BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Application for a rate increase by Tampa Electric Company d/b/a Peoples Gas System	)	Docket No. 020384-GU Filed: October 21, 2002

DIRECT TESTIMONY

OF

MARK A. CICCHETTI

On Behalf of the Citizens of the State of Florida

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Public Counsel

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Attorney for the Citizens
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TESTIMONY OF MARK ANTHONY CICCHETTI

QUALIFICATIONS AND EXPERIENCE

Q. Please state your name and address and on whose behalf you are testifying in this proceeding.

A. My name is Mark Anthony Cicchetti and my business address is 2931 Kerry Forest Parkway, Suite 202, Tallahassee, Florida 32309. I am testifying on behalf of the Office of Public Counsel.

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

A. I am a Project Manager and Manager of the Tallahassee Office for C.H. Guernsey & Co. Guernsey is an engineering, architectural and consulting firm that has been in business for over 70 years. The services Guernsey provides include: cost of service and rate studies; regulatory and litigation support; economic and financial studies; valuation studies; power supply planning, solicitation, and procurement; fuel purchasing; transmission and distribution planning and facilities design; strategic planning; telecommunications and e-business applications; architectural design for headquarters and warehouse facilities; environmental assessments; security systems; and web site development and internet applications.

For ten years prior to joining Guernsey, I was President of Cicchetti & Co., a financial research and consulting firm specializing in public utility finance, economics, and regulation. I also have been employed by the Florida State Board of Administration as Manager of Arbitrage Compliance and the Florida Public Service Commission as Chief of Finance. A detailed narrative description of my experience and qualifications is contained in Exhibit__(MAC-1).

Q. Have you previously testified before this Commission?

A. Yes, I have testified before this Commission numerous times.

PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to address the cost of common equity capital and an appropriate equity ratio for Peoples Gas System ("Peoples").

Q. Please summarize your conclusions.

A. With respect to an appropriate allowed return on equity, I conclude the cost of common equity capital for Peoples is within the range of 9.30% to 10.90% and I recommend the Commission allow the midpoint of this range, 10.10%. With respect to an appropriate equity ratio, I conclude Peoples' equity ratio should be set at 50.00% of investor capital.

CAPITAL ATTRACTION AND FINANCIAL INTEGRITY STANDARDS

Q. What guiding principles did you consider in determining a fair rate of return for Peoples?

A. I relied on the principles established by the Supreme Court of the United States in Bluefield Waterworks and Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679 (1923) and Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944). Briefly stated, the Hope and Bluefield decisions provide that the return to the equity owner should be commensurate with returns on investments having corresponding risks and should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.

Q. Please define the cost of common equity capital.

A. The cost of common equity capital is the minimum rate of return necessary to attract capital to a common equity investment. The cost of common equity is a function of risk. The greater the risk the greater the return investors require.

PORTFOLIO THEORY AND RELEVANT RISK

Q. What risks do common equity investors face?

A. A stock's risk consists of company specific risk known as diversifiable risk and market risk known as non-diversifiable risk. Company specific risk is caused by events that are unique to a particular firm such as the loss of a major customer, strikes, lawsuits, and so on. Since these things occur randomly, their effects can be eliminated through diversification - negative events at one firm will be offset by positive events at another. Market risk, on the other hand, is associated with events that affect all firms simultaneously such as inflation, war, and recession. Since all firms are affected simultaneously, the effect of these events cannot be eliminated through diversification. Therefore, since we assume investors are risk averse (that is, accept the highest return for a given level of risk or accept the lowest level of risk for a given return), the relevant risk of a stock is the risk that cannot be diversified away. Rational investors do not accept risks that can be easily eliminated. Numerous empirical studies have shown the capital markets are efficient and investors are compensated only for risks that cannot be diversified away. Therefore, the relevant risk of a stock is the risk it contributes to a well-diversified portfolio and is measured by beta. Beta is a measure of a stock's volatility relative to an average stock. A beta of 1.0 indicates that the individual stock's return moves up or down in the same proportion as the market return. A beta above or

below 1.0 indicates higher or lower return volatility, and therefore greater or lesser risk, relative to the market as a whole.

Q. What determines the relevant risk of a stock?

A. The relevant risk of a stock is determined by the degree to which the stock tends to move up and down with the market. The relevant risk facing a common equity investor can be disaggregated into business risk and financial risk. Business risk relates to the uncertainty surrounding the level of operating income expected to be earned, while financial risk relates to the types of securities used to finance the firm, that is, financial leverage. It is generally accepted that companies with high business risk should capitalize their operations with a relatively lower amount of debt and fixed obligations.

Q. What general economic factors influence investment decisions?

A. The interrelated factors of inflation and interest rates are major factors that influence the investment decision-making process.

Q. Of what significance are inflation and interest rates to an investor?

A. Interest rates are important to investors because the required return on an investment is affected by the returns available on alternative investments. Additionally, rising inflation and rising interest rates erode earnings. Public utilities in general are particularly sensitive to the effects of high inflation and high interest rates. As with other industries, rising labor and other operating expenses directly impact public utility companies' earnings. Also, due to the capital intensive nature of the public utility industries, plant costs and related financing costs have a particularly strong impact on the earnings of these companies.

