994. The GDP
18 growth rate for 1994 was 4.0%. The civilian unemployment rate stood at 5.7%
19 in January 1995, a slight increase from the 5.6% figure in the fourth quarter
20 of 1994 but a significant decrease from the 6.6% rate in the first quarter of
21 1994, the 6.1% average rate for 1994, and the 6.8% average rate for 1993.
22 Unemployment has had a downward trend for the past 2.5 years.

23 The economic expansion has raised concerns about increases in inflation.
24 The annual inflation rate, as measured by the change in the Consumer Price
25 Index, was 3.6% and 2.2% in the third and fourth quarters of 1994,

1 | respectively. The March 1, 1995 issue of the Blue Chip Financial Forecasts
2 | estimates the annual inflation rate will rise to 3.5% by the fourth quarter
3 | of 1995. The Federal Reserve has stated that it has an objective of
4 | sustained, noninflationary growth. Since January 1994, the Federal Reserve
5 | has taken several actions that increased the Federal funds rate by 300 basis
6 | points, from 3.00% in January 1994 to the current 6.00%. The Federal funds
7 | rate is the rate banks charge on overnight loans to each other and depends on
8 | the amount of reserves in the banking system. Typically, the Federal Reserve
9 | targets the Federal funds rate by increasing or decreasing reserves in the
10 | banking system, which, in turn, controls the supply of money. This is the
11 | most common way the Federal Reserve carries out monetary policy.

12 | Q. How do current economic conditions affect the cost of equity?

13 | A. Inflation and interest rates significantly affect investor return
14 | requirements. Inflation has a major impact on interest rates because it
15 | erodes purchasing power. The rate of inflation built into interest rates is
16 | the rate of inflation expected in the future.

17 | Q. Why is an assessment of risk important in determining the cost of
18 | equity?

19 | A. An assessment of risk is important in determining the cost of equity
20 | because investors are risk-averse. The higher the risk of an investment, the
21 | higher the return that investors require and vice versa.

22 | Q. How have you assessed risk in your analysis?

23 | A. I have analyzed conditions in the natural gas distribution industry and
24 | for FPUC. Included in this analysis is an assessment of business risk as well
25 | as opportunities and prospects for the industry and FPUC. Regarding financial

1 risk, I have analyzed the effect my recommended cost of equity will have on
2 the interest coverage ratio of FPUC.

3 Q. Please define business risk and financial risk.

4 A. Business risk is the uncertainty inherent in projections of future
5 returns on assets and depends on many factors such as demand variability,
6 sales price variability, the ability to adjust output prices for changes in
7 input prices, and the extent to which costs are fixed.

8 Financial risk is the additional risk, above business risk, faced by
9 stockholders due to the firm's use of financial leverage.

10 Q. What is your analysis of conditions in the natural gas distribution
11 industry?

12 A. The natural gas distribution industry faces risks and opportunities.
13 Bypass of the local distribution company (LDC) by large industrial customers
14 and competition from fuel oil continue to be significant risks. Flexible rate
15 design mitigates these risks by allowing the LDC to retain industrial
16 customers and compete with other fuels available to industrial customers. An
17 additional concern is the effect of the restructuring caused by Order 636 of
18 the Federal Energy Regulatory Commission (FERC).

19 Q. Please discuss the effect FERC Order 636 has had on natural gas
20 distribution companies.

21 A. For interstate pipeline companies, Order 636 removed the obligation to
22 provide a supply of gas to customers and it unbundled pipeline rates for
23 sales, transportation, and storage of gas. The supply obligation, and the
24 risks inherent with it, now rests with the LDCs, which must purchase supplies
25 of gas from producers and reserve pipeline capacity to transport the gas.

1 | However, this risk is reduced since Order 636 does not represent a sudden
2 | change but is instead the culmination of gradual changes by FERC. Pipelines
3 | have been unbundling rates and LDCs have been purchasing gas since FERC Order
4 | 436, which began open access, was issued in 1985. Also, the proceedings that
5 | resulted in Order 636 began in 1991.

6 | Additional concerns are the recovery of transition costs caused by
7 | implementing Order 636, increased operating leverage for the LDC due to the
8 | straight fixed-variable rate structure charged by the pipelines, and price
9 | risk associated with supply contracts that are either fixed price or have a
10 | market-sensitive price.

11 | Order 636 became effective on November 1, 1993. LDCs adequately managed
12 | gas supplies during the record-setting cold winter that followed, which was
13 | a good test of how LDCs can manage in the 636 environment. Still, one winter
14 | does not constitute a complete test. I believe that some uncertainty remains
15 | regarding the effects of Order 636 on LDCs.

16 | Q. What opportunities exist for LDCs?

17 | A. Natural gas has a very high and growing market share in the U.S. It is
18 | a clean, efficient, competitively-priced fuel in ample supply. In addition,
19 | both the Clean Air Act Amendments passed in 1990 and the National Energy
20 | Policy Act of 1992 encourage the use of natural gas. Many LDCs face
21 | attractive prospects for expanding their share in residential, commercial, and
22 | industrial markets as well as developing markets for fleet vehicles,
23 | residential and commercial gas cooling, and cogeneration.

24 | Q. Are there other positive signs for LDCs?

25 |

1 A. Yes. In analyzing LDCs and pipeline companies for bond ratings,
2 Standard and Poor's (S & P) evaluates each company's business position based
3 on qualitative factors such as market growth potential, exposure to industrial
4 risk, adequacy and diversity of supply, and regulatory environment. The
5 business positions are ranked in seven categories from above average to below
6 average. Significantly, no LDCs have below average or somewhat below average
7 business positions.

8 Q. How do the risks and opportunities you have discussed affect FPUC?

9 A. FPUC is exposed to the remaining uncertainty regarding FERC Order 636.
10 Also, like all Florida investor-owned gas companies, FPUC is served by only
11 one pipeline, Florida Gas Transmission (FGT). This factor is mitigated by
12 FGT's Phase III expansion that increased capacity by 60%. FPUC anticipates
13 that this pipeline expansion program will provide adequate future pipeline
14 capacity through the FGT system to permit continued customer and load growth
15 into the next century.

16 FPUC has gained experience in directly contracting for gas supplies and
17 this experience should enable the company to operate effectively in the 636
18 environment. FPUC has lowered its cost of gas by purchasing gas from
19 suppliers rather than from FGT.

20 Regarding risk due to potential bypass and industrial fuel switching,
21 FPUC depends significantly on interruptible and transportation customers.
22 This fact makes FPUC somewhat susceptible to fuel switching and bypass risk.

23 FPUC has favorable opportunities for growth but experienced little
24 growth in residential customers from 1989 to 1993. According to FPUC's 1993
25 Annual Report, FPUC anticipates growth in commercial accounts, additions of

1 residential subdivisions, and expanding sales through new applications such
2 as gas air conditioning and desiccant units.

