

**ORIGINAL**

**BEFORE THE FLORIDA  
PUBLIC SERVICE COMMISSION**

**DOCKET NO. 041291-EI  
FLORIDA POWER & LIGHT COMPANY**

**IN RE: FLORIDA POWER & LIGHT COMPANY'S  
PETITION FOR AUTHORITY TO RECOVER  
PRUDENTLY INCURRED STORM RESTORATION COSTS  
RELATED TO THE 2004 STORM SEASON  
THAT EXCEED THE STORM RESERVE BALANCE**

**March 8, 2005**

**REBUTTAL TESTIMONY & EXHIBIT OF:**

**WILLIAM E. AVERA**

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2                               **FLORIDA POWER & LIGHT COMPANY**  
3                               **REBUTTAL TESTIMONY OF WILLIAM E. AVERA**  
4                                       **DOCKET NO. 041291-EI**

5   **Q.   Please state your name and business address.**

6   A.   William E. Avera, 3907 Red River, Austin, Texas, 78751.

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

8   A.   I am a principal in Financial Concepts and Applications, Inc. (“FINCAP”), a firm  
9       engaged in financial, economic, and policy consulting to business and government.

10  **Q.   What is the purpose of your rebuttal testimony?**

11  A.   On November 4, 2004, Florida Power & Light Company (“FPL”) initiated this  
12       proceeding to recover extraordinary storm-related costs, in excess of insurance  
13       proceeds and reserves. The purpose of my testimony is to respond to the direct  
14       testimony of Mr. James A. Rothschild, on behalf of the Office of Public Counsel  
15       (“OPC”). As Mr. Rothschild noted, his testimony was premised on OPC’s  
16       interpretation of the Revenue Sharing Agreement arising from the stipulation in  
17       Docket No. 001148-EI:

18               My starting point is OPC’s position that there is a requirement flowing  
19               from the stipulation that FPL first has to experience an earnings drop  
20               to no more than 10.0% on equity before it is entitled to request  
21               incremental recover of any expenses. (p. 4)

22       I refute Mr. Rothschild’s assertions regarding the impact of this interpretation on  
23       FPL’s ability to earn a fair rate of return on equity (“ROE”) and its implications for

1 FPL's ongoing ability to attract capital. Specifically, my rebuttal testimony  
2 demonstrates that:

- 3 • *The interpretation of the Revenue Sharing Agreement assumed by Mr.*  
4 *Rothschild is inconsistent with sound regulatory policy and the*  
5 *expectations of the investment community;*
- 6 • *Mr. Rothschild has provided no meaningful support for his conclusion*  
7 *that a 10 percent ROE is "conservatively high," with other objective*  
8 *benchmarks confirming the inadequacy of this threshold return; and,*
- 9 • *OPC's recommendation to effectively disallow reasonable and*  
10 *necessary expenses would send an alarming signal to investors and*  
11 *would have a negative impact on FPL's financial flexibility and the*  
12 *cost of capital.*

13 **Q. Please describe your educational background and professional experience.**

14 A. A description of my background and qualifications, including a resume containing the  
15 details of my experience, is attached as Exhibit No. WEA-1.

16 **Q. Are there established regulatory policies related to FPL's application to recover**  
17 **the accumulated storm restoration costs?**

18 A. Yes. A fundamental tenet of the regulatory compact is that the utility is entitled to an  
19 opportunity to recover from customers all reasonable and necessary costs incurred in  
20 providing service, including a fair return on investment, and that these costs should be  
21 borne by those for whose benefit they were incurred. In exchange, the utility agrees  
22 to provide safe, reliable service to customers at a reasonable cost.

1 **Q. Is FPL's request to recover storm-related costs, net of insurance proceeds and**  
2 **reserves, through a monthly surcharge consistent with regulatory policy?**

3 A. Absolutely. The inclusion of all reasonable and necessary costs in rates is the essence  
4 of public utility regulation. Not only is this obligation related to the control of natural  
5 monopolies, it is also essential to encourage efficient utility operations and assure  
6 reliable utility service to consumers. Apart from maintaining adequate utility service,  
7 the opportunity to recover reasonable and necessary expenditures, such as those  
8 associated with FPL's extraordinary storm restoration efforts, is central to the cost-of-  
9 service approach to regulation adopted in Florida and elsewhere in this country.

10 **Q. Are the extraordinary costs at issue in this proceeding analogous to other**  
11 **expenses that might be deferred and recovered through future rates?**

12 A. Yes. Perhaps the most directly comparable example would be the regulatory  
13 treatment typically afforded to fuel and purchased power costs, with expenses in  
14 excess of the amount recovered from customers routinely being capitalized after-the-  
15 fact and recovered through future rates. In fact, unexpected weather conditions,  
16 capacity shortages, or fuel cost volatility can produce power market conditions that  
17 share many of the characteristics that distinguish catastrophic events, such as natural  
18 disasters.

19 In the aftermath of the unprecedented storm season in 2004, FPL has been  
20 forced to incur significant costs in meeting its commitment to provide reliable service  
21 that have not been considered in existing rates. Obviously, FPL has no control over  
22 acts of nature and no ability to control or influence the events that have conspired to  
23 drive storm-related costs considerably above the amounts available through insurance  
24 and existing reserves.