However, the impacts associated with inflation and interest rates currently are less for utilities than they have been in the past because inflation and interest rates are at or near the lowest levels they have been in the last thirty years.

THE CREDIT AND CAPITAL MARKETS

Q. Have you examined changes in inflation rates?

A. Yes. As shown on Exhibit__(MAC-2), inflation as measured by the consumer price index has subsided considerably since the highs experienced in the 1970's and 1980's and is expected to be approximately 2.1% in the long-term as indicated by the spread between 30-year treasury securities and treasury inflation protection securities ("TIPS"). Furthermore, the GDP price index is estimated to increase by 1.7% in 2002 and is expected to continue around that low rate. Global competition and slow economic growth are factors contributing to the expectations of low inflation. Exhibit__(MAC-2) shows inflation as measured by the GDP Index, the current 30-year treasury and TIPS rates, and *Value Line's* forecast for the GDP Index. Q Have you examined changes in interest rates?

A. Yes. Interest rates are at historically low levels. Exhibit__(MAC-2) shows the 10-year treasury note rate over the last ten years.

It should be noted that recent and current economic statistics do not provide a complete basis for determining the value of long-term investments. Rather, they only provide insight into the current environment within which long-term assets are being valued and function as a reference point for past and present forecasts.

Q. Please discuss the current economic environment and current expectations regarding inflation and interest rates.

A. As the U.S. economy enters the fourth quarter, economic activity is characterized as slow and uneven. Retail sales are mixed with sales of home furnishings and appliances running strong while apparel sales are slow due to unseasonably warm weather in parts of the U.S. Auto sales are above 2001 levels due mostly to aggressive financing and rebate incentives.

Manufacturing activity is sluggish and business travel and air travel have remained at depressed levels. There has been little gain in employment activity with corresponding little pressure on wages -- although there is widespread concern about the effects of rising health care costs.

Oil prices have risen from the beginning of the year, incorporating a war premium estimated at $5 to $6 per barrel. Natural gas prices have remained steady through most of 2002 but have recently increased due to, at least in part, disruption in the Gulf of Mexico from Hurricanes Isadore and Lila. However, natural gas inventories are expected to be at a record high level by the beginning of the heating season.

Commercial real estate markets have remained weak in most parts of the country while residential sales and construction have been strong due to the favorable interest rate environment. In Florida, strong residential sales have created a shortage of homes in some areas.

Across the country, bank loan demand is generally mixed although demand for mortgages and refinancing remains high. Business lending remains weak while consumer loan demand is strong. Credit standards have been tightened for commercial and industrial loans although delinquency rates have been stable or declining.

In conclusion, the U.S. economy is sputtering. The economy is characterized by low inflation, low interest rates, and slow and uneven growth. The stock market remains significantly below its' highs of recent years and return expectations are relatively low. For utilities, increases in plant and operating costs associated with inflation, and the related financing costs, are expected to remain muted into the foreseeable future.

The future course of the economy and of inflation is difficult to predict. However, a component of required returns is compensation for expected inflation, the level of which directly impacts the cost of both debt and equity. As shown on Exhibit__(MAC-2) the current *Blue Chip* consensus forecast for the bellwether long-term treasury bond for the coming year is 5.50% and the current long-term forecast for inflation is 2.1%.

DESCRIPTION OF INDUSTRY AND COMPANY

Q. Have you examined the current state of the natural gas industry?

A. Yes. Natural gas provides twenty-five percent of the United States' energy needs and is the fastest growing major energy source. The industry is characterized by sound fundamentals such as steady long-term growth, stable cash-flows, strong balance sheets, reliable earnings, solid assets, and low business risk. Generally, the industry has successfully navigated the regulatory restructuring initiated at both the federal and state levels and natural gas utilities are considered attractive investments.

Q. Please describe Peoples.

A. Peoples engages in the purchase, sale, and distribution of natural gas for residential, commercial, industrial, and electric power generation customers in Florida. In June 1997, TECO Energy acquired Lykes Energy, Inc. and merged Lykes' regulated gas distribution business into Tampa Electric Company. Lykes' former regulated gas distribution business is now the Peoples Gas System Division of Tampa Electric Company. West Florida Natural Gas was also acquired in June 1997 and integrated into Peoples adding 30,000 customers in parts of the panhandle and central Florida. Peoples is the largest natural gas distribution business in Florida. Peoples serves approximately 273,000 customers, is conservatively financed, and is expected to grow at a rate of 4% to 6% annually. Peoples' above average growth prospects are expected to be driven by increased industrial usage and strong residential growth. The Company operates in one of the fastest growing service territories in the country in a highly regarded regulatory environment.