3 Q. How does the concept of efficient capital markets affect your analysis?

4 A. I believe that the capital markets are efficient, meaning that current
5 market prices of stocks and bonds reflect all publicly available information.
6 The economic conditions, risks, and opportunities that I have discussed are
7 reflected in the stock prices of LDCs. Therefore, an analysis using current
8 capital market information such as stock prices for LDCs and interest rates
9 will appropriately reflect the cost of equity.

10 Q. Can the cost of equity be estimated precisely?

11 A. No. Estimating the cost of equity is a subjective procedure. The cost
12 of equity depends on investor expectations, which cannot be known entirely and
13 which change frequently. Therefore, the cost of equity cannot be measured
14 precisely and it is generally estimated within a range. When analyzing cost
15 of equity estimates, it is important to understand the rationale underlying
16 the subjective inputs and how well the models relied upon reflect reality.

17 Q. What methods did you use to determine the cost of common equity for
18 FPUC?

19 A. To determine the cost of equity for FPUC, I used a two-stage annually
20 compounded discounted cash flow (DCF) model and a risk premium analysis. I
21 applied these models to the common stocks of the companies in the Moody's
22 Natural Gas Distribution Index. This procedure allowed me to determine the
23 general cost of equity for LDCs.

24 Relying on an index of comparable companies, instead of a single
25 company, helps minimize forecasting errors and should provide more reliable

1 | information for use in measuring the cost of equity. Use of an index of
2 | companies avoids abnormal conditions that might be associated with one
3 | company.

4 | Q. Please describe the Moody's Natural Gas Distribution Index.

5 | A. The companies in the Moody's Natural Gas Distribution Index are
6 | representative of the natural gas distribution industry. Being in the same
7 | industry, these companies face similar risks and are subject to similar
8 | economic and regulatory influences. I have listed the companies and their
9 | investment characteristics on Exhibit PHL-2.

10 | The investment risk characteristics for the index are: an average Value
11 | Line safety ranking of 1.50, with 1 being the highest and 5 the lowest, an
12 | average Value Line beta of .61, a range of bond ratings from Aa3 to A3, and
13 | an average equity ratio of 48%, including short-term debt. According to S &
14 | P, the companies in the index have business positions ranging from low average
15 | to high average and somewhat above average.

16 | Q. What is the theory behind a DCF model?

17 | A. The DCF model is based on two principles. First, investors value an
18 | asset based on the future cash flows they expect to receive. Second,
19 | investors value a dollar today more than a dollar received in the future,
20 | meaning that the time value of money is assumed. Therefore, in a DCF
21 | analysis, the cost of equity is the discount rate that equates the present
22 | value of expected cash flows associated with a share of stock to the present
23 | market price of the stock.

24 | On Exhibit PHL-3, I have provided the basic DCF equation and defined the
25 | terms in the equation. The basic model has three simplifying assumptions: 1)

1 dividends are paid annually and grow at a constant rate; 2) the price of the
2 stock is determined on the dividend payment date; and 3) dividends increase
3 once a year starting one year from the dividend payment date.

4 Q. What DCF model have you used in your analysis?

5 A. I have used a two-stage annually compounded DCF model. An assumption
6 behind the basic DCF model is that dividends grow at a constant rate. Yet
7 growth in dividends can vary from period to period. A two-stage DCF model,
8 also known as a non-constant growth model, allows for two periods of dividend
9 growth: a near term period during which dividends are specifically forecasted
10 and a subsequent period of sustainable growth.

11 On Exhibit PHL-4, I have presented the equation for my two-stage
12 annually compounded DCF model and defined the terms. This model is consistent
13 with the valuation practices of institutional investors and financial
14 analysts. An additional advantage of the two-stage model is that it can use
15 the specific dividend forecast from Value Line and then use a sustainable
16 growth rate. The two-stage model allows for more precision than the basic
17 model.

18 Q. What are the inputs for your DCF model?

19 A. I used current stock prices for the companies in Moody's index, specific
20 dividend forecasts for the initial growth period, and a sustainable or long-
21 term growth rate. For current stock prices, I first calculated the average
22 of the high and low stock prices for January 1995 for each company in the
23 index. I then calculated an average stock price for the index, which is the
24 input to my model. I used Value Line's forecast of dividends for 1995 and
25 1998 and assumed a constant growth rate between these years to estimate

1 dividends for the initial growth period. I calculated the long-term growth
2 rate using the earnings retention method, also known as the "b x r approach."
3 The inputs for my earnings retention method are Value Line's expected earned
4 return on equity (r) and the expected retention rate (b) for 1998.

5 Q. Have you included an allowance for issuance costs in your DCF model?

6 A. Yes. My DCF model includes an allowance for issuance cost, calculated
7 as 3% of the stock price. An allowance for issuance cost enables the utility
8 to recover the costs incurred when issuing common stock. Issuance costs
9 include registration fees, legal fees, underwriter fees, and printing and
10 mailing expenses. Investors could not earn the required return on their
11 investment without an issuance cost adjustment because the sales price of the
12 stock will exceed the net proceeds to the company because the company will
13 incur issuance costs. A company can incur these costs whether the stock is
14 publicly traded or privately held.

15 Conceptually, this situation with common stock is similar to that of
16 bonds and preferred stock. With bonds, for example, the cost charged to
17 ratepayers reflects issuance costs and is recovered over the life of the bond.
18 The cost to the company for a specific bond issue is the interest expense plus
19 the amortization of issuance costs divided by the principal value less the
20 unamortized issuance costs. The result is that the cost to the utility is
21 greater than the return to the creditor.

22 Unlike bonds, common stock does not have a finite life. Therefore,
23 issuance costs cannot be amortized and must be recovered by an upward
24 adjustment to the allowed return on equity. This adjustment reflects the fact
25 that, due to the issuance costs, the utility earns a return on an equity

1 balance that is less than the actual amount paid by investors. Historically,
2 utility underwriting expenses associated with issuing common stock have
3 averaged 3 to 4 percent of gross proceeds.

4 Q. What are the results of your DCF analysis?

5 A. The results of my DCF analysis show that the cost of equity for the
6 index is 9.83%. Exhibit PHL-5 shows the inputs and results of my analysis.

7 Q. What is the theory behind a risk premium analysis?

8 A. The basic theory supporting a risk premium analysis is that common
9 equity is more risky than debt. Therefore, the cost of common equity is
10 higher than the cost of debt. Common equity is more risky than debt because
11 the returns on common equity are less certain than the returns on debt. Debt
12 is a contractual obligation and the debtholder receives interest payments on
13 the debt as specified by contract. Further, if a default occurs, bondholders
14 have a claim on the assets of the company. In contrast, the return on common
15 equity is a residual return in that interest must be paid in full before
16 dividends on common equity can be paid.

17 Since equity is more risky than debt and since investors are risk
18 averse, investors require a higher return on common equity compared to the
19 return on debt. Current yields on debt are readily observable in the capital
20 markets. With a risk premium approach, the equity risk premium is estimated
21 and added to the current yield on debt to determine the cost of equity.
22 Exhibit PHL-6 presents the equation I used for my risk premium model.