1 **Q. Is there any merit to Mr. Rothschild’s position that FPL’s investors have already**  
2 **been compensated for bearing the risks associated with the unprecedented storm**  
3 **season in 2004?**

4 A. No. Mr. Rothschild wrongly claims that, because the terms of the stipulation imply  
5 an ROE for FPL that exceeds the yield on risk-free Treasury bonds, investors are  
6 already compensated for FPL’s “entire risk profile, including the risk of storm  
7 damage” (p. 8). In fact, however, regulators routinely shield utilities and their  
8 investors from exposure to business variability and unforeseen events, including  
9 factors such as fluctuations in fuel and purchased power costs or the impact of natural  
10 disasters. As discussed earlier, investors’ required rates of return for utilities are  
11 premised on this regulatory compact that allows the utility an opportunity to recover  
12 reasonable and necessary costs. And by sheltering utilities from exposure to  
13 extraordinary or catastrophic events that are beyond the control of management,  
14 ratepayers benefit from lower capital costs than they would otherwise bear. Of  
15 course, the corollary is also true – shifting the burden of extraordinary risks to  
16 shareholders would have the effect of considerably increasing investors’ required rate  
17 of return and, in turn, the cost of equity. As discussed in Mr. Dewhurst’s testimony,  
18 contrary to Mr. Rothschild’s allegation, there is little to indicate that shareholders  
19 included exposure to the costs of recovering from an unprecedented storm season in  
20 their assessment of FPL’s investment risks or their required rate of return. Rather, the  
21 published opinions of bond rating agencies and others in the investment community  
22 support a finding that FPL’s request in this proceeding is entirely consistent with a  
23 straightforward interpretation of the terms of the 2002 stipulation.

1 **Q. Does the fact that allowed rates of return may exceed the yields on risk-free**  
2 **government debt provide any support for Mr. Rothschild's position?**

3 A. No. The fact that allowed rates of return – including the bottom-end benchmark  
4 specified in the stipulation – exceed the yields on risk-free Treasury bonds says  
5 nothing about whether investors are being compensated for assuming the risks of  
6 unforeseen or catastrophic events, as Mr. Rothschild now argues. While the  
7 regulatory compact allows for the recovery of prudently incurred expenses necessary  
8 to provide customers with reliable service, investors nonetheless remain exposed to a  
9 broad spectrum of other risks that fully warrant a cost of equity considerably in  
10 excess of a risk-free rate of return. Moreover, because existing rates do not  
11 incorporate a return on storm costs in excess of insurance proceeds and reserves,  
12 shareholders have already assumed additional risk, and borne part of the burden,  
13 associated with FPL's recovery efforts. Contrary to Mr. Rothschild's assertions, the  
14 fact that investors require a premium significantly above the yields on risk-free  
15 government debt provides no reason to believe that FPL's cost of equity includes  
16 compensation for the extraordinary risks associated with the unprecedented storm  
17 season in 2004. While the stipulation expressly concluded that "FPL will no longer  
18 have an authorized [ROE] range for the purposes of addressing earnings levels," the  
19 10 to 12 percent range retained "for all other purposes" is generally in line with  
20 returns allowed for other electric utilities across the country. Accordingly, it includes  
21 a risk premium commensurate only with the normal business and operating risks  
22 facing FPL; it clearly does not include a risk premium adequate to compensate  
23 investors for bearing the extraordinary risks of absorbing the financial impact of  
24 catastrophic weather.

1 **Q. Did Mr. Rothschild provide any meaningful support for his assertion (p. 8) that a**  
2 **10 percent ROE is “more than adequate” for FPL?**

3 A. No. First, it is important to note that Mr. Rothschild’s opinion was not based on any  
4 independent analyses of investors’ required rate of return for FPL. Rather, Mr.  
5 Rothschild’s “support” consisted of selected half-truths that paint an incomplete – and  
6 inaccurate – picture of investors’ risk perceptions and return requirements for electric  
7 utilities in today’s capital markets.

8 **Q. What was Mr. Rothschild’s first piece of “evidence”?**

9 A. Mr. Rothschild claimed that the 10 percent bottom threshold of the ROE sharing  
10 range is now generous because there have been instances of authorized rates of return  
11 that fall below this benchmark. As Mr. Rothschild stated:

12 Since the date of the stipulation, there have been some electric  
13 companies that have been awarded a cost of equity of less than 10%.  
14 (pp. 8-9)

15 Of course, what Mr. Rothschild’s statement ignores is the fact that, since the  
16 stipulation, the vast majority of authorized ROEs for electric utilities have been well  
17 in excess of the 10 percent lower bound. The rates of return on common equity  
18 authorized for utilities by regulatory commissions across the U.S. are compiled by  
19 Regulatory Research Associates (“RRA”) and published in its Regulatory Focus  
20 report. In the thirty years since RRA began reporting this information, average  
21 annual authorized rates of return for electric utilities have *never* fallen to the 10  
22 percent threshold that Mr. Rothschild now characterizes as “more than adequate.”

23 Moreover, the fact that there have been isolated instances in which utilities  
24 have been awarded lower returns says nothing about FPL’s specific risks and

1 circumstances. For example, the four companies specifically referenced by Mr.  
2 Rothschild – Public Service Electric and Gas Company, Jersey Central Power &  
3 Light Company (“JCPL”), Atlantic City Electric Company, and Connecticut Light  
4 and Power Company – all operate in states that have undergone industry  
5 restructuring. As part of this restructuring, the operations of formerly integrated  
6 electric utilities have been disaggregated into three primary components – generation,  
7 transmission, and distribution. As a result of this unbundling, authorized returns for  
8 these utilities are predicated on a set of circumstances that differs markedly from  
9 those currently faced by FPL.

10 Consider JCPL, for example. In August 2002 the New Jersey Board of Public  
11 Utilities (“BPU”) authorized a rate of return on equity for JCPL of 9.5 percent. But  
12 as the BPU made clear in its order, this ROE was premised on its belief that JCPL had  
13 experienced a “significant reduction in the risks it faces” as a result of the divestiture  
14 of its generating assets brought about by restructuring. [Final Order, Docket No.  
15 ER02080506]. As the BPU summarized:

16 Most notably, the Board believes that the overall risks facing the  
17 electric utility distribution companies in New Jersey have decreased as  
18 a result of the various provisions of [the Electric Discount and Energy  
19 Competition Act]. Foremost is the Basic Generation Service Auction  
20 process that the Board has adopted for the procurement of power for  
21 the electric companies in New Jersey. The BGS process eliminates the  
22 risks associated with the companies’ planning, construction and  
23 operation of generation facilities. The resulting “wires only”  
24 distribution companies should therefore require a lower cost of capital



1                   that ratepayers are required to support in their retail rates. [Final  
2                   Order, Docket No. ER02080506 at p. 38]

3                   Under the BPU's reasoning, the risks of FPL would imply a significantly higher cost  
4                   of equity; a fact that was lost in Mr. Rothschild's flawed comparison.