EQUITY RATIO ANALYSIS

Q. Have you examined Peoples' equity ratio?

A. Yes, I have.

Q. In your opinion, should Peoples' equity ratio be reduced for ratemaking purposes?

A. Yes.

Q. Why do you believe Peoples' equity ratio should be reduced for ratemaking purposes?

A. It is important to ensure that ratepayers do not subsidize, through a utility's cost of capital, the costs associated with non-utility investments made by the utility, its parent,

or affiliates. This can be accomplished by ensuring that only the reasonable and prudent costs associated with the provision of utility service are charged to ratepayers. Generally, when attempting to prevent cross-subsidization between utility and non-utility affiliates, regulators tend to concentrate on costs such as the allocation of common plant or other shared assets and expenses. However, significant cross-subsidization between utility and non-utility affiliates can occur if regulated rates incorporate a rate of return above the required return or if regulated rates reflect an equity ratio above the level required to allow the utility to maintain financial flexibility and financial integrity. Additionally, utilities can manipulate their revenue requirement and their earnings level through changes to their equity ratio.

In a purely competitive environment it would not be possible for a firm to increase its price above the market rate in one market to subsidize a price in another market. However, in a regulated environment, regulation is a proxy for competition. Therefore, as regulated utilities or their affiliates enter more non-regulated lines of business it becomes even more important to ensure ratepayers only bear the reasonable and prudent costs associated with the provision of utility service.

Q. Is there any reason for concern regarding Peoples' equity ratio and Peoples' affiliate relationships?

A. Yes. As has been widely reported in the press, Teco Energy's stock price has plunged to an eleven year low and the debt securities of Teco Energy and its subsidiaries including Tampa Electric Company have been downgraded by Standard & Poor's, Moody's, and Fitch. The downgrade in Tampa Electric Company's debt will increase the cost to the company to issue debt--and ultimately to ratepayers if allowed in rates.

Teco Energy's financial troubles stem from the company's large and highly concentrated exposure to merchant power markets. As stated by Fitch in its September 23, 2002 press release, "The downgrade of Tampa Electric's ratings reflects the increase in leverage and business risk at the parent, and Fitch's rating policy that links parent and subsidiary ratings."

The downgrade in Tampa Electric's debt rating associated with non-regulated investments by its affiliates emphasizes the need to ensure the financing costs allowed in regulated utility rates are only those associated with the provision of regulated utility service.

As shown on Exhibit__(MAC-3), Peoples proposed equity ratio as a percentage of investor capital is significantly above the industry average and significantly above the average of the comparison companies in Moody's natural gas distribution index. Additionally, as shown on Exhibit__(Mac-3), page 2, both Peoples (53.68%) and Tampa Electric (55.56%) currently have equity ratios substantially above that of Teco Energy, Inc. (41.36%), the parent company of both Peoples and Tampa Electric. This indicates Teco Energy, Inc.'s risky, non-regulated ventures, in total, are financed with less equity than the less risky regulated operations. This signifies reliance on the regulated companies for credit support by the parent corporation. Financing the riskier assets with less equity is contrary to generally accepted financial theory and Peoples' excessive proposed equity ratio is significantly above the industry norm. As stated by Moody's in *Moody's Approach to Rating Gas Transmission and distribution Companies - An Update*, June 2000, "Gas companies also manage their capital structures with their regulators in mind. Regulators often indicate an allowed equity-to-capital ratio, which

usually approaches 50%. This level of equity gives a company a solid layer of permanent capital on which it can earn reasonable returns with little financial risk. Thus, LDC's maintain a capitalization at a 50%/50% debt/equity mix, with occasionally a thin layer of preferred stock."

Q. What is an appropriate equity ratio for ratemaking purposes for Peoples?

A. Exhibit__(MAC-4) shows Standard and Poor's financial guidelines for utilities. As shown on Exhibit__(MAC-4), the total debt to total capital benchmark for a BBB utility of average business risk is 50% - 51%. This corresponds to an equity ratio of 49% to 50%. As shown on Exhibit__(MAC-4), Peoples' proposed total debt to total capital is under 42.55%, significantly below the guideline for a BBB rated utility. Peoples' proposed equity ratio is 57.45%. In my opinion, Peoples has not justified its need for such a costly capital structure, i.e. low debt ratio and high equity ratio. In addition to being the most costly capital structure component, the tax impacts associated with common equity magnify the costs of equity in the capital structure. Ratepayers should not have to bear the added costs of unnecessarily high equity ratios that are needed by the local distribution company's parent or affiliates to provide credit support for leveraged investments in risky operations.

Based on the reasons stated above: 1.) ratepayers should pay only the reasonable and prudent costs associated with the provision of utility service; 2.) The tax impacts associated with equity magnify the costs associated with a high equity ratio; 3.)a utility's equity ratio should be reasonable and allow the Company to attract capital at a reasonable cost; 4.) increased investment by Peoples' affiliates into riskier non-regulated lines of business; 5.) the ability of the Company to manipulate its equity ratio to the

detriment of its ratepayers and competitors and to the benefit of itself and its affiliates; 6.) the fact that Peoples' total debt to total capital ratio is significantly below the industry average and significantly below the Standard and Poor's total debt to total capital guidelines for a BBB rated utility company of average risk; 7.) Peoples' riskier affiliates have not been financed with more equity indicating reliance on the regulated utility for credit support and; 8.) the company has not justified the need for such a costly capital structure: I recommend Peoples' equity ratio be set at 50% of investor capital for ratemaking purposes. An equity ratio of 50% is Standard and Poor's total debt to total capital financial guideline for a BBB rated utility of average risk and the level indicated by Moody's to be the industry norm.