23 Q. Please describe your risk premium model.

24 A. My risk premium uses DCF estimates of the cost of common equity for the
25 Moody's Natural Gas Distribution Index for each of the past 120 months, that

1 is, from February 1985 through January 1995. I used the same DCF methodology
2 that I described earlier, with the stock prices, forecasted dividends, and
3 growth rates current for each particular month. For each monthly result, I
4 subtracted the concurrent yield on 30-year Treasury Bonds to obtain the risk
5 premium for that month.

6 Q. Based upon this analysis, what is your estimate of the risk premium?

7 A. The risk premium averaged 281 basis points, or 2.81%, for the period
8 February 1985 through January 1995.

9 Q. What measure of debt cost did you add to the risk premium to determine
10 the cost of equity?

11 A. I used the March 1, 1995 Blue Chip Financial Forecasts' (Blue Chip)
12 consensus forecast of the yield for 30 year Treasury Bonds. Blue Chip is a
13 publication that provides interest rate forecasts from 50 leading financial
14 forecasters. The forecasted yield for 30 year Treasury Bonds for 1995 is
15 7.8%. This is based on the forecasts for the first three quarters of 1995.
16 I believe use of a forecasted yield on Treasury Bonds is appropriate since it
17 encompasses investor expectations about the economy.

18 Q. Based on your risk premium analysis, what is the cost of equity for the
19 index?

20 A. I added the risk premium of 2.81% to 7.8%, the expected yield on 30 year
21 Treasury Bonds. The resulting 10.61% is the cost of equity for the index
22 based on my risk premium analysis. Exhibit PHL-7 presents my risk premium
23 cost of equity calculation and data.

24 Q. Given the results of your DCF and risk premium analysis, what is the
25 range for the cost of equity for the index?

1 A. The cost of equity for the Moody's Natural Gas Distribution Index ranges
2 from 9.83% to 10.61%. I have rounded this range to the nearest 10 basis
3 points, which makes the range 9.80% to 10.60%.

4 Q. Is the range for the cost of equity for the index appropriate for FPUC?

5 A. No. While the range I calculated for the index is an appropriate
6 starting place, FPUC is riskier than the companies in the index and should be
7 allowed a higher cost of equity.

8 Q. Why is FPUC riskier than the companies in the index?

9 A. Exhibit PHL-8 compares the total capitalization and gas sold or
10 transported for the companies in the index to that of FPUC. This shows that
11 FPUC is significantly smaller than the companies in the index. As such, FPUC
12 is less diverse with respect to its markets and may be more severely affected
13 by economic changes. Studies suggest that smaller firms are generally riskier
14 than larger firms and have higher costs of equity. Small firms experience
15 more business failures and have a less liquid market for their shares.

16 Q. How did you adjust the cost of equity that you calculated for the index
17 to estimate the cost of equity for FPUC?

18 A. As I noted earlier, the bond ratings for the companies in Moody's index
19 range from Aa3 to A3. (See Exhibit PHL-2). Using S & P's system as an
20 example, bonds in the top four categories of bond ratings, AAA, AA, A, and
21 BBB, are considered investment grade and are eligible for bank investment
22 under the regulations of the Controller of the Currency. In addition, laws
23 of various states restrict investments by banks, insurance companies, pension
24 funds and fiduciaries generally to investment grade bonds. Bonds rated BB or
25 lower are considered speculative, indicating issuers may not make timely

1 interest and principal payments. As a public utility providing an essential
2 service, and given efficient management and a sound regulatory environment (S
3 & P considers Florida a supportive regulatory environment.), FPUC's credit
4 should be considered investment grade.

5 I used the historic spread between the yields on Aa3 and Baa3 public
6 utility bonds as a proxy for the higher return required for FPUC. Four of the
7 eight companies in the Moody's index have a bond rating of Aa3. Therefore, I
8 have used Aa3 as a representative bond rating for the index. The Aa3 bond
9 rating is slightly higher than the median bond rating for the index. The Baa3
10 rating is the lowest level of investment grade. By using the spread between
11 an Aa3 rating and a Baa3 rating, I believe that I am ensuring a proper
12 adjustment for FPUC's smaller size.

13 Q. How did you calculate the historic spread between Aa3-rated and Baa3-
14 rated public utility bonds?

15 A. I subtracted the yield on Aa3 public utility bonds from the yield on
16 Baa3 public utility bonds as reported in Moody's Bond Survey for the last 120
17 months and averaged the results. Exhibit PHL-9 presents the data and results.
18 The spread over the past 120 months between Aa3 and Baa3 public utility bonds
19 is 59 basis points, which I have rounded to 60 basis points.

20 Q. What is your estimate of the cost of equity for FPUC?

21 A. Adding the 60 basis points to my DCF and risk premium results provides
22 a range of 10.40% to 11.20% for the cost of equity of FPUC. Exhibit PHL-10
23 presents the range for FPUC. I believe that the top of this range is
24 appropriate for the cost of equity for FPUC, therefore, I recommend 11.20% as
25 the cost of equity for Florida Public Utilities Company.

1 Determining the appropriate point estimate is a difficult but necessary
2 decision in estimating the cost of equity and, ultimately, it rests on
3 judgement. Having adjusted for FPUC's smaller size, I analyzed other
4 pertinent risk characteristics. On the favorable side, FPUC has the proven
5 ability to contract directly for gas in an economical way, which is a definite
6 advantage in the 636 environment. On the unfavorable side, historical
7 customer growth has been flat with anticipated customer growth requiring
8 capital spending and, thus, financing stress. Also, compared to the companies
9 in the index, FPUC is more dependent on interruptible and transportation
10 customers. Further, FPUC has a comparatively low equity ratio. In my
11 judgement, the top of the range for the cost of equity, 11.20% is reasonable
12 and will compensate FPUC appropriately.

13 By convention, the Florida Public Service Commission allows a range
14 around the authorized cost of equity. Therefore, I recommend that the cost
15 of equity for FPUC is 11.20% for all regulatory purposes, with a range of plus
16 or minus 100 basis points.

17 Q. Have you checked your recommended cost of equity for its effect on
18 FPUC's financial condition?

19 A. Yes. Using my recommended cost of equity of 11.20%, I have estimated
20 the projected pre-tax interest coverage ratio for FPUC to be 2.6x. This
21 compares favorably with S & P's utility financial benchmark ratios, which are
22 listed on Exhibit PHL-11. Also listed on that exhibit are the benchmark total
23 debt to total capital ratios.

24 Q. Have you reviewed the testimony that company witness Robert S. Jackson
25 filed in this case?

1 A. Yes, I have.

2 Q. Do you have comments about Mr. Jackson's direct testimony?

3 A. Yes, I have comments about Mr. Jackson's comparable earnings analysis
4 and market-to-book value adjustment to his DCF results.