5   **Q.   What other data concerning allowed rates of return disproves Mr. Rothschild's**  
6   **conclusions?**

7   A.   Closer to home, in June 2002 the FPSC authorized an ROE for Peoples Gas System  
8           of 11.75 percent (D-020384-GU), with City Gas Company of Florida being granted a  
9           return on equity of 11.25 percent in August 2003 (D-030569-GU). Given that  
10          investors are likely to perceive the investment risks of integrated electric utilities as  
11          exceeding those of a gas distribution company, these findings also contradict Mr.  
12          Rothschild's conclusion that a 10 percent ROE is "conservatively high."

13   **Q.   Do the earned rates of return cited by Mr. Rothschild (p. 9) provide any insight**  
14   **as to investors' required ROE for FPL?**

15   A.   No. In an effort to buttress his position, Mr. Rothschild observes that, for the 23  
16          companies in the Electric Utility (East) industry group of The Value Line Investment  
17          Survey ("Value Line"), more than half of the earned rates of return reported for 2004  
18          are less than 10 percent, "with some companies ... expected to earn 8.0% or less on  
19          equity" (p. 9). Once again, however, Mr. Rothschild's comparison paints an  
20          incomplete and erroneous picture.

21                 First, earned rates of return on book equity based on past accounting data do  
22                 not reflect the forward-looking rates of return actually required by investors in the  
23                 capital markets. Investors capitalize expected future cash flows and not historical  
24                 accounting earnings, and what was earned on book value is not directly related to

1 current market requirements. Moreover, the comparable earnings standard is based  
2 on the notion that the allowed return should be commensurate with returns on other  
3 investments *having comparable risks*. Not only is the earned return on book equity  
4 divorced from the actual expectations of investors in the capital markets, Mr.  
5 Rothschild has presented no evidence that would support a finding that a group  
6 composed of all utilities in Value Line's Electric Utility (East) industry are risk-  
7 comparable to FPL.

8 Second, there is considerable evidence that the single-period earned returns  
9 cited by Mr. Rothschild are downward-biased. Specifically, if rates of return are  
10 based on end-of-year book values, as are those reported by Value Line, they will  
11 understate actual returns because of growth in common equity over the year.  
12 Consider a hypothetical firm that begins the year with a net book value of common  
13 equity of \$100. During the year the firm earns \$13 and pays out \$3 in dividends, with  
14 the ending net book value being \$110. Using the year-end book value of \$110 to  
15 calculate the rate of return results in a value of 11.8 percent, while the average annual  
16 return is actually 12.4 percent – earnings of \$13 divided by the *average* net book  
17 value over the year (\$105).

18 Additionally, the single-period earned returns referenced by Mr. Rothschild  
19 are colored by Value Line's lukewarm assessment of near-term prospects in the  
20 electric utility industry. Specifically, Value Line has reduced its Timeliness ranking (a  
21 relative measure of year-ahead stock price performance for the 98 industries it covers)  
22 for the electric utility industry groups to between 84 and 90, noting that "[t]he electric  
23 utility industry carries one of our lowest industry Timeliness ranks." [Dec. 31, 2004  
24 at 695]. While this cautious outlook may explain the fact that Mr. Rothschild's

1 earned returns on book value are below investors' required rate of return, it is not  
2 necessarily indicative of long-term expectations or investors' actual returns. Indeed,  
3 Value Line noted in its February 11, 2005 edition that "Edison Electric Institute's  
4 index of electric utility stocks posted a 22.8% total return last year."

5 **Q. Does Mr. Rothschild's discussion of earned rates of return tell the whole story?**

6 A. No. As with his comparison to allowed rates of return, Mr. Rothschild's review of  
7 Value Line's earned rates of return is incomplete. Indeed, while Mr. Rothschild  
8 focuses on a single historical period – 2004 – Value Line's most recent projections for  
9 the electric utility industry indicate an expected return on book equity for their 2007-  
10 2009 forecast horizon of 11 percent. [Feb. 11, 2005 at 1775]. The average of Value  
11 Line's book returns for the 23 utilities in the Electric Utility (East) industry group  
12 exceed the 10 percent threshold in 2004, 2005, and for the 2007-2009 period, with  
13 earned returns for FPL Group ranging from 11.0 to 12.0 percent. Similarly, a  
14 February 10, 2005 research report by A.G. Edwards noted that "[o]ur 2006 and 2007  
15 EPS estimates assume Florida Power and Light earns an 11.75% ROE in 2006 and a  
16 12.0% ROE in 2007."

17 Finally, Mr. Rothschild's observation that certain electric utilities, "including  
18 Allegheny Energy, Central Vermont, Northeast Utilities, and TECO," (p. 9) have  
19 earned returns at or below 8 percent only serves to illustrate the illogical nature of his  
20 conclusions. The financial turmoil surrounding Allegheny Energy, which completely  
21 omitted common dividend payments in 2003, has been well publicized. While Value  
22 Line reports an earned return on equity of 5.0 percent for Allegheny Energy for 2004,  
23 no one could credibly claim that this is in any way related to investors' required rate  
24 of return for a utility with "junk" bond ratings. Indeed, the average 2004 earned

1 return on book equity for the four firms specifically cited by Mr. Rothschild is 5.1  
2 percent. The fact that this average earned return falls below the yields available on  
3 far less risky senior debt illustrates the lack of economic logic underlying Mr.  
4 Rothschild's position.