RATE OF RETURN ANALYSIS

Q. What methods did you use to determine the required return on common equity for Peoples?

A. To determine the required return on common equity, I used a two-stage, annually compounded discounted cash flow (DCF) model and a risk-premium analysis.

It is important to note that estimating the cost of common equity is a subjective procedure. It is impossible to measure it precisely and it is generally estimated within a range. The cost of common equity is a function of investor expectations and it is impossible to know all investors' expectations at any point in time. Consequently, professional judgment must be exercised when determining proxies for investor expectations. When analyzing cost of equity estimates, it is important to understand the rationale underlying the subjective inputs and how well the models relied upon reflect reality.

Q. How did you apply the DCF and risk premium models to obtain Peoples' cost of common equity?

A. I conducted a DCF analysis and a Risk Premium analysis on Moody's Natural Gas Distribution Index. Relying on an index of companies, rather than a single company, helps minimize forecasting errors and should provide more reliable information for use in measuring the cost of common equity.

Q. Please describe the investment risk characteristics that comprise Moody's Natural Gas Distribution Index.

A. The investment risk parameters for Moody's Natural Gas Distribution Index companies are: a *Value Line* Safety Rank of 2, a *Value Line* beta of .65, an S&P bond rating of A, and an average equity ratio of 43.17% of investor capital. Exhibit __(MAC-5) shows the investment characteristics for Moody's Natural Gas Distribution index.

Q. Please briefly describe the models you used.

A. The discounted cash flow model is the most commonly used market based approach for estimating a utility investor's required return on common equity capital. In a DCF analysis, the cost of equity is the discount rate which equates the present value of expected cash flows associated with a share of stock to the present price of the stock.

A risk premium analysis recognizes that equity is riskier than debt. Equity investors thus require a "risk premium" over the cost of debt as compensation for assuming additional risk.

Q. Please describe the discounted cash flow model used in your analysis.

A. I used a two-stage variable growth rate DCF model in order to use the specific dividend forecasts for the next five years provided by *Value Line*. *Value Line* is an independent, respected, widely circulated source of investment information. Exhibit__(MAC-6) shows a two-stage DCF model. In the two-stage model, dividend growth is estimated on an individual basis for an initial growth period. After the initial period, dividends are assumed to grow into perpetuity at the expected long-term growth rate.

Q. How did you use this model to determine the cost of common equity capital for the index?

A. The current stock price (P_o) was determined by averaging the high and the low stock price for each company. I assumed an initial growth period based upon *Value Line's* explicit dividend forecasts (n). I used *Value Line's* forecast of dividends, and assumed a constant rate of growth in between to estimate the expected dividends (D_t) during the initial growth period. The long-term constant rate of growth expected (g_n) was calculated using the earnings retention method (b x r approach) and *Value Line's* expected return on equity (r) and expected retention rate (b).

Q. Did you incorporate an allowance for flotation costs in applying your DCF model?

A. Yes. The DCF calculations I performed include and adjustment of 3% to recognize the expenses associated with issuing stock. An allowance for issuance costs enables the utility to recover the costs incurred when issuing common stock. Issuance expenses include registration, legal, and underwriter fees, and printing and mailing expenses. Investors would never be able to earn the required return on their investment without an issuance cost adjustment because the sales price will always exceed the net proceeds to

the company as a result of incurring issuance costs. These costs will be incurred whether the stock is publicly traded or privately held.

Conceptually, the situation with common stock is similar to that of bonds and preferred stock. With bonds for example, the issuance expenses are reflected in the cost charged to ratepayers and are recovered over the life of the bond. The cost to the company for a specific bond issue is the interest expense plus the amortization of issuance costs divided by the principal value less the unamortized issuance costs. The result is that the cost to the utility is greater than the return to the creditor.

Unlike the case of bonds, however, common stock does not have a finite life. Therefore, issuance costs cannot be amortized and must be recovered by an upward adjustment to the allowed return on equity. This adjustment reflects the fact that, due to the issuance costs, the utility earns a return on an equity balance that is less than the actual amount paid by investors. (See Brigham, E.F., Aberwald, D., and Gapenski, L.D., "Common Equity Flotation Costs and Rate Making," Public Utilities Fortnightly, May 2, 1985, pp. 28-36). Historically, utility underwriting expenses associated with issuing common stock have averaged 3 to 4 percent of gross proceeds. (See Petteway, R.H., "A Note on the Flotation Costs of New Equity Capital Issues of Electric Companies," Public Utilities Fortnightly, March 18, 1982, pp. 68-69. When the adjustment for flotation costs (FC) is recognized, the cost of equity is given on Exhibit__(MAC-6).

Q. What is the required return on common equity for the index based upon your two-stage annually-compounded DCF model?

A. Solving the equation on Exhibit__(MAC-6) for the cost of equity (K) produces a required return on common equity for the index of 10.60% (rounded). Exhibit__(MAC-6) shows the inputs and results of my analysis.