5 Q. What are your comments about Mr. Jackson's comparable earnings study?

6 A. Mr. Jackson uses Value Line's projected earned returns on common equity
7 for 12 gas companies. The problem with this approach is that, though the cost
8 of equity depends on investor expectations, the comparable earnings approach
9 ignores capital markets. Value Line's projected earned returns are based on
10 projected book value. However, the market value of a share of stock reflects
11 investors' expectations and fluctuates according to the investors' return
12 requirements. Therefore, one significant problem with the comparable earnings
13 approach is that it relies on accounting-based earned returns though
14 investors' required returns, derived from the capital markets, are appropriate
15 for determining the cost of equity.

16 Also, Mr. Jackson's comparable earnings study uses a group of regulated
17 utilities. The book return on equity for regulated firms is affected by the
18 past actions of regulators. Therefore, a circularity problem exists with
19 using a comparable earnings study that includes regulated utilities since the
20 earned returns of utilities are influenced by the rate of return set by their
21 regulators.

22 Q. What are your comments on Mr. Jackson's market-to-book value adjustment
23 to his DCF results?

24

25

1 A. Mr. Jackson adjusts the result of his DCF study upward because the
2 market-to-book ratios of the companies in his comparison group is above 1.0.
3 I disagree with this adjustment.

4 According to DCF theory, the required rate of return on common equity
5 is the discount rate that equates the stream of dividends in the future with
6 the market price of a share of a company's stock. Investors' required
7 returns, as specified by the capital markets, change with investor
8 expectations for investment opportunities, inflation, and risks. Investors
9 bid the price of a share of stock up or down according to changes in their
10 required returns. That the market price of a share of stock is above or below
11 its book value does not necessitate an adjustment to the DCF result. Instead,
12 this indicates that the required return has changed with changes in investor
13 expectations and the market price of the stock. The required return is the
14 minimum return necessary to attract capital and, therefore, is appropriate for
15 calculating the rate of return on rate base. Adjusting the DCF result for a
16 market-to-book value greater than 1.0 will not reflect the required rate of
17 return.

18 Q. Please summarize your testimony.

19 A. The purpose of my testimony was to determine the appropriate cost of
20 equity for Florida Public Utilities Company. Using generally accepted
21 financial models and making appropriate adjustments for risk, I recommend that
22 the cost of equity for FPUC is 11.20%.

23 Q. Does this conclude your testimony?

24 A. Yes, it does.

25

INDEX OF SCHEDULES

EXHIBIT PHL-1	INDEX
EXHIBIT PHL-2	MOODY'S INVESTMENT CHARACTERISTICS
EXHIBIT PHL-3	BASIC DCF EQUATION
EXHIBIT PHL-4	TWO-STAGE ANNUALLY COMPOUNDED DCF MODEL
EXHIBIT PHL-5	DCF INPUTS AND RESULTS
EXHIBIT PHL-6	BASIC RISK PREMIUM EQUATION
EXHIBIT PHL-7	RISK PREMIUM CALCULATION AND DATA
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MOODY'S NATURAL GAS DISTRIBUTION INDEX
INVESTMENT RISK CHARACTERISTICS

COMPANY	CURRENT S & P BOND RATING	CURRENT MOODY'S BOND RATING	CURRENT VALUE LINE SAFETY RANKING	CURRENT VALUE LINE BETA	1993 EQUITY RATIO	1993 S & P COVERAGE RATIO	CURRENT S & P BUS. POS.
ATLANTA GAS LIGHT	A-	A3	2	0.65	42%	2.85	LOW AVG.
BAY STATE GAS	A	A2	2	0.55	45%	3.31	AVG.
BROOKLYN UNION GAS	A	A1	1	0.50	51%	3.36	SOMEWHAT ABV. AVG.
INDIANA ENERGY	AA-	AA3	1	0.65	57%	3.65	HIGH AVG.
LACLEDE GAS	AA-	AA3	1	0.50	49%	3.48	AVG.
NORTHWEST NATURAL GAS	A	A3	2	0.55	40%	3.36	HIGH AVG.
PEOPLES ENERGY	AA-	AA3	2	0.75	51%	3.53	AVG.
WASHINGTON GAS LIGHT	AA-	AA3	1	0.70	52%	4.03	HIGH AVG.
AVERAGE			<u>1.50</u>	<u>0.61</u>	<u>48%</u>	<u>3.45</u>	

SOURCE: Value Line Investment Survey, Edition 3, December 30, 1994
Standard and Poor's Global Sector Review, July 1994
Standard and Poor's Bond Guide, February 1995
1994 Financial Statistics Public Utilities, C.A. Turner Utility Reports

BASIC DCF EQUATION

$$P_0 = \frac{D_1}{(1+K)} + \frac{D_2}{(1+K)^2} + \frac{D_3}{(1+K)^3} + \dots + \frac{D^{\infty}}{(1+K)^{\infty}}$$

where: D_t = Dividends paid at the end of period t

K = Investor's required rate of return

P_0 = The current price of the stock

this also can be written as

$$P_0 = \sum_{t=1}^{\infty} \frac{D_t}{(1+K)^t}, \text{ as } n \text{ approaches } \infty$$

Assuming constant growth in dividends and $g < K$, these equations reduce to

$$K = \frac{D_1}{P_0} + g$$

where g is the constant growth rate in dividends.

TWO-STAGE ANNUALLY COMPOUNDED DCF MODEL

$$P_0(1-FC) = \frac{D_1}{(1+K)} + \frac{D_2}{(1+K)^2} + \dots + \frac{D_n}{(1+K)^n} + \frac{D_n(1+g)}{K-g} \frac{1}{(1+K)^n}$$

Where

P_0 = The current stock price

D_1, D_2, \dots, D_n = Expected dividends each year

FC = Flotation costs

K = Investors required rate of return

g = The constant growth rate after year n

COST OF EQUITY FOR FPUC
DISCOUNTED CASH FLOW MODEL

COMPANY	DIV1	DIV2	DIV3	DIV4	EPS4	ROE4	Growth		Hi-Price	LO-Price	January Average Price
							Yr 1-4	4+			
ATLANTA GAS LIGHT	2.08	2.13	2.19	2.24	2.80	12.50	1.0250	1.0250	32.375	29.750	31.063
BAY STATE GAS	1.46	1.54	1.62	1.70	2.40	11.00	1.0520	1.0321	23.875	22.250	23.063
BROOKLYN UNION GAS	1.39	1.43	1.46	1.50	2.15	11.50	1.0257	1.0348	24.500	22.000	23.250
INDIANA ENERGY	1.08	1.15	1.22	1.29	1.95	13.50	1.0610	1.0457	20.625	17.750	19.188
LACLEDE GAS	1.24	1.25	1.27	1.28	1.75	12.50	1.0106	1.0336	20.250	18.500	19.375
NORTHWEST NAT. GAS	1.78	1.83	1.89	1.95	3.00	12.00	1.0309	1.0420	30.500	27.500	29.000
PEOPLES ENERGY	1.84	1.87	1.91	1.94	2.55	12.50	1.0178	1.0299	27.875	26.125	27.000
WASHINGTON GAS LIGHT	2.24	2.28	2.31	2.35	3.00	11.50	1.0161	1.0249	35.250	32.250	33.750
AVERAGE	1.64	1.68	1.73	1.78	2.45	12.13	1.0299	1.0335			25.711

