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IN REPLY REFER TO:

November 20, 2002

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Blanca S. Bayo, Director
Division of Commission Clerk & Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Docket No. 020384-GU -- Petition for rate increase by PEOPLES GAS SYSTEM

Dear Ms. Bayo:

Enclosed for filing in the above docket on behalf of Peoples Gas System, please find the original and 20 copies of the Surrebuttal Testimony of Dr. Roger A. Morin, together with a certificate of service with respect to such testimony.

Please acknowledge your receipt and the date of filing of the enclosures on the duplicate copy of this letter, and return the same to me in the enclosed preaddressed envelope.

Thank you for your assistance.

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Sincerely,

Ansley Watson

ANSLEY WATSON, JR.

AWjr/a
Enclosures

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cc: Parties of Record
Ms. Angela Llewellyn
Matthew R. Costa, Esquire

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Petition for rate increase by Peoples Gas System	: :	Docket No. 020384-GU Submitted for Filing: 11-21-02

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the Surrebuttal Testimony of Dr. Roger A. Morin has been furnished to the following by Federal Express** or hand delivery* to the following, this 20th day of November, 2002:

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PEOPLES GAS SYSTEM

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 020384-GU

In Re: Petition of Peoples Gas System, For Authority to Increase Its Rates and Charges

Submitted for Filing: 11/21/2002

SURREBUTTAL TESTIMONY:

DR. ROGER A. MORIN
On Behalf of Peoples Gas System

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Dr. Roger A. Morin. My business address is Georgia State University, Robinson College of Business, University Plaza, Atlanta, Georgia, 30303. I am Professor of Finance at the College of Business, Georgia State University and Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University. I am also a principal in Utility Research International, an enterprise engaged in regulatory finance and economics consulting to business, regulators, and government.

Q. ARE YOU THE SAME DR. R. A. MORIN WHO HAS FILED RATE OF RETURN AND REBUTTAL TESTIMONIES IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. This testimony is in surrebuttal to Mr. Cicchetti's (Office of the Public Counsel) cost of capital rebuttal testimony. The objectives of my surrebuttal testimony are to demonstrate that 1) my rebuttal comments of Mr. Cicchetti's testimony remain unscathed, 2) Mr. Cicchetti's attempts to rebut my testimony are ineffectual, and 3) his criticisms of my rate of return estimates are without foundation.

Q. HAS MR. CICCHETTI MADE ANY ARGUMENTS IN HIS REBUTTAL THAT WOULD CAUSE YOU TO ALTER YOUR TESTIMONY AND/OR ANY OF YOUR REBUTTAL COMMENTS?

A. No, he has not. My rebuttal comments are necessarily brief as I have dealt with several of the issues raised by Mr. Cicchetti in my rebuttal testimony. I shall confine my surrebuttal comments to reinforcing and clarifying my stand on the issues raised by Mr. Cicchetti.

Q. WHAT IS THE MAIN CONCLUSION OF YOUR SURREBUTTAL TESTIMONY?

A. The main conclusion of my surrebuttal testimony is that Mr. Cicchetti's rebuttal comments are erroneous and largely without foundation.

Q. DO YOU HAVE ANY GENERAL COMMENTS ON MR. CICCHETTI'S REBUTTAL TESTIMONY?

A. Yes, I do. Before responding specifically to the more technical issues raised in Mr. Cicchetti's rebuttal, I was astonished and disappointed with Mr. Cicchetti's opening salvo in his rebuttal, questioning my degree of objectivity and independence in this proceeding and accusing my testimony of being client-dependent. I must admit that I have never been the recipient of such unprofessional remarks in my 25-year career participating in hundreds of regulatory proceedings. I am strongly tempted to quote from Mr. Cicchetti's own testimony (Page 2 lines 9-11) which unprofessionally and unfairly describes my testimony as "*not unbiased - particularly if that person is being paid by one of the adversaries in the proceeding*", and to characterize Mr. Cicchetti's own objectivity in similar language. I am reminded of the old adage "what is good for the goose is good for the gander". Unlike Mr. Cichetti's highly unprofessional remarks questioning my integrity and degree of independence, however, I will resist such indecorous temptation and say that one's methodology should be guided by what is theoretically and empirically correct and not by the direction and magnitude of the numbers produced by choice of method or by the identity of the client. My own methodologies have always been guided by that overriding principle, regardless of outcome and regardless of client identity.