Q. Please describe the risk premium approach of determining the cost of common equity.

A. The return to equity owners is a residual return and is less certain than the yield on bonds. Therefore, equity owners must be compensated for this additional risk. The risk premium approach estimates the cost of common equity by adding a premium to the cost rate of debt to compensate the investor for the greater risk inherent in an equity investment. The basic risk premium model takes the form: $K_e = B_y + R_p$ where: K_e = the cost of common equity; B_y = the yield on debt; R_p = the risk premium on common stock.

In order to apply the methodology, a risk premium for common stock over some measure of debt cost must be estimated. The debt security used in a risk premium analysis should be risk free to isolate the spread component of the return and avoid default risk and circularity concerns that are associated with debt securities issued by companies.

Q. How did you estimate the equity-debt risk premium?

A. I began my analysis by estimating the required market returns for Moody's Natural Gas Distribution Index for each month of the 1992 to 2002 ten-year period (120 data points) using the same DCF methodology described previously. This was accomplished by using the *Value Line* data that was available to investors each month of the 1992 to 2002 period, and the then current stock prices.

Q. How was the equity-debt risk premium determined?

A. For each month, the required returns on common equity derived from my DCF analyses were compared to the then current yield on long-term government bonds, as reported by Federal Reserve Board, to determine the risk premium for common equity over the yield on long-term government bonds.

Q. What is your estimate of the equity-debt risk premium for the index?

A. As shown on Exhibit__(Mac-8) the equity-debt risk premium for the index averaged 3.50% (rounded) over the period 1992 to 2002.

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

A. I used the September 1, 2002 *Blue Chip Financial Forecasts'* (Blue Chip) consensus forecast for long-term government bond yields for the coming year of 5.5%. *Blue Chip Financial Forecasts* is a publication that provides interest rate forecasts from leading economists and financial analysts.

Q. What is the risk premium cost of common equity for the index?

A. Combining the next four quarters expected yield on long-term government bonds of 5.5% with the equity-debt risk premium of 3.5% results in a risk premium cost of equity of 9.00% for the index. Exhibit__(MAC-8) shows the results of the Risk Premium analysis.

Q. How does the investment risk of Peoples compare to that of Moody's Gas Distribution Index?

A. As shown on Exhibit__(MAC-5), the companies comprising Moody's Natural Gas Distribution Index have a bond rating of A. Peoples' 2001 revenues were $353 million. As shown on Exhibit__(MAC-5), Peoples is much smaller, based on revenues, than the companies in Moody's Natural Gas Distribution Index. Peoples has no formal bond rating, lacks stand-alone capital market participation, and its securities lack liquidity and trading volume. Peoples has a significantly lower percentage of residential customers and has significantly more exposure to the industrial market than the index companies on average. On the positive side, Peoples receives outstanding regulation and is conservatively financed, even at an equity ratio of 50%. Overall, I believe Peoples is somewhat more risky than the comparison companies comprising Moody's Natural Gas Distribution Index.

Q. Did you make an adjustment to the required return on equity to recognize the difference in risk between the index and peoples?

A. Yes. I used a bond yield differential to estimate the additional return required by Peoples over the index. I believe the differential between the yields of A and Baa public utility long-term bonds over the last ten years of 30 basis points, as reported by Moody's, is a reasonable estimate of the additional return required. I believe it is reasonable to assume the average marginal cost of debt to Peoples to be equal to a Moody's bond rating of Baa. A bond rating below Baa is not investment grade. Certain financial institutions, pension funds, and others with fiduciary responsibility only can invest in investment grade securities. Bonds below investment grade are characterized, at best, as "uncertain as to position" by Moody's. It would be unreasonable to assume that the debt of Florida-regulated utility is below that described by Moody's Baa rating

and therefore below investment grade. Exhibit__(MAC-9) shows the results of my DCF and Risk Premium Analyses.

FAIR RATE OF RETURN FOR PEOPLES GAS SYSTEM

Q. Based on your DCF and risk premium analyses, what is your conclusion as to the investor required rate of return on common equity for Peoples?

A. Based on my DCF and Risk Premium analyses, I conclude the investor required rate of return on common equity for Peoples is within the range of 9.30% to 10.90% with a midpoint of 10.10%. As shown on Exhibit__(MAC-10), a return on common equity of 10.10% will allow Peoples a coverage ratio of 3.05X. In my opinion, such a coverage ratio, given Peoples financial profile, business risk, and regulatory climate will allow Peoples to maintain its, financial integrity and attract capital at a reasonable cost.

Q. Please summarize your testimony.

A. My testimony addressed two subject areas. The first area was the determination of an appropriate equity ratio for Peoples. With respect to an appropriate equity ratio I conclude Peoples' equity ratio should be set at 50.00% of investor capital for ratemaking purposes.

The second area I addressed was the appropriate return Peoples should be allowed for ratemaking purposes. With respect to an appropriate allowed return, I conclude the cost of common equity capital for Peoples is within the range of 9.30% to 10.90% and I recommend the Commission allow the midpoint of this range, 10.10%.