9.83% = Cost of equity required to match the current stock price with the expected cash flows

\$24.94 = January 1995 average stock price less 3% flotation costs, or $P_0(1-f_c)$

\$24.94 = \$1.49 \$1.40 \$1.31 \$1.22 \$19.52 = discounted annual expected cash flows

Data Sources:

1. Stock Prices - S&P Stock Guide, February 1995 Edition
2. DPS, EPS, ROE - Value Line Edition 3, December 30, 1994

BASIC RISK PREMIUM EQUATION

$$K_e = K_d + RP$$

Where K_e = The cost of equity

K_d = The expected cost of debt

RP = The expected risk premium

**ESTIMATED MONTHLY RISK PREMIUMS
MOODY'S NATURAL GAS DISTRIBUTION INDEX
FEBRUARY 1985 - JANUARY 1995**

YEAR	MONTH	Annual Cost of Equity Gas	Risk Free Rate	Risk Premium	
1985	MAR	14.526	11.56	2.966	
	APR	14.243	11.92	2.323	
	MAY	14.257	11.55	2.707	
	JUN	14.160	11.08	3.080	
	JUL	14.478	10.48	3.998	
	AUG	14.596	10.62	3.976	
	SEP	15.130	10.70	4.430	
	OCT	14.573	10.78	3.793	
	NOV	14.654	10.66	3.994	
	DEC	14.240	10.19	4.050	
	1986	JAN	13.465	9.68	3.785
		FEB	13.393	9.59	3.803
MAR		13.328	9.26	4.068	
APR		12.606	8.15	4.456	
MAY		12.363	7.58	4.783	
JUN		12.400	8.13	4.270	
JUL		11.525	8.27	3.255	
AUG		11.397	7.88	3.517	
SEP		11.367	7.74	3.627	
OCT		11.136	8.10	3.036	
NOV		11.330	8.06	3.270	
DEC		11.066	7.82	3.246	
1987	JAN	11.553	7.66	3.893	
	FEB	11.360	7.62	3.740	
	MAR	11.334	7.71	3.624	
	APR	11.021	7.64	3.381	
	MAY	11.456	8.35	3.106	
	JUN	11.590	8.85	2.740	
	JUL	11.437	8.67	2.767	
	AUG	11.546	8.77	2.776	
	SEP	11.547	9.06	2.487	
	OCT	11.833	9.67	2.163	
	NOV	12.553	9.73	2.823	
	DEC	12.692	9.10	3.592	

ESTIMATED MONTHLY RISK PREMIUMS (continued)

YEAR	MONTH	Annual Cost of Equity Gas	Risk Free Rate	Risk Premium
1988	JAN	12.833	9.23	3.603
	FEB	12.480	8.93	3.550
	MAR	12.133	8.48	3.653
	APR	12.053	8.64	3.413
	MAY	12.053	8.97	3.083
	JUN	12.036	9.30	2.736
	JUL	11.730	9.11	2.620
	AUG	11.707	9.28	2.427
	SEP	11.973	9.42	2.553
	OCT	11.736	9.14	2.596
	NOV	11.703	8.96	2.743
	DEC	11.747	9.09	2.657
1989	JAN	11.693	9.10	2.593
	FEB	11.710	9.05	2.660
	MAR	11.776	9.15	2.626
	APR	12.220	9.31	2.910
	MAY	12.127	9.17	2.957
	JUN	11.967	8.93	3.037
	JUL	11.763	8.37	3.393
	AUG	11.584	8.13	3.454
	SEP	11.492	8.23	3.262
	OCT	11.168	8.29	2.878
	NOV	11.180	8.12	3.060
	DEC	11.046	8.00	3.046
1990	JAN	10.725	8.00	2.725
	FEB	10.864	8.37	2.494
	MAR	11.025	8.63	2.395
	APR	11.135	8.73	2.405
	MAY	11.285	8.92	2.365
	JUN	11.404	8.87	2.534
	JUL	11.180	8.60	2.580
	AUG	11.150	8.62	2.530
	SEP	11.410	8.93	2.480
	OCT	10.830	9.08	1.750
	NOV	11.000	8.89	2.110
	DEC	11.000	8.58	2.420

ESTIMATED MONTHLY RISK PREMIUMS (continued)

YEAR	MONTH	Annual Cost of Equity Gas	Risk Free Rate	Risk Premium
1991	JAN	10.740	8.27	2.470
	FEB	10.886	8.31	2.576
	MAR	10.869	8.09	2.779
	APR	10.582	8.36	2.222
	MAY	10.530	8.26	2.270
	JUN	10.538	8.31	2.228
	JUL	10.520	8.52	2.000
	AUG	10.506	8.47	2.036
	SEP	10.407	8.15	2.257
	OCT	10.721	7.95	2.771
	NOV	10.489	7.86	2.629
	DEC	10.465	7.80	2.665
1992	JAN	10.336	7.55	2.786
	FEB	10.391	7.46	2.931
	MAR	10.444	7.76	2.684
	APR	10.428	7.90	2.528
	MAY	10.544	7.85	2.694
	JUN	10.478	7.77	2.708
	JUL	10.282	7.70	2.582
	AUG	10.117	7.37	2.747
	SEP	9.945	7.15	2.795
	OCT	9.605	7.05	2.555
	NOV	9.811	7.24	2.571
	DEC	9.887	7.40	2.487
1993	JAN	9.441	7.29	2.151
	FEB	9.313	7.16	2.153
	MAR	9.128	6.87	2.258
	APR	8.934	6.63	2.304
	MAY	9.042	6.63	2.412
	JUN	9.168	6.67	2.498
	JUL	9.382	6.54	2.842
	AUG	8.605	6.33	2.275
	SEP	8.624	6.16	2.464
	OCT	8.675	5.93	2.745
	NOV	8.693	5.89	2.803
	DEC	8.968	6.23	2.738
1994	JAN	8.960	6.26	2.700
	FEB	8.632	6.23	2.402
	MAR	8.721	6.44	2.281
	APR	8.965	6.89	2.075
	MAY	9.232	7.30	1.932
	JUN	9.361	7.47	1.891
	JUL	9.553	7.42	2.133
	AUG	9.514	7.60	1.914
	SEP	9.599	7.54	2.059
	OCT	9.727	7.77	1.957
	NOV	9.618	8.01	1.608
	DEC	9.972	8.15	1.822
1995	JAN	10.124	7.95	2.174
	FEB	9.831	7.92	1.911