5 **Q. Does Mr. Rothschild's comparison of financial risks (pp. 9-10) support his**  
6 **conclusion regarding the reasonableness of a 10 percent ROE for FPL?**

7 A. No. While the uncertainties inherent in financial leverage are certainly one element  
8 considered by investors in their assessment of relative risks and required returns,  
9 there are a host of other factors that are integral to their evaluation. Consider the  
10 example of bond ratings, which are widely regarded as an objective measure of  
11 overall investment risks. The analyses of ratings agencies, such as Standard & Poor's  
12 Corporation ("S&P"), encompass a thorough review of a plethora of considerations  
13 that impact investment uncertainties. As S&P noted, this review:

14 ... includes analysis of the nature of the company's business and its  
15 operating environment, evaluation of the company's strategic and  
16 financial management, financial analysis, and a rating  
17 recommendation. ...The many factors assessed include industry  
18 prospects for growth, stability, or decline, and the pattern of business  
19 cycles (*see Cyclicity*). It is critical to determine vulnerability to  
20 technological change, labor unrest, or regulatory interference.  
21 Industries that have long lead times or that require a fixed plant of a  
22 specialized nature face heightened risk. [*Corporate Rating Criteria,*  
23 2004]

1 By focusing on a single factor – FPL’s equity ratio – to the exclusion of all other  
2 considerations, Mr. Rothschild’s comparison presents a distorted and inaccurate view  
3 of overall investment risks.

4 **Q. What other considerations invalidate Mr. Rothschild’s financial risk arguments?**

5 A. Apart from the fact that financial leverage alone does not accurately capture  
6 investors’ risk perceptions, the 65.1 percent equity ratio referenced by Mr. Rothschild  
7 (p. 10) is not representative of the financial risk associated with FPL. A significant  
8 portion of FPL’s power requirements are obtained through long-term purchased  
9 power contracts that obligate FPL to make certain capacity and minimum contractual  
10 payments. Investors perceive these commitments as akin to those associated with  
11 traditional debt financing, and consider them in evaluating FPL’s financial risks.

12 The implications of purchased power commitments for a utility’s financial  
13 risks have been repeatedly cited by major bond rating agencies. Consequently, it has  
14 been necessary for FPL to maintain a relatively greater proportion of equity capital in  
15 order to maintain its credit standing. Incorporating the debt equivalent of FPL’s  
16 obligations under its purchased power contracts in the Company’s capital structure  
17 would have the effect of increasing its financial leverage and reducing its common  
18 equity ratio well below the 65.1 percent calculated by Mr. Rothschild. Indeed, after  
19 adjusting for the off-balance sheet financial impact of purchased power commitments,  
20 FPL has an adjusted common equity ratio at December 31, 2004 of approximately 55  
21 percent. This falls within the range of 2004 capitalizations reported by Value Line for  
22 the Electric Utility (East) group referenced by Mr. Rothschild.

1 **Q. Should the FPSC place any reliance on Mr. Rothschild’s quantification of the**  
2 **impact of financial risk on investors’ required rate of return?**

3 A. No. Because the cost of equity is inherently unobservable, there is no way to  
4 precisely quantify the impact of specific factors, such as a change in financial risk, on  
5 investors’ required rate of return. Apart from the fact that Mr. Rothschild provides no  
6 support or explanation of his determination that an equity ratio of 65.1 percent  
7 implies a reduction in the cost of equity vis-à-vis the Value Line Electric Utility (East)  
8 group of 75 basis points, this conclusion is meaningless for two reasons.

9 First, while I agree that *other things equal*, a higher common equity ratio  
10 would imply lower investment risks and a lower required return, Mr. Rothschild has  
11 not demonstrated that to be the case here. As noted earlier, there is no evidence to  
12 suggest that the 23 firms referenced by Mr. Rothschild constitute a valid basis for  
13 comparison with FPL. Meanwhile, the investment community has recognized that  
14 FPL faces other risks, including exposure to nuclear uncertainties, economic  
15 volatility, and burdensome capital spending requirements, which distinguish it from  
16 other utilities. Second, because Mr. Rothschild has conducted no market-based  
17 analyses of the cost of equity for the firms in the Electric Utility (East) group, there is  
18 no basis to conclude that applying his 75 basis point adjustment would produce an  
19 implied return at or below 10 percent. Thus, even if Mr. Rothschild’s unsupported  
20 supposition were correct, it provides no insight as to the reasonableness of the  
21 bottom-end ROE specified in the stipulation.

1 **Q. Does a decline in interest rates imply a corresponding change in the cost of**  
2 **equity, as Mr. Rothschild represents (p. 10)?**

3 A. No. While interest rate trends are directly observable in the capital markets, the  
4 impact of such changes on investors' required rate of return on equity is not as readily  
5 determined. While the cost of equity generally moves in the same direction as  
6 interest rates, it is widely accepted that the cost of equity does not increase or  
7 decrease in lockstep with changes in bond yields. Indeed, there is substantial  
8 evidence that equity risk premiums tend to move inversely with interest rates. Thus,  
9 when interest rates are relatively low, the spread between the cost of equity and the  
10 interest rate on debt is greater than when interest rates are higher.

11 It is generally thought that this "inverse relationship" between interest rates  
12 and equity risk premiums is caused by investors' inflation expectations. As Eugene F.  
13 Brigham, formerly with the Public Utility Research Center at the University of  
14 Florida, explained in a 1985 *Financial Management* article, when inflation  
15 expectations are low, so are interest rates and the inherent inflation hedge of stocks  
16 does little to offset the higher risks associated with holding common equity. When  
17 interest rates rise because of increasing fears of inflation, the inflation hedge of stocks  
18 becomes more valuable, offsetting part of the returns required to bear the greater risks  
19 of stocks – thereby lowering the spread between interest rates and investors' required  
20 rate of return on equity.

21 Because equity risk premiums widen when interest rates fall, the cost of  
22 equity declines less than the level of bond yields. This inverse relationship has been  
23 recognized in the financial literature and by regulators. Based on a review of the  
24 financial literature, *Regulatory Finance: Utilities Cost of Capital* concluded that:

1                   These studies imply that the cost of equity changes only half as much  
2                   as interest rates change. (p. 292)

3 **Q. Is there evidence that suggests investors expect interest rates will increase going**  
4 **forward?**

5 A. Yes. The general expectation is that interest rates will begin to rise with  
6 strengthening economic growth, with Value Line citing “the strong possibility of  
7 rising interest rates in 2005” in its December 17, 2004 report (p. 459). Indeed, the  
8 Federal Reserve on February 2, 2005 raised interest rates for the sixth time since June  
9 2004 and signaled it was likely to continue to act at a "measured" pace. The latest  
10 quarter-point increase raised the federal funds rate to 2.5 percent; more than double  
11 the 46-year low of 1.00 percent in effect when the Fed began its credit-tightening  
12 campaign in 2004. Meanwhile, the Wall Street Journal reported (Jan. 5, 2005 at A2)  
13 expectations of a steady rise in rates:

14                   The minutes suggest that the Fed is less likely to pause in its interest-  
15                   rate increases this year than the markets may have expected. In the  
16                   wake of the minutes’ release, long-term bond prices fell sharply, and  
17                   yields, which move in the opposite direction, rose.