Q. Does this conclude your testimony?

A. Yes, it does.

EXHIBITS

Experience and Qualifications

I received a Bachelor of Science degree in Business Administration in 1980 and a Master of Business Administration degree in Finance in 1981, both from Florida State University. Upon graduation I accepted a planning analyst position with Flagship Banks, Inc., a bank holding company. As a planning analyst, my duties included merger and acquisition analysis, lease-buy analysis, branch feasibility analysis, and special projects.

In 1983, I accepted a regulatory analyst position with the Florida Public Service Commission. As a regulatory analyst, I provided in-depth analysis of the cost of equity and required overall rate of return in numerous major and minor rate cases. I reviewed and analyzed the current and forecasted economic conditions surrounding those rate cases and applied financial integrity tests to determine the impacts of various regulatory treatments. I also co-developed an integrated spreadsheet model which links all elements of a rate case and calculates revenue requirements. I received a meritorious service award from the Florida Public Service Commission for my contributions to the development of that model.

In February 1987, I was promoted to Chief of the Bureau of Finance. In that capacity I provided expert testimony on the cost of common equity, risk and return,

corporate structure, capital structure, and industry structure. I provided technical guidance to the Office of General Counsel regarding the development of financial rules and regulations. In addition, I authored the Commission's rules regarding diversification and affiliated transactions, chaired the Commission's Committee on Leveraged Buyouts, supervised the finance bureau's regulatory analysts, co-developed and presented a seminar on public utility regulation to help educate the Florida Public Service Commission attorneys, and provided technical expertise to the Commission in all areas of public utility finance for all industries.

In February 1990, I accepted the position of Chief of Arbitrage Compliance in the Division of Bond Finance, Department of General Services. As Manager of the Arbitrage Compliance Section, I was responsible for assuring that over $16 billion of State of Florida tax-exempt securities remained in compliance with the federal arbitrage requirements enacted by the Tax Reform Act of 1986. I provided investment advice to trust fund managers on how to maximize yields while remaining in compliance with the federal arbitrage regulations. I designed and implemented the first statewide arbitrage compliance system which included data gathering, financial reporting, and computation and analysis subsystems.

In July 1990, I founded Cicchetti & Company. Through Cicchetti & Company I provided financial research and consulting services, including the provision of expert testimony, in the areas of public utility finance, economics, and regulation. Topics I have testified on include cost of equity, capital structure, corporate structure, regulatory theory, cross-subsidization, industry structure, the overall cost of capital, incentive regulation, the establishment of the leverage formula for the water and wastewater industry, reconciling rate base and capital structure, risk and return, and the appropriate regulatory treatment of construction work in progress, used and useful property, construction cost recovery charges, and the tax gross-up associated with contributions-in-aid-of-construction.

In January, 2001, I joined C.H. Guernsey & Co. as a Senior Financial Consultant and Manager of the Tallahassee, Florida Office.

In 1985, I was certified by the Florida Public Service Commission as a Class B Practitioner in the areas of finance and accounting.

In June, 1985, I published an article in Public Utilities Fortnightly titled "Reconciling Rate Base and Capital Structure: The Balance Sheet Method." In September, 1986, I was awarded third place in the annual, national, Competitive Papers Session sponsored by Public Utilities Reports, Inc., in conjunction with the University of Georgia and Georgia State University, for my

paper titled "The Quarterly Discounted Cash Flow Model, the Ratemaking Rate of Return, and the Determination of Revenue Requirements for Regulated Public Utilities." An updated version of that paper was published in the June, 1989 edition of the National Regulatory Research Institute Quarterly Bulletin. I subsequently served twice as a referee for the Competitive Papers Sessions. On June 15, 1993, I published an article on incentive regulation in *Public Utilities Fortnightly* titled "Irregular Incentives." On September 1, 2002, I published an article in *Public Utilities Fortnightly* titled "Gas Distribution: A Higher Risk Business.

I was awarded the designation Certified Rate of Return Analyst by SURFA in 1992. I am a member of the Financial Management Association International and have been listed in Who's Who in the World and Who's Who in America.

I have made public utility and finance related presentations to various groups such as the Southeastern Public Utilities Conference, the National Society of Rate of Return Analysts, the National Association of State Treasurers, and the Government Finance Officers Association.

ECONOMIC STATISTICS

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
CPI	3.0	3.0	2.6	2.8	2.9	2.3	1.5	2.2	3.4	2.8
GDP Price Index	2.7	2.6	2.3	2.5	2.1	1.9	1.2	1.4	2.1	2.4
10-Year Treasury	7.0	5.9	7.1	6.6	6.4	6.4	5.3	5.6	6.0	5.0

Inflation Forecast

30-Year treasury 5.0% - 30-Year TIPS 2.90%	2.10%
Value Line GDP Index - 2002 estimate	1.7%

Long-Term Treasury Forecast

	4th 02	1st.-03	2nd-03	3rd-03
Blue Chip Financial Forecasts - Long-Term Treasury	5.3	5.4	5.6	5.7

Source: *Value Line*, October 11, 2002
Bloomberg, October 4, 2002
Blue Chip Financial Forecasts, September 1, 2002