AVERAGE

2.811

SOURCES: Value Line Investment Survey
S&P Stock Guide
Moody's Bond Survey

TOTAL CAPITALIZATION AND SALES VOLUME

COMPANY	1993 TOTAL CAPITALIZATION	1993 GAS SOLD OR TRANSPORTED MCF
ATLANTA GAS LIGHT	\$1,578,600,000	266,420,000
BAY STATE GAS	\$563,000,000	50,418,000 *
BROOKLYN UNION GAS	\$1,897,847,000	128,972,000 *
INDIANA ENERGY	\$631,280,000	111,354,000
LACLEDE GAS	\$515,312,000	108,011,000
NORTHWEST NAT. GAS	\$849,036,000	104,362,900
PEOPLES ENERGY	\$1,765,870,000	277,614,000
WASHINGTON GAS LT	\$1,194,702,000	137,508,500
AVERAGE	\$1,124,455,875	148,082,550
FPUC - Consd. Gas. Div.	\$29,784,622	6,201,000

* Gas Sales Only

SOURCE: 1994 FINANCIAL STATISTICS PUBLIC UTILITIES, C. A. TURNER
UTILITY REPORTS, MFRs Sched. B-1,

BOND YIELD DIFFERENTIALS
 Public Utility Bond Yield Averages
 Source: Moody's Bond Survey

120 Month Average		0.0769		0.0769		0.1091		0.1091		0.1091		0.1091		
YEAR	MON	Aa3 SPREAD		A1 SPREAD		A2 SPREAD		A3 SPREAD		Baa1 SPREAD		Baa2 SPREAD		Baa3
1995	JAN	8.68	0.02	8.71	0.02	8.73	0.14	8.87	0.14	9.01	0.14	9.15	0.14	9.29
	DEC	8.71	0.02	8.74	0.02	8.76	0.13	8.89	0.13	9.03	0.13	9.16	0.13	9.29
	NOV	8.93	0.03	8.95	0.03	8.98	0.12	9.10	0.12	9.23	0.12	9.35	0.12	9.47
	OCT	8.81	0.03	8.83	0.03	8.86	0.13	8.99	0.13	9.11	0.13	9.24	0.13	9.37
	SEP	8.59	0.03	8.61	0.03	8.64	0.11	8.75	0.11	8.87	0.11	8.98	0.11	9.11
	AUG	8.35	0.03	8.38	0.03	8.41	0.11	8.52	0.11	8.63	0.11	8.74	0.11	8.85
	JUL	8.41	0.03	8.44	0.03	8.47	0.11	8.58	0.11	8.69	0.11	8.80	0.11	8.91
	JUN	8.24	0.03	8.28	0.03	8.31	0.11	8.42	0.11	8.53	0.11	8.64	0.11	8.75
	MAY	8.27	0.03	8.30	0.03	8.33	0.09	8.42	0.09	8.52	0.09	8.61	0.09	8.70
	APR	8.15	0.03	8.19	0.03	8.22	0.08	8.30	0.08	8.39	0.08	8.47	0.08	8.55
	MAR	7.78	0.04	7.81	0.04	7.85	0.09	7.94	0.09	8.02	0.09	8.11	0.09	8.20
	FEB	7.38	0.04	7.43	0.04	7.47	0.10	7.57	0.10	7.66	0.10	7.76	0.10	7.86
1994	JAN	7.23	0.05	7.28	0.05	7.33	0.11	7.44	0.11	7.55	0.11	7.66	0.11	7.77
	DEC	7.23	0.05	7.29	0.05	7.34	0.13	7.47	0.13	7.60	0.13	7.73	0.13	7.86
	NOV	7.21	0.04	7.26	0.04	7.30	0.13	7.43	0.13	7.56	0.13	7.69	0.13	7.82
	OCT	6.94	0.05	6.98	0.05	7.03	0.08	7.11	0.08	7.19	0.08	7.27	0.08	7.35
	SEP	6.94	0.05	6.99	0.05	7.04	0.10	7.14	0.10	7.25	0.10	7.35	0.10	7.45
	AUG	7.13	0.06	7.19	0.06	7.25	0.11	7.36	0.11	7.48	0.11	7.59	0.11	7.70
	JUL	7.43	0.05	7.49	0.05	7.54	0.13	7.67	0.13	7.80	0.13	7.93	0.13	8.06
	JUN	7.61	0.07	7.68	0.07	7.75	0.10	7.85	0.10	7.95	0.10	8.05	0.10	8.15
	MAY	7.71	0.07	7.79	0.07	7.86	0.11	7.97	0.11	8.07	0.11	8.18	0.11	8.29
	APR	7.70	0.06	7.75	0.06	7.81	0.10	7.91	0.10	8.01	0.10	8.11	0.10	8.21
	MAR	7.81	0.05	7.85	0.05	7.90	0.07	7.97	0.07	8.03	0.07	8.10	0.07	8.17
	FEB	7.96	0.04	8.00	0.04	8.04	0.09	8.13	0.09	8.22	0.09	8.31	0.09	8.40
1993	JAN	8.18	0.04	8.23	0.04	8.27	0.10	8.37	0.10	8.47	0.10	8.57	0.10	8.67