18 Consistent with these general expectations for higher interest rates, the February 1,  
19 2005 edition of Blue Chip Financial Forecasts anticipates that the yields on 20-year  
20 Treasury bonds will climb to 5.6 percent by the fourth quarter of 2005. Given that  
21 this is essentially equal to the 5.64 percent benchmark yield for March 2002 cited by  
22 Mr. Rothschild (p. 10), this implies no change in capital market requirements since  
23 the time of the stipulation.



1 **Q. Do the 75-year projections of the Social Security Administration (“SSA”)**  
2 **provide a sound basis on which to evaluate or establish rates of return for**  
3 **electric utilities?**

4 A. No. Mr. Rothschild cites a January 2005 article in Business Week, reporting that the  
5 SSA’s chief actuary “has determined that the total return on the stock market will be  
6 6.5% over the inflation rate during the next 75 years” (p. 11). But real-world  
7 investors in the capital markets, not the SSA, determine the cost of equity and as  
8 Business Week noted, “no one can really project anything over 75 years.” The SSA is  
9 not an investment advisory service and their projections do not typically serve as a  
10 resource for stock market investors. Indeed, the issue of fundamentally changing the  
11 social security system, and the projections that surround the evaluation of the  
12 Administration’s proposals, are perhaps the most controversial and politically charged  
13 issue in recent history. This atmosphere of political jockeying and controversy  
14 provides no meaningful basis on which to establish or evaluate the rate of return on  
15 equity that investors require to commit capital to an electric utility, such as FPL.

16 **Q. Is the 9.35 percent market rate of return that Mr. Rothschild derives from the**  
17 **SSA’s projections consistent with other accepted benchmarks for investors’**  
18 **required rate of return?**

19 A. No. Mr. Rothschild’s market rate of return departs significantly from the findings of  
20 well respected, published sources concerning the returns that investors expect from an  
21 investment in common stocks. For example, in an article entitled “The Market Risk  
22 Premium: Expectational Estimates Using Analysts’ Forecasts,” published in the  
23 Journal of Applied Finance (Vol. 11, No.1, 2001), Robert S. Harris and Felicia C.

1 Marston found that investors' required rate of return on the S&P 500 averaged 15.67  
2 percent.

3 Similarly, historical realized rates of return also imply a cost of equity to the  
4 market as a whole that exceeds Mr. Rothschild's measure by a considerable margin.  
5 Perhaps the most exhaustive and widely referenced annual study of realized rates of  
6 return is published by Ibbotson Associates. In their *2004 Yearbook, Valuation*  
7 *Edition*, Ibbotson Associates reported that, over the period 1926 through 2003, the  
8 arithmetic mean realized rate of return on the S&P 500 was 12.4 percent.

9 **Q. What other evidence indicates that a 9.35 percent market return falls far short of**  
10 **investors' requirements?**

11 A. The reasonableness of Mr. Rothschild's conclusions can be evaluated under the  
12 Capital Asset Pricing Model ("CAPM"), which is a theory of market equilibrium that  
13 measures risk using the beta coefficient. Beta reflects the tendency of a stocks price  
14 to follow changes in the market, with the CAPM being mathematically expressed as:

15 
$$R_j = R_f + \beta_j(R_m - R_f)$$

16 Where:  $R_j$  = required rate of return for stock  $j$ ;

17  $R_f$  = risk-free rate;

18  $R_m$  = expected return on the market portfolio; and,

19  $\beta_j$  = beta, or systematic risk, for stock  $j$ .

20 Based on SSA's projections and his 4.58 percent government bond yield, Mr.  
21 Rothschild apparently predicts that equity returns will exceed the yields on Treasury  
22 bonds by 477 basis points. After multiplying this market equity risk premium by a  
23 representative beta value of 0.75 and incorporating Mr. Rothschild's 4.58 percent  
24 risk-free rate, this implies an expected return for FPL of 8.2 percent. This result,

1 which falls some 180 basis points below even Mr. Rothschild's meager 10 percent  
2 benchmark, is simply illogical and provides further evidence that Mr. Rothschild's  
3 evidence and conclusions are unrelated to the requirements of real-world investors in  
4 the capital markets.

5 **Q. Can the FPSC take comfort in Mr. Rothschild's assertion (p. 12) that**  
6 **"enforcing" an ROE of 10 percent will not lead to ratings downgrades or a**  
7 **higher cost of capital for FPL?**

8 A. Hardly. As support, Mr. Rothschild cavalierly observes that the terms of the  
9 stipulation "are not new news" to the investment community, before reasserting his  
10 position that the 10 percent bottom-end threshold ROE of the stipulation is "fully  
11 adequate." But as Mr. Dewhurst documents, while the stipulation may not be "new  
12 news," OPC's novel interpretation of this agreement is diametrically exposed to the  
13 expectations of investors.

14 Moreover, in the wake of the crisis in western power markets in 2000-2001,  
15 investors' sensitivity to regulatory uncertainties has increased dramatically. For many  
16 utilities, cost recovery was either prevented or postponed. As a result, they were  
17 denied the opportunity to earn risk-equivalent rates of return and access to capital was  
18 cut off. In the aftermath, perhaps the preeminent issue of concern to investors is the  
19 potential that regulators will prevent utilities from recovering reasonable and  
20 necessary expenses incurred to provide customers with reliable service.