EQUITY RATIO COMPARISONS

MOODY'S NATURAL GAS DISTRIBUTION INDEX

Company	Equity Ratio as a Percentage of Total Investor Capital
AGL Resources	34.58%
Keyspan Corp.	33.58%
Laclede Group	42.64%
N.W. Nat'l Gas	49.42%
Peoples Energy (Illinois)	46.38%
WGL Holdings	52.42%
Average	43.17%

Source: Form 10-Q, for the period 6/30/02

Peoples Gas System (Florida) - Proposed 57.45%

Source: MFR's

Peoples Gas System (Florida) - Actual 12/31/01	53.68%
Tampa Electric	55.56%
Teco Energy, Inc.	41.36%

Source: MFR's, Form 10-Q, for the period 6/30/02

Natural Gas Distribution Industry (excluding short-term debt) 43.00%

Source: *Value Line*, 9/20/02

STANDARD & POOR'S RATIO GUIDELINES

Total Debt/Capitalization (%)

		Rating category
Company business risk profile		BBB
Average	5	51
	6	50

Peoples Gas System (Florida) - Proposed 42.55

Source: *Standard & Poor's*, Corporate Rating Criteria
MFR's

MOODY'S NATURAL GAS INDEX
INVESTMENT CHARACTERISTICS

	VALUE LINE SAFETY RANK	VALUE LINE BETA	EQUITY RATIO	S&P BOND RATING	REVENUES ($MILL)
AGL RESOURCES	2	.70	34.58%	A-	2,240
KEYSPAN CORP.	2	.65	33.58%	A	6,100
LACLEDE GAS	2	.60	42.64%	A+	750
N.W. NAT'L GAS	2	.60	49.42%	A	705
PEOPLES ENERGY	1	.75	46.38%		1,440
WGL HOLDINGS	1	.65	52.42%	AA-	975
AVERAGE	1.67	.65	43.17%	A	2,035

Source: *Value Line*, Ed. 3, 9/20/02
S&P Bond Guide, 9/02

Two-Stage, Annually Compounded
Discounted Cash Flow Model

	Expected Dividends					Est. EPS	Est. ROE	Dividend Growth	Stock Price
	2002	2003	2004	2005	2006	2006	2006+	2006+	9/02
AGL RES.	1.08	1.08	1.11	1.13	1.16	2.10	13.00	5.82%	22.61
Keyspan	1.78	1.78	1.81	1.84	1.87	3.70	13.00	6.43%	33.41
Laclede	1.36	1.38	1.40	1.43	1.45	2.25	12.00	4.27%	23.61
N.W. Nat'l	1.26	1.27	1.30	1.32	1.35	2.60	11.00	5.29%	28.50
Peoples	2.08	2.12	2.16	2.20	2.24	4.30	12.00	5.75%	33.92
WGL	1.27	1.28	1.29	1.29	1.30	2.45	12.50	5.87%	23.69
Average	1.47	1.49	1.51	1.54	1.56	2.90	12.25	5.57%	27.62

The cost of common equity is calculated using a two-stage, annually compounded discounted cash flow model:

$$Po(1-fc) = \sum_{t=1}^{n} Dt/(1+k)^t = (Dn(1+gn))/(k-gn) * (1/(1+k))^t$$

Solving the above equation for k using Po = $27.62, fc =3%, and n = 5, provides a cost of common equity of: 10.58%

1) Data obtained or calculated from information provided in *Value Line*, Edition 3, 6/21/02.

2) The average stock price is the average of the high and low stock price for September 2002, Nomura Research Institute, Ltd.

RISK PREMIUM ANALYSIS

1992 - 2002

MONTH	GAS INDEX COST OF EQUITY	RISK FREE RATE	RISK PREMIUM
Oct 92	9.61	7.34	2.27
Nov	9.81	7.53	2.28
Dec	9.89	7.61	2.28
Jan 93	9.44	7.44	2.00
Feb	9.31	7.34	1.97
Mar	9.13	7.09	2.04
Apr	8.93	6.82	2.11
May	9.04	6.85	2.19
Jun	9.17	6.92	2.25
Jul	9.38	6.81	2.57
Aug	8.61	6.63	1.97
Sep	8.62	6.32	2.30
Oct	8.68	6.00	2.68
Nov	8.69	5.94	2.75
Dec	8.97	6.21	2.76
Jan 94	8.96	6.25	2.71
Feb	8.63	6.29	2.34
Mar	8.72	6.49	2.23
Apr	8.97	6.91	2.06
May	9.23	7.27	1.96
Jun	9.36	7.41	1.95
Jul	9.55	7.40	2.15
Aug	9.51	7.58	1.93
Sep	9.60	7.49	2.11
Oct	9.73	7.71	2.02
Nov	9.62	7.94	1.68
Dec	9.97	8.08	1.89
Jan 95	10.12	7.87	2.25
Feb	9.83	7.85	1.98
Mar	9.68	7.61	2.07
Apr	9.67	7.45	2.22