	DEC	8.36	0.04	8.39	0.04	8.43	0.09	8.52	0.09	8.60	0.09	8.69	0.09	8.78
	NOV	8.55	0.04	8.59	0.04	8.63	0.08	8.71	0.08	8.78	0.08	8.86	0.08	8.94
	OCT	8.46	0.04	8.50	0.04	8.54	0.07	8.61	0.07	8.69	0.07	8.76	0.07	8.83
	SEP	8.32	0.04	8.36	0.04	8.40	0.05	8.45	0.05	8.49	0.05	8.54	0.05	8.59
	AUG	8.35	0.05	8.39	0.05	8.44	0.05	8.49	0.05	8.53	0.05	8.58	0.05	8.63
	JUL	8.49	0.04	8.53	0.04	8.57	0.04	8.61	0.04	8.65	0.04	8.69	0.04	8.73
	JUN	8.68	0.05	8.73	0.05	8.78	0.04	8.82	0.04	8.86	0.04	8.90	0.04	8.94
	MAY	8.75	0.06	8.81	0.06	8.87	0.05	8.92	0.05	8.96	0.05	9.01	0.05	9.06
	APR	8.82	0.06	8.87	0.06	8.93	0.06	8.99	0.06	9.05	0.06	9.11	0.06	9.17
	MAR	8.87	0.05	8.92	0.05	8.97	0.06	9.03	0.06	9.10	0.06	9.16	0.06	9.22
	FEB	8.82	0.06	8.87	0.06	8.93	0.05	8.98	0.05	9.04	0.05	9.09	0.05	9.14
1992	JAN	8.70	0.07	8.77	0.07	8.84	0.05	8.89	0.05	8.93	0.05	8.98	0.05	9.03
	DEC	8.77	0.06	8.82	0.06	8.88	0.06	8.94	0.06	9.01	0.06	9.07	0.06	9.13
	NOV	8.93	0.06	8.99	0.06	9.05	0.08	9.13	0.08	9.20	0.08	9.28	0.08	9.36
	OCT	8.99	0.07	9.05	0.07	9.12	0.07	9.19	0.07	9.25	0.07	9.32	0.07	9.39
	SEP	9.02	0.07	9.09	0.07	9.16	0.06	9.22	0.06	9.28	0.06	9.34	0.06	9.40
	AUG	9.14	0.08	9.21	0.08	9.29	0.06	9.35	0.06	9.41	0.06	9.47	0.06	9.53
	JUL	9.36	0.10	9.45	0.10	9.55	0.05	9.60	0.05	9.64	0.05	9.69	0.05	9.74
	JUN	9.38	0.10	9.49	0.10	9.59	0.07	9.66	0.07	9.72	0.07	9.79	0.07	9.86
	MAY	9.25	0.09	9.35	0.09	9.44	0.07	9.51	0.07	9.57	0.07	9.64	0.07	9.71
	APR	9.25	0.11	9.35	0.11	9.46	0.06	9.52	0.06	9.58	0.06	9.64	0.06	9.70
	MAR	9.34	0.11	9.44	0.11	9.55	0.06	9.61	0.06	9.68	0.06	9.74	0.06	9.80
	FEB	9.26	0.10	9.37	0.10	9.47	0.07	9.54	0.07	9.61	0.07	9.68	0.07	9.75
1991	JAN	9.50	0.11	9.60	0.11	9.71	0.08	9.79	0.08	9.88	0.08	9.96	0.08	10.04
	DEC	9.52	0.10	9.63	0.10	9.73	0.08	9.81	0.08	9.88	0.08	9.96	0.08	10.04
	NOV	9.69	0.10	9.80	0.10	9.90	0.07	9.97	0.07	10.05	0.07	10.12	0.07	10.19
	OCT	9.86	0.09	9.96	0.09	10.05	0.08	10.13	0.08	10.20	0.08	10.28	0.08	10.36
	SEP	9.95	0.08	10.04	0.08	10.12	0.07	10.19	0.07	10.25	0.07	10.32	0.07	10.39
	AUG	9.83	0.05	9.87	0.05	9.92	0.07	9.99	0.07	10.05	0.07	10.12	0.07	10.19
	JUL	9.66	0.05	9.70	0.05	9.75	0.06	9.81	0.06	9.86	0.06	9.92	0.06	9.98
	JUN	9.67	0.07	9.73	0.07	9.80	0.05	9.85	0.05	9.91	0.05	9.96	0.05	10.01
	MAY	9.89	0.06	9.94	0.06	10.00	0.05	10.05	0.05	10.11	0.05	10.16	0.05	10.21
	APR	9.85	0.04	9.88	0.04	9.92	0.07	9.99	0.07	10.06	0.07	10.13	0.07	10.20
	MAR	9.66	0.06	9.77	0.06	9.85	0.07	9.92	0.07	9.99	0.07	10.06	0.07	10.13
	FEB	9.63	0.06	9.70	0.06	9.76	0.07	9.83	0.07	9.89	0.07	9.96	0.07	10.03
1990	JAN	9.45	0.06	9.50	0.06	9.56	0.06	9.62	0.06	9.68	0.06	9.74	0.06	9.80
	DEC	9.32	0.06	9.38	0.06	9.44	0.05	9.49	0.05	9.55	0.05	9.60	0.05	9.65
	NOV	9.34	0.09	9.42	0.09	9.51	0.04	9.55	0.04	9.60	0.04	9.64	0.04	9.68
	OCT	9.37	0.09	9.45	0.09	9.54	0.03	9.57	0.03	9.61	0.03	9.64	0.03	9.67