21 Investors recognize that constructive regulation is a key ingredient in  
22 supporting utility credit ratings and financial integrity, particularly during times of  
23 adverse conditions. While investors view the regulatory environment in Florida as  
24 supportive, in some circumstances regulatory uncertainty can eclipse all of the other

1 risk factors facing particular utilities. Given the negative outlook currently assigned  
2 to FPL's long-term debt ratings, the perception of a lack of regulatory support would  
3 almost certainly lead to further downgrades.

4 **Q. Are there indications that the investment community is not apt to be as sanguine**  
5 **as Mr. Rothschild?**

6 A. Yes. Contrary to Mr. Rothschild's assurances, Moody's Investors Service noted in a  
7 February 1, 2005 *Credit Opinion* report that "[r]egulatory risk this year related to the  
8 12/31/05 expiration of current rate agreement and hurricane cost recovery" posed  
9 challenges and observed that a "negative regulatory development" could lead to a  
10 ratings downgrade. Thus, while FPL's conservative posture and ongoing regulatory  
11 support have benefited customers and provided a strong platform for continued  
12 success, actions that serve to erode financial strength or impair financial flexibility  
13 could have swift and damaging consequences.

14 **Q. Why is the recovery of extraordinary storm costs of particular significance to**  
15 **investors?**

16 A. In addition to the immediate issue of unrecovered storm-related expenditures,  
17 investors perceive the expiration of the current stipulation and the resulting rate  
18 proceeding as one of the key risks confronting FPL. Because of the overhang of this  
19 impending rate case, investors' sensitivity to regulatory risks are particularly  
20 heightened, with the FPSC's actions being interpreted as a gauge of future regulatory  
21 support. Indeed, the investment community has cited the FPSC's January 18, 2005  
22 decision to permit the collection of deferred storm repair costs on an interim basis as  
23 a supportive and reassuring development for FPL's financial position.

1           On the other hand, OPC’s proposal to engineer a backdoor reduction in FPL’s  
2 ROE through a novel reinterpretation of the stipulation would send an alarming  
3 message to investors at the very time when FPL must attract the capital necessary to  
4 meet the needs of a growing service area. Considering investors’ preoccupation with  
5 utilities’ exposure to regulatory risk, Mr. Rothschild’s assertion that the investment  
6 community “would have no reason to be concerned” if FPL is denied the opportunity  
7 to recover storm related costs is clearly nonsensical.

8 **Q. Should regulators and customers be concerned about investors’ perceptions?**

9 A. Absolutely. Investors’ assessment of regulatory support and risk has a direct impact  
10 on FPL’s financial strength and ability to attract capital. FPL faces a number of  
11 potential challenges that might require the relatively swift commitment of  
12 considerable capital resources in order to maintain the high level of service to which  
13 its customers have become accustomed. For example, while FPL’s nuclear program  
14 is universally regarded as exemplary, mandated shutdowns in response to security  
15 threats or a catastrophic event elsewhere in the U.S. would impose significant reliance  
16 on wholesale power markets to meet energy shortfalls. FPL’s reliance on purchased  
17 power for a significant portion of its power requirements also imposes increased  
18 vulnerability to supply disruptions, especially in light of its relative geographic  
19 isolation on the Florida peninsula.

20           Similarly, any interruption of gas supplies due to deliverability constraints  
21 imposed on FPL’s suppliers could also result in the need for a considerable financial  
22 commitment for an alternative fuel source or replacement power. Given the potential  
23 for significant volatility in wholesale energy markets and FPL’s lack of control over  
24 the timing of such events, FPL must have the wherewithal to meet these challenges

1 even when capital and energy market conditions are unfavorable. Apart from this  
2 exposure to the vagaries of capital and energy market conditions, FPL must  
3 simultaneously meet the needs of a fast-growing service area, with Fitch noting (Sep.  
4 23, 2004) that “significant ongoing capital expenditure requirements for new  
5 generating resources to meet customer and usage growth” were a credit concern for  
6 FPL.

7 Ultimately, it is customers and the service area economy that enjoy the  
8 rewards that come from ensuring that the utility has the financial wherewithal to take  
9 whatever actions are required to ensure a reliable energy supply. The unprecedented  
10 storm season in 2004 illustrates the benefits that accrue from a utility that has the  
11 financial wherewithal to respond to unforeseen events. Despite the extent of the  
12 damage and lack of sufficient reserves, FPL’s strong financial and liquidity position  
13 ensured its ability to respond quickly and effectively to these unprecedented events,  
14 restoring service to over 5.4 million customers. To meet such challenges successfully  
15 and economically, it is crucial that investors remain confident that FPL will continue  
16 to receive constructive regulatory support.

17 **Q. What is your conclusion regarding the impact of OPC’s proposals on investors’**  
18 **risk perceptions?**

19 A. The investment community is intensely focused on the actions of the FPSC, and a  
20 perceived lack of regulatory support will undoubtedly have ramifications far beyond  
21 the more limited issues at hand in the present case. While a combination of strong  
22 finances and a history of supportive regulation allowed FPL the financial flexibility to  
23 respond quickly to the catastrophic impact of the 2004 hurricane season, attempts to  
24 reinterpret the stipulation so as to deny FPL the opportunity of earning a fair ROE

1 will have profound consequences for investors' assessment of the risks associated  
2 with committing capital to FPL. Denying utilities the ability to recover abnormal  
3 costs, such as those related to the extreme storm season in 2004, would imply a  
4 dramatic increase in investment risk and required rate of return to FPL and other  
5 utilities operating in Florida, with the end-result being a substantially greater cost of  
6 utility service for customers throughout the state.

7 **Q. Does this conclude your rebuttal testimony?**

8 **A. Yes.**

## **QUALIFICATIONS OF WILLIAM E. AVERA**

I received a B.A. degree with a major in economics from Emory University. After serving in the United States Navy, I entered the doctoral program in economics at the University of North Carolina at Chapel Hill. Upon receiving my Ph.D., I joined the faculty at the University of North Carolina and taught finance in the Graduate School of Business. I subsequently accepted a position at the University of Texas at Austin where I taught courses in financial management and investment analysis. I then went to work for International Paper Company in New York City as Manager of Financial Education, a position in which I had responsibility for all corporate education programs in finance, accounting, and economics.