MONTH	GAS INDEX COST OF EQUITY	RISK FREE RATE	RISK PREMIUM
May 95	9.04	7.36	1.68
Jun	9.68	6.95	2.73
Jul	9.67	6.57	3.10
Aug	9.66	6.72	2.94
Sep	9.74	6.86	2.88
Oct	9.32	6.55	2.77
Nov	9.39	6.37	3.02
Dec	9.43	6.26	3.17
Jan 96	9.60	6.06	3.54
Feb	9.03	6.05	2.98
Mar	9.08	6.24	2.84
Apr	9.23	6.60	2.63
May	9.55	6.79	2.76
Jun	9.64	6.93	2.71
Jul	9.55	7.06	2.49
Aug	9.96	7.03	2.93
Sep	9.81	6.84	2.97
Oct	10.07	7.03	3.04
Nov	9.76	6.81	2.95
Dec	9.62	6.48	3.14
Jan 97	9.74	6.55	3.19
Feb	9.57	6.83	2.74
Mar	9.66	6.69	2.97
Apr	9.77	6.93	2.84
May	10.15	7.09	3.06
Jun	10.02	6.94	3.08
Jul	9.90	6.77	3.13
Aug	9.92	6.51	3.41
Sep	9.95	6.58	3.37
Oct	9.86	6.50	3.36
Nov	9.87	6.33	3.54
Dec	9.58	6.11	3.47
Jan 98	9.56	5.99	3.57
Feb	9.37	5.81	3.56
Mar	9.49	5.89	3.60

MONTH	GAS INDEX COST OF EQUITY	RISK FREE RATE	RISK PREMIUM
Apr 98	9.53	5.95	3.58
May	9.44	5.92	3.52
Jun	9.64	5.93	3.71
Jul	10.34	5.70	4.64
Aug	9.92	5.68	4.24
Sep	9.96	5.54	4.42
Oct	9.87	5.20	4.67
Nov	9.87	5.01	4.86
Dec	9.58	5.25	4.33
Jan 99	9.56	5.06	4.50
Feb	9.78	5.16	4.62
Mar	10.30	5.37	4.93
Apr	10.42	5.58	4.84
May	10.49	5.55	4.94
Jun	10.20	5.81	4.39
Jul	10.14	6.04	4.10
Aug	9.89	5.98	3.91
Sep	9.97	6.07	3.90
Oct	10.14	6.07	4.07
Nov	10.17	6.26	3.91
Dec	10.13	6.15	3.98
Jan 00	10.45	6.35	4.10
Feb	10.96	6.63	4.33
Mar	11.36	6.23	5.13
Apr	11.28	6.05	5.23
May	10.69	5.85	4.84
Jun	10.55	6.15	4.40
Jul	10.52	5.93	4.59
Aug	10.37	5.85	4.52
Sep	10.15	5.72	4.43
Oct	10.03	5.83	4.20
Nov	9.87	5.80	4.07
Dec	9.68	5.78	3.90
Jan 01	9.29	5.49	3.80
Feb	9.45	5.54	3.91
Mar	9.59	5.45	4.14

MONTH	GAS INDEX COST OF EQUITY	RISK FREE RATE	RISK PREMIUM
Apr 01	9.73	5.34	4.39
May	9.60	5.65	3.95
Jun	9.59	5.78	3.81
Jul	9.64	5.67	3.97
Aug	10.06	5.61	4.45
Sep	10.14	5.48	4.66
Oct	10.27	5.48	4.79
Nov	10.28	5.32	4.96
Dec	10.33	5.12	5.21
Jan 02	10.42	5.48	4.94
Feb	10.37	5.45	4.92
Mar	10.62	5.56	5.06
Apr	10.40	5.88	4.52
May	10.13	5.82	4.31
Jun	10.18	5.79	4.39
Jul	10.35	5.66	4.69
Aug	10.72	5.54	5.18
Sep	10.57	5.23	5.34
AVERAGE RISK PREMIUM			3.44

Source: *Value Line* 1992-2002
Federal Reserve Board

RISK PREMIUM ANALYSIS

RESULTS

Risk Premium Cost of Equity = Estimated Risk Free Rate + Equity Risk Premium

9.00% = 5.5% + 3.50%

Source: *Blue Chip Financial Forecasts*, 9/02

SUMMARY OF RESULTS

DCF Cost of Equity	9.00%
Risk Premium Cost of Equity	10.60%
Average	9.80%
Bond Yield Differential	.30%
Cost of Equity	10.10%

CAPITAL STRUCTURE

	Amount	%	Cost	After-Tax Wtd. Cost	Pre-Tax Wtd. Cost
Common Equity	$219,321,040	44.75	10.10%	4.52%	7.43%
Long-term Debt	187,039,604	38.17	7.81	2.98	2.98
Short-term Debt	32,281,436	6.59	4.00	.26	.26
Customer Deps.	27,148,675	5.54	6.81	.38	.38
Tax Credits	686,068	.14	0.00	0.00	0.00
Deferred Taxes	23,571,457	4.81	0.00	0.00	0.00
	$490,048,281	100%		8.14%	11.05%

TIE Ratio = 3.05X

Note: Deferred taxes were increased $7,992,760 with a corresponding pro rata reduction to investor funds. Equity was reduced $32,666,886 to 50% of investor capital with a corresponding increase to long-term debt. The remaining adjustments were pro rata to reconcile rate base and capital structure.