BOND YIELD DIFFERENTIALS
Public Utility Bond Yield Averages
Source: Moody's Bond Survey

120 Month Average		0.0769		0.0769		0.1091		0.1091		0.1091		0.1091		
YEAR	MON	Aa3 SPREAD		A1 SPREAD		A2 SPREAD		A3 SPREAD		Baa1 SPREAD		Baa2 SPREAD		Baa3
	SEP	9.43	0.08	9.50	0.08	9.58	0.04	9.62	0.04	9.66	0.04	9.70	0.04	9.74
	AUG	9.35	0.08	9.44	0.08	9.52	0.04	9.56	0.04	9.60	0.04	9.64	0.04	9.68
	JUL	9.32	0.09	9.41	0.09	9.50	0.05	9.55	0.05	9.59	0.05	9.64	0.05	9.69
	JUN	9.46	0.09	9.55	0.09	9.64	0.05	9.69	0.05	9.75	0.05	9.80	0.05	9.85
	MAY	9.86	0.07	9.92	0.07	9.99	0.10	10.09	0.10	10.19	0.10	10.29	0.10	10.39
	APR	10.07	0.05	10.13	0.05	10.18	0.10	10.28	0.10	10.39	0.10	10.49	0.10	10.59
	MAR	10.11	0.06	10.17	0.06	10.23	0.09	10.32	0.09	10.41	0.09	10.50	0.09	10.59
	FEB	9.98	0.05	10.02	0.05	10.07	0.10	10.17	0.10	10.28	0.10	10.38	0.10	10.48
1989	JAN	9.95	0.06	10.02	0.06	10.08	0.10	10.18	0.10	10.28	0.10	10.38	0.10	10.48
	DEC	9.95	0.05	10.01	0.05	10.06	0.13	10.19	0.13	10.31	0.13	10.44	0.13	10.57
	NOV	9.85	0.06	9.91	0.06	9.97	0.11	10.08	0.11	10.20	0.11	10.31	0.11	10.42
	OCT	9.83	0.03	9.87	0.03	9.90	0.15	10.05	0.15	10.20	0.15	10.35	0.15	10.50
	SEP	10.43	0.09	10.52	0.09	10.61	0.17	10.78	0.17	10.96	0.17	11.13	0.17	11.30
	AUG	10.96	0.11	11.06	0.11	11.17	0.17	11.34	0.17	11.52	0.17	11.69	0.17	11.86
	JUL	10.85	0.09	10.95	0.09	11.04	0.16	11.20	0.16	11.36	0.16	11.52	0.16	11.68
	JUN	10.61	0.09	10.70	0.09	10.79	0.16	10.95	0.16	11.11	0.16	11.27	0.16	11.43
	MAY	10.62	0.09	10.72	0.09	10.81	0.19	11.00	0.19	11.19	0.19	11.38	0.19	11.57
	APR	10.37	0.08	10.46	0.08	10.54	0.23	10.77	0.23	11.00	0.23	11.23	0.23	11.46
	MAR	9.98	0.06	10.03	0.06	10.09	0.20	10.29	0.20	10.49	0.20	10.69	0.20	10.89
	FEB	9.97	0.06	10.04	0.06	10.10	0.18	10.28	0.18	10.47	0.18	10.65	0.18	10.83
1988	JAN	10.60	0.08	10.68	0.08	10.76	0.19	10.95	0.19	11.15	0.19	11.34	0.19	11.53
	DEC	10.85	0.07	10.91	0.07	10.98	0.19	11.17	0.19	11.36	0.19	11.55	0.19	11.74
	NOV	10.69	0.07	10.75	0.07	10.82	0.19	11.01	0.19	11.21	0.19	11.40	0.19	11.59
	OCT	11.19	0.08	11.26	0.08	11.34	0.19	11.53	0.19	11.72	0.19	11.91	0.19	12.10
	SEP	10.85	0.19	11.03	0.19	11.22	0.12	11.34	0.12	11.46	0.12	11.58	0.12	11.70
	AUG	10.18	0.13	10.32	0.13	10.45	0.15	10.60	0.15	10.75	0.15	10.90	0.15	11.05
	JUL	9.85	0.15	10.00	0.15	10.15	0.16	10.31	0.16	10.46	0.16	10.62	0.16	10.78
	JUN	9.75	0.14	9.88	0.14	10.02	0.15	10.17	0.15	10.31	0.15	10.46	0.15	10.61
	MAY	9.72	0.09	9.82	0.09	9.91	0.16	10.07	0.16	10.24	0.16	10.40	0.16	10.56
	APR	9.23	0.08	9.30	0.08	9.38	0.16	9.54	0.16	9.69	0.16	9.85	0.16	10.01
	MAR	8.74	0.10	8.83	0.10	8.93	0.09	9.02	0.09	9.10	0.09	9.19	0.09	9.28
	FEB	8.79	0.10	8.90	0.10	9.00	0.08	9.08	0.08	9.16	0.08	9.24	0.08	9.32
1987	JAN	8.73	0.11	8.84	0.11	8.95	0.11	9.06	0.11	9.16	0.11	9.27	0.11	9.38
	DEC	8.91	0.10	9.02	0.10	9.12	0.12	9.24	0.12	9.37	0.12	9.49	0.12	9.61
	NOV	9.10	0.09	9.19	0.09	9.28	0.14	9.42	0.14	9.55	0.14	9.69	0.14	9.83
	OCT	9.33	0.09	9.43	0.09	9.52	0.14	9.66	0.14	9.81	0.14	9.95	0.14	10.09
	SEP	9.36	0.08	9.44	0.08	9.52	0.15	9.67	0.15	9.81	0.15	9.96	0.15	10.11
	AUG	9.12	0.09	9.20	0.09	9.29	0.14	9.43	0.14	9.56	0.14	9.70	0.14	9.84
	JUL	9.16	0.11	9.26	0.11	9.37	0.11	9.48	0.11	9.58	0.11	9.69	0.11	9.80
	JUN	9.45	0.09	9.53	0.09	9.62	0.14	9.76	0.14	9.89	0.14	10.03	0.14	10.17
	MAY	9.45	0.07	9.52	0.07	9.59	0.14	9.73	0.14	9.88	0.14	10.02	0.14	10.16
	APR	8.96	0.09	9.05	0.09	9.14	0.16	9.30	0.16	9.47	0.16	9.63	0.16	9.79
	MAR	9.27	0.11	9.37	0.11	9.48	0.14	9.62	0.14	9.77	0.14	9.91	0.14	10.05
	FEB	10.07	0.09	10.17	0.09	10.26	0.16	10.42	0.16	10.58	0.16	10.74	0.16	10.90
1986	JAN	10.56	0.12	10.67	0.12	10.79	0.15	10.94	0.15	11.09	0.15	11.24	0.15	11.39
	DEC	10.70	0.13	10.84	0.13	10.97	0.17	11.14	0.17	11.31	0.17	11.48	0.17	11.65
	NOV	11.23	0.13	11.36	0.13	11.49	0.18	11.67	0.18	11.86	0.18	12.04	0.18	12.22
	OCT	11.74	0.13	11.88	0.13	12.01	0.17	12.18	0.17	12.35	0.17	12.52	0.17	12.69
	SEP	11.83	0.15	11.98	0.15	12.13	0.20	12.33	0.20	12.52	0.20	12.72	0.20	12.92
	AUG	11.81	0.16	11.97	0.16	12.13	0.20	12.33	0.20	12.53	0.20	12.73	0.20	12.93
	JUL	11.72	0.17	11.90	0.17	12.07	0.21	12.28	0.21	12.49	0.21	12.70	0.21	12.91
	JUN	11.83	0.15	11.98	0.15	12.13	0.18	12.31	0.18	12.48	0.18	12.66	0.18	12.84
	MAY	12.81	0.16	12.96	0.16	13.12	0.17	13.29	0.17	13.45	0.17	13.62	0.17	13.79
	APR	13.32	0.15	13.46	0.15	13.61	0.17	13.78	0.17	13.94	0.17	14.11	0.17	14.28
	MAR	13.62	0.12	13.75	0.12	13.87	0.11	13.98	0.11	14.08	0.11	14.19	0.11	14.30
	FEB	12.95	0.07	13.01	0.07	13.08	0.12	13.20	0.12	13.32	0.12	13.44	0.12	13.56

RANGE FOR FPUC

RANGE FOR MODELS	9.83% to 10.61%
ROUND TO NEAREST 10 BASIS POINTS	9.80% to 10.60%
SPREAD TO ADJUST FOR SMALLER SIZE	60 Basis Points
RANGE FOR FPUC	10.40% to 11.20%

S & P UTILITY FINANCIAL BENCHMARK RATIOSGAS DISTRIBUTORS

PRETAX INTEREST COVERAGE (X)	AA	A	BBB
BUSINESS POSITION:			
ABOVE AVERAGE	3.75	3.00	2.00
AVERAGE	4.25	3.75	2.75
BELOW AVERAGE	--	4.25	3.25
TOTAL DEBT TO TOTAL CAPITAL (%)	AA	A	BBB
BUSINESS POSITION:			
ABOVE AVERAGE	46	51	58
AVERAGE	41	46	53
BELOW AVERAGE	--	42	49

SOURCE: Standard and Poor's Global Sector Review, July 1994

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application for a rate) DOCKET NO. 940620-GU
increase by FLORIDA PUBLIC)
UTILITIES COMPANY.) FILED: MARCH 3, 1995

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that one copy each of Staff's Testimony of Pete Lester and Nancy E. Pruitt has been furnished to Wayne Schiefelbein, Esquire, Gatlin, Woods, Carlson and Cowdery, 1709 D Mahan Drive, Tallahassee, Florida 32308 on behalf of Florida Public Utilities Company and that true and correct copies thereof have been furnished by U.S. Mail this 3rd day of March, 1995, to the following:

F. C. Cressman
Florida Public Utilities Co.
Post Office Box 3395
West Palm Beach, FL 33402-3395

for Michael A. Palecki
VICKI D. JOHNSON
Staff Counsel

Florida Public Service Commission
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Tallahassee, FL 32399-0863
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