In 1977, I joined the staff of the Public Utility Commission of Texas (PUCT) as Director of the Economic Research Division. During my tenure at the PUCT, I managed a division responsible for financial analysis, cost allocation and rate design, economic and financial research, and data processing systems, and I testified in cases on a variety of financial and economic issues. Since leaving the PUCT in 1979, I have been engaged as a consultant. I have participated in a wide range of assignments involving utility-related matters on behalf of utilities, industrial customers, municipalities, and regulatory commissions. I have previously testified before the Federal Energy Regulatory Commission, as well as the Federal Communications Commission, the Surface Transportation Board (and its predecessor, the Interstate Commerce Commission), the Canadian Radio-Television and Telecommunications Commission, and regulatory agencies, courts, and legislative committees in over 30 states, including the Florida Public Service Commission.

I was appointed by the PUCT to the Synchronous Interconnection Committee to advise the Texas legislature on the costs and benefits of connecting Texas to the national electric transmission



grid. In addition, I served as an outside director of Georgia System Operations Corporation, the system operator for electric cooperatives in Georgia.

I have served as Lecturer in the Finance Department at the University of Texas at Austin and taught in the evening graduate program at St. Edward's University for twenty years. In addition, I have lectured on economic and regulatory topics in programs sponsored by universities and industry groups. I have taught in hundreds of educational programs for financial analysts in programs sponsored by the Association for Investment Management and Research, the Financial Analysts Review, and local financial analysts societies. These programs have been presented in Asia, Europe, and North America, including the Financial Analysts Seminar at Northwestern University. I hold the Chartered Financial Analyst (CFA<sup>®</sup>) designation and have served as Vice President for Membership of the Financial Management Association. I also have served on the Board of Directors of the North Carolina Society of Financial Analysts. I was elected Vice Chairman of the National Association of Regulatory Commissioners (NARUC) Subcommittee on Economics and appointed to NARUC's Technical Subcommittee on the National Energy Act. I also have served as an officer of various other professional organizations and societies. A resume containing the details of my experience and qualifications is attached.

**WILLIAM E. AVERA**

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**Summary of Qualifications**

Ph.D. in economics and finance; Chartered Financial Analyst (CFA<sup>®</sup>) designation; extensive expert witness testimony before courts, alternative dispute resolution panels, regulatory agencies and legislative committees; lectured in executive education programs around the world on ethics, investment analysis, and regulation; undergraduate and graduate teaching in business and economics; appointed to leadership positions in government, industry, academia, and the military.

**Employment**

*Principal,*  
FINCAP, Inc.  
(Sep. 1979 to present)

Financial, economic and policy consulting to business and government. Perform business and public policy research, cost/benefit analyses and financial modeling, valuation of businesses (over 100 entities valued), estimation of damages, statistical and industry studies. Provide strategy advice and educational services in public and private sectors, and serve as expert witness before regulatory agencies, legislative committees, arbitration panels, and courts.

*Director, Economic Research  
Division,*  
Public Utility Commission of Texas  
(Dec. 1977 to Aug. 1979)

Responsible for research and testimony preparation on rate of return, rate structure, and econometric analysis dealing with energy, telecommunications, water and sewer utilities. Testified in major rate cases and appeared before legislative committees and served as Chief Economist for agency. Administered state and federal grant funds. Communicated frequently with political leaders and representatives from consumer groups, media, and investment community.

*Manager, Financial Education,*  
International Paper Company  
New York City  
(Feb. 1977 to Nov. 1977)

Directed corporate education programs in accounting, finance, and economics. Developed course materials, recruited and trained instructors, liaison within the company and with academic institutions. Prepared operating budget and designed financial controls for corporate professional development program.

*Lecturer in Finance,*  
The University of Texas at Austin  
(Sep. 1979 to May 1981)  
Assistant Professor of Finance,  
(Sep. 1975 to May 1977)

Taught graduate and undergraduate courses in financial management and investment theory. Conducted research in business and public policy. Named Outstanding Graduate Business Professor and received various administrative appointments.

*Assistant Professor of Business,*  
University of North Carolina at  
Chapel Hill  
(Sep. 1972 to Jul. 1975)

Taught in BBA, MBA, and Ph.D. programs. Created project course in finance, Financial Management for Women, and participated in developing Small Business Management sequence. Organized the North Carolina Institute for Investment Research, a group of financial institutions that supported academic research. Faculty advisor to the Media Board, which funds student publications and broadcast stations.

### **Education**

*Ph.D., Economics and Finance,*  
University of North Carolina at  
Chapel Hill  
(Jan. 1969 to Aug. 1972)

Elective courses included financial management, public finance, monetary theory, and econometrics. Awarded the Stonier Fellowship by the American Bankers' Association and University Teaching Fellowship. Taught statistics, macroeconomics, and microeconomics.

Dissertation: *The Geometric Mean Strategy as a Theory of Multiperiod Portfolio Choice*

*B.A., Economics,*  
Emory University, Atlanta, Georgia  
(Sep. 1961 to Jun. 1965)

Active in extracurricular activities, president of the Barkley Forum (debate team), Emory Religious Association, and Delta Tau Delta chapter. Individual awards and team championships at national collegiate debate tournaments.

### **Professional Associations**

Received Chartered Financial Analyst (CFA) designation in 1977; Vice President for Membership, Financial Management Association; President, Austin Chapter of Planning Executives Institute; Board of Directors, North Carolina Society of Financial Analysts; Candidate Curriculum Committee, Association for Investment Management and Research; Executive Committee of Southern Finance Association; Vice Chair, Staff Subcommittee on Economics and National Association of Regulatory Utility Commissioners (NARUC); Appointed to NARUC Technical Subcommittee on the National Energy Act.

### **Teaching in Executive Education Programs**

*University-Sponsored Programs:* Central Michigan University, Duke University, Louisiana State University, National Defense University, National University of Singapore, Texas A&M University, University of Kansas, University of North Carolina, University of Texas.