1. HISTORICAL RISK PREMIUM

Q. DO YOU AGREE WITH MR. CICCHETTI'S CRITICISM OF HISTORICAL RISK PREMIUM STUDIES?

A. No, I do not. On page 3 of his rebuttal testimony, Mr. Cicchetti challenges my use of the historical difference between realized stock and bond returns as a proxy for the expected difference, because historical risk premiums may be biased estimates of expected risk premiums.

Had I performed this calculation over a short time period, Mr. Cicchetti's argument would have some merit. The danger with relying on annual risk premiums measured over short time periods involves the distinction between expected and realized return. The historical risk premium approach fundamentally assumes that average realized return is an appropriate surrogate for expected return, or in other words that investor expectations are realized. Realized returns can be substantially different from prospective returns anticipated by investors especially over short time periods, and therefore constitute a hazardous benchmark on which to base the risk premium between stocks and bonds.

I have therefore ignored the realized risk premiums measured over short time periods, since they are heavily dependent on short term market movements. I have instead relied on the long-term results, since periods of such length are long enough to smooth out short-term aberrations, and to encompass several business and interest rate cycles. Over such long periods, surely investor expectations and realizations converge, or else no one would ever invest any money. Thus, Mr. Cicchetti's concern is unwarranted.

I remind Mr. Cicchetti that to guard against the possibility that the historical average is not representative of the current risk premium, I also developed a forward-looking risk premium estimate for the market which produced almost the same answer.

Q. WHAT DOES PROFESSOR BRIGHAM HAVE TO SAY ON THE USE OF HISTORICAL RISK PREMIUMS?

A. On page 3 lines 19-22, Mr. Cicchetti cites a working paper authored by Professor Brigham where he concludes that risk premiums must be based on expectations rather than realized returns. I draw Mr. Cichetti's attention to Professor Brigham's best-selling corporate finance textbook (Financial Management: Theory and Practice, 10th ed., South-Western, 2001) where he clearly recommends the use of both historical risk premium studies and prospective risk premium studies as I have done in my direct testimony and as I recommend in my own textbook, Regulatory Finance. The relevant passage from Professor Brigham's book is cited below. Mr. Cichetti should have heeded Professor's Brigham's advice in that regard.

> *"The market risk premium, RP_M, is the expected market return minus the risk-free rate, $k_M - k_{RF}$. It can be estimated on the basis of (1) historical data or (2) forward-looking data."*

Professor Brigham goes on to describe both approaches in much the same way in which I have applied them in my own testimony.

Q. DR. MORIN, WHAT DO YOU CONCLUDE ON THE USE OF HISTORICAL RISK PREMIUM STUDIES?

A. Historical return studies over long periods do indeed provide a useful guide for the future. This is because over long periods investor expectations and realizations converge. Otherwise, investors would never commit investment capital. Investor expectations are eventually revised to match historical realizations, as market prices adjust to bring anticipated and actual investment results into conformity. In the long-run, the difference between expected and realized risk premiums will decline because short-run periods during which investors earned a lower risk premium than they expected are offset by short-run periods during which investors earned a higher risk premium than they expected. The use of historical achieved risk premium to determine cost of equity capital would be incorrect only if the historical risk premiums are measured over short periods, but correct if long periods are utilized. Long-term results (1926-2001) should be relied upon, since periods of such length are long enough to smooth out short-term aberrations, and to encompass several business and interest rate cycles. Over long periods, it is clear that investor expectations are realized, for no one would ever invest any funds.

2. DCF GROWTH RATES: EARNINGS VERSUS DIVIDENDS

Q. DO YOU AGREE WITH MR. CICCHETTI'S CRITICISM OF YOUR DCF GROWTH RATES?

A. No, I do not. On page 4 of his rebuttal, Mr. Cicchetti argues that it is inappropriate to rely on earnings growth as a proxy for expected dividend growth when implementing the DCF model. I disagree.

DCF proponents have variously based their growth computations on earnings per share, dividends per share, and book value per share. Because the ability to pay dividends stems from a company's ability to generate earnings, growth in earnings per share exerts a powerful influence on the market's dividend growth expectations. Dividend growth can only be sustained if there is growth in earnings.