*Business and Government-Sponsored Programs:* Advanced Seminar on Earnings Regulation, American Public Welfare Association, Association for Investment Management and Research, Congressional Fellows Program, Cost of Capital Workshop, Electricity Consumers Resource Council, Financial Analysts Association of Indonesia, Financial Analysts Review, Financial Analysts Seminar at Northwestern University, Governor's Executive Development Program of Texas, Louisiana Association of Business and Industry, National Association of Purchasing Management, National Association of Tire Dealers, Planning Executives Institute, School of Banking of the South, State of Wisconsin Investment Board, Stock Exchange of Thailand, Texas Association of State Sponsored Computer Centers, Texas Bankers' Association, Texas Bar Association, Texas Savings and Loan League, Texas Society of CPAs, Tokyo Association of Foreign Banks, Union Bank of Switzerland, U.S. Department of State, U.S. Navy, U.S. Veterans Administration, in addition to Texas state agencies and major corporations.

Presented papers for Mills B. Lane Lecture Series at the University of Georgia and Heubner Lectures at the University of Pennsylvania. Taught graduate courses in finance and economics in evening program at St. Edward's University in Austin from January 1979 through 1998.

### **Expert Witness Testimony**

Testified in over 200 cases before regulatory agencies addressing cost of capital, rate design, and other economic and financial issues.

*Federal Agencies:* Federal Communications Commission, Federal Energy Regulatory Commission, Surface Transportation Board, Interstate Commerce Commission, and the Canadian Radio-Television and Telecommunications Commission.

*State Regulatory Agencies:* Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Kansas, Maryland, Michigan, Missouri, Nevada, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Virginia, Washington, West Virginia, and Wisconsin.

Testified in over 30 cases before federal and state courts, arbitration panels, and alternative dispute tribunals (over 60 depositions given) regarding damages, valuation, antitrust liability, fiduciary duties, and other economic and financial issues.

### **Board Positions and Other Professional Activities**

Audit Committee and Outside Director, Georgia System Operations Corporation (electric system operator for member-owned electric cooperatives in Georgia); Chairman, Board of Print Depot, Inc. and FINCAP, Inc.; Co-chair, Synchronous Interconnection Committee, appointed by Governor George Bush and Public Utility Commission of Texas; Operator of AAA Ranch, a certified organic producer of agricultural products; Appointed to Organic Livestock Advisory Committee by Texas Agricultural Commissioner Susan Combs; Appointed by Texas Railroad Commissioners to study

group for *The UP/SP Merger: An Assessment of the Impacts on the State of Texas*; Appointed by Hawaii Public Utilities Commission to team reviewing affiliate relationships of Hawaiian Electric Industries; Chairman, Energy Task Force, Greater Austin-San Antonio Corridor Council; Consultant to Public Utility Commission of Texas on cogeneration policy and other matters; Consultant to Public Service Commission of New Mexico on cogeneration policy; Evaluator of Energy Research Grant Proposals for Texas Higher Education Coordinating Board.

### **Community Activities**

Board Member, Sustainable Food Center; Chair, Board of Deacons, Finance Committee, and Elder, Central Presbyterian Church of Austin; Founding Member, Orange-Chatham County (N.C.) Legal Aid Screening Committee.

### **Military**

Captain, U.S. Naval Reserve (retired after 28 years service); Commanding Officer, Naval Special Warfare (SEAL) Engineering Support Unit; Officer-in-charge of SWIFT patrol boat in Vietnam; Enlisted service as weather analyst (advanced to second class petty officer).

### **Bibliography**

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- "Usefulness of Current Values to Investors and Creditors," in *Inflation Accounting/Indexing and Stock Behavior* (1977)
- "Consumer Expectations and the Economy," *Texas Business Review* (Nov. 1976)
- "Portfolio Performance Evaluation and Long-run Capital Growth," with Henry A. Latané in *Proceedings of the Eastern Finance Association* (1973)
- Book reviews in *Journal of Finance* and *Financial Review*. Abstracts for *CFA Digest*. Articles in *Carolina Financial Times*.

#### **Selected Papers and Presentations**

- "The Who, What, When, How, and Why of Ethics", San Antonio Financial Analysts Society (Jan. 16, 2002). Similar presentation given to the Austin Society of Financial Analysts (Jan. 17, 2002)
- "Ethics for Financial Analysts," Sponsored by Canadian Council of Financial Analysts: delivered in Calgary, Edmonton, Regina, and Winnipeg, June 1997. Similar presentations given to Austin Society of Financial Analysts (Mar. 1994), San Antonio Society of Financial Analysts (Nov. 1985), and St. Louis Society of Financial Analysts (Feb. 1986)
- "Cost of Capital for Multi-Divisional Corporations," Financial Management Association, New Orleans, Louisiana (Oct. 1996)
- "Ethics and the Treasury Function," Government Treasurers Organization of Texas, Corpus Christi, Texas (Jun. 1996)
- "A Cooperative Future," Iowa Association of Electric Cooperatives, Des Moines (December 1995). Similar presentations given to National G & T Conference, Irving, Texas (June 1995), Kentucky Association of Electric Cooperatives Annual Meeting, Louisville (Nov. 1994), Virginia, Maryland, and Delaware Association of Electric Cooperatives Annual Meeting, Richmond (July 1994), and Carolina Electric Cooperatives Annual Meeting, Raleigh (Mar. 1994)
- "Information Superhighway Warnings: Speed Bumps on Wall Street and Detours from the Economy," Texas Society of Certified Public Accountants Natural Gas, Telecommunications and Electric Industries Conference, Austin (Apr. 1995)
- "Economic/Wall Street Outlook," Carolinas Council of the Institute of Management Accountants, Myrtle Beach, South Carolina (May 1994). Similar presentation given to Bell Operating Company Accounting Witness Conference, Santa Fe, New Mexico (Apr. 1993)

- "Regulatory Developments in Telecommunications," Regional Holding Company Financial and Accounting Conference, San Antonio (Sep. 1993)
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