There is another convincing practical reason for employing earnings growth forecasts rather than dividend growth forecasts, namely, the extreme scarcity of dividend forecasts compared to the wide availability of earnings forecast. Given the paucity and variability of dividend forecasts, using the latter would produce unreliable DCF results. From a practicality and reliability point of view, there are considerably more earnings growth estimates available than there are dividend growth estimates.

In any event, Mr. Cicchetti's concern is unwarranted because the use of the DCF model prospectively assumes constant growth in both earnings and dividends.

Q. SHOULD DCF CALCULATIONS RELY ON REGULATED UTILITIES' PROJECTED DIVIDEND GROWTH RATES AT THIS TIME?

A. No, they should not. It is inappropriate to use the projected dividend growth of energy utilities at this time in the DCF model. The problem with the use of dividend growth forecasts is that they are largely dominated by the anticipated dividend performance over the next few years, a period of transition to competition.

Q. WHAT IS THE IMPACT OF CHANGING DIVIDEND POLICIES ON THE RELIABILITY OF DIVIDEND GROWTH PROJECTIONS?

A. The reason for skepticism about dividend growth projections is that it is widely expected that energy utilities will lower their dividend payout ratio over the next several years in response to the gradual penetration of competition in the revenue stream. In other words, earnings and dividends are not expected to grow at the same rate in the future. According to the latest edition of Value Line, the expected dividend growth for the both the natural gas and the electric utility industry is far less than the expected earnings growth over the next few years.

Whenever the dividend payout ratio is expected to change, the intermediate growth rate in dividends cannot equal the long-term growth rate, because dividend/earnings growth must adjust to the changing payout ratio. The assumptions of constant perpetual growth and constant payout ratio are clearly not met.

The implementation of the standard DCF model is of questionable relevance in this circumstance.

Because the dividend payout ratio of utilities is expected to decline to more sustainable levels, so that near-term dividend growth is not representative of long-term growth prospects, only earnings growth forecasts should be given any weight.

3. ALLOWED RISK PREMIUMS

Q. PLEASE RESPOND TO MR. CICCHETTI'S CRITICISM OF YOUR ALLOWED RISK PREMIUM ANALYSIS.

A. On page 5 of his rebuttal testimony, Mr. Cicchetti criticizes my allowed risk premium analysis on the grounds that it is circular and that one should not rely on returns allowed in other jurisdictions when determining the cost of capital. I disagree.

First, as I stated in my direct and rebuttal testimonies, allowed returns, while certainly not a precise indication of a company's cost of equity capital, are nevertheless important determinants of investor growth perceptions and investor expected returns, and they provide a useful perspective on Mr. Cicchetti's recommendation. The fact remains that Mr. Cicchetti's recommended return on equity would be among the lowest, if not the lowest, in the country.

Second, and more importantly, I did not rely on allowed returns contrary to Mr. Cicchetti's assertion but on allowed risk premiums. The latter is the difference between the allowed return on equity and the contemporaneous return on level of interest rates. Presumably, allowed risk premiums are based on cost of capital expert testimonies presented before regulatory bodies and, as such, reflect the cost of capital, that is, investors' risk premium requirements over and above the prevailing level of the risk-free rate. Allowed risk premiums as opposed to allowed returns reflect economic conditions. For example, to the extent that there is an expected inflation premium embedded in both the return on stocks and the return on bonds, the difference between them is unaffected by inflation. Thus, I disagree with Mr. Cicchetti's claim that allowed risk premiums are irrelevant.

4. CURRENT CAPITAL MARKET CONDITIONS

Q. DO YOU AGREE WITH MR. CICCHETTI'S VIEWS ON RECENT CAPITAL MARKET TRENDS?

A. Yes, I do in part. Long-term interest rates have certainly declined since the preparation of my testimony to the 5% level, and not the 4.7% level cited in Mr. Cicchetti's rebuttal. However, dividend yields (stock prices) have increased in recent months, offsetting the lower interest rate levels. It is not clear at this time as to the net effect of all these changes on my recommendation. I suspect it is minimal. It is my intention to fully update all my cost of capital studies with current data sometime prior to formal hearings.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.