BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

REVIEW OF 2007 ELECTRIC INFRASTRUCTURE STORM HARDENING PLAN FILED PURSUANT TO RULE 25-6.0342, F.A.C., SUBMITTED BY FLORIDA PUBLIC UTILITIES COMPANY. DOCKET NO. 070300-EI

PETITION FOR RATE INCREASE BY FLORIDA PUBLIC UTILITIES COMPANY. DOCKET NO. 070304-EI

/

VOLUME 3

Pages 352 through 567

ELECTRONIC VERSIONS OF THIS TRANSCRIPT ARE A CONVENIENCE COPY ONLY AND ARE NOT THE OFFICIAL TRANSCRIPT OF THE HEARING. THE .PDF VERSION INCLUDES PREFILED TESTIMONY.

PROCEEDINGS:	HEARING
BEFORE:	CHAIRMAN MATTHEW M. CARTER, II COMMISSIONER LISA POLAK EDGAR COMMISSIONER KATRINA J. McMURRIAN COMMISSIONER NANCY ARGENZIANO COMMISSIONER NATHAN A. SKOP
DATE:	Wednesday, February 27, 2008
TIME:	Commenced at 9:30 a.m. Recessed at 4:35 p.m.
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	MARY ALLEN NEEL, RPR, FPR
APPEARANCES:	(As heretofore noted.)

I N D E X

WITNESSES

EXHIBITS

NUMBER		ID.	ADMTD.
27 - 29			381
30 - 46	Appendix A and JRW-1 through JRW-16	383	482
47 - 49	PWM-1 through PWM-3	483	565

P R O C E E D I N G S

(Transcript follows in sequence from Volume 2.)

CHAIRMAN CARTER: Okay. We are back on the record with our hearing, and last time Mr. Horton was in the process of cross-examination. Mr. Horton, you're recognized.

MR. HORTON: Thank you.

Thereupon,

HUGH LARKIN, JR.

called as witness on behalf of the Citizens of the State of Florida, continued his sworn testimony as follows:

CROSS-EXAMINATION

BY MR. HORTON:

Q. Are you ready, Mr. Larkin?

A. I am.

Q. All right, sir. We were talking about rate case expense and the preparation of rate cases, and in your testimony, and precisely on page 31, lines 8 and 9, you make the statement, "Preparation and filing of rate cases are normal costs incurred by utilities in the normal course of business." And my question to you is, do you know how often companies file a rate case?

A. Generally every four or five years.

Q. Have you ever put together a rate case?

A. We have -- not from the company standpoint, but we do it all the time from a regulatory -- from a consumer standpoint, yes.

Q. From the review side, but you've never put one together from scratch that has to be filed, the petition and all that? You've never done it from the company side?

A. No.

Q. Okay. Do you have a feel or an idea how much work is required to put together a rate case?

A. Well, I mean, you're putting it together from records you're familiar with, so I can't say that it would be -- there are lots of hours involved, but I don't think it's a task that is unsurmountable.

Q. But while that work is going on, regular work needs to go on as well, does it not?

A. Yes, but the regular work is generally done by clerks and staff people.

Q. You don't think there's regular work that needs to be going on by staff accountants and other personnel that are involved with the rate case?

A. Yes, but they're supervising, and they can handle that.

Q. Okay. Do you have an idea how much discovery has been filed in this case?

A. The number of questions asked?

Q. Generally.

A. A couple of hundred questions, but most of them could have been replied to by providing the documents that the company used. Normally we don't ask information that the company shouldn't have done themselves or put together themselves in preparing the case, so I don't think that there's a lot of extra work involved in answering discovery.

Q. Well, if you ask an interrogatory question, Mr. Larkin, doesn't that require that the person responsible sit down, draft up and review and respond to the interrogatory?

A. Yes.

Q. That's not something that's just readily available that they can pick up and provide, is it?

A. I would think so. I mean, when you ask me questions, I look at it, and I can dictate the answer within four or five minutes. And I've got the information. If they say, "Where did you get this," or "How did you do this," or "What's your view of that," boy, if I can't do -- you asked me like 25 questions. I don't think it took me an hour to answer them, hour and a half maybe.

Q. Do you think it's -- you have employees that

work for you in your business?

A. Yes.

Q. And do you offer them any type of recognition for extraordinary efforts when they're doing their job?

A. No. They get a base salary, and at the end of the year, if we made money, then I divide it up between the people.

Q. So you provide bonuses?

A. Pardon?

Q. You provide bonuses to your employees?

A. Well, most of the compensation comes through bonuses. They get just enough to pay their bills through the year, and then at the end of the year, whatever money is there I divide up between the people that are working.

Q. Are you aware that Florida Public Utilities does not provide bonuses to its employees no matter how much work they do?

A. Well, I'm not familiar. I think you probably should ask Patricia Merchant about the compensation plan, because I'm not that familiar with it.

Q. You are aware that Florida Public Utilities does not have a very large staff, do they?

A. Well, I --

Q. Electric staff.

A. -- assume they've got a staff that's commensurate with the size of the company.

Q. You would expect that the company would put together a rate case like this in the most efficient way, and that may involve the use of outside consultants as well as employees; correct?

A. I would assume so.

Q. And if that meant utilizing outside employees -- or excuse me, outside consultants to perform some of the work that the staff normally would have performed so that they could work on the rate case, would that be an appropriate expense to recover?

A. If it's designated and they can show that it's directly related to the rate case, it is appropriate to recover it.

Q. Let me -- if -- strike that. Let me turn to another subject, inspection and testing of the substations.

A. Yes.

Q. You would agree that it would be prudent for the company to inspect and test its substation equipment, would you not?

A. That they do do that work?

Q. That they should do that.

A. Yes.

Q. And the inspection and testing could prevent costly repairs later if it's performed regularly, would it not, could it not?

A. It should.

Q. And the testing and inspection would also contribute to the hardening efforts that this Commission is interested in with respect to the storms, would it not?

A. It may or may not.

Q. Okay. Now, I believe you were provided some documents that were used in the development of the company's substation maintenance.

A. I was provided two pages, or a one-page document that listed numbers, and then a reference or a document that is generic maintenance document.

Q. But you were provided a response to that. You were provided that -- you say it's a generic maintenance document, but it includes recommendations on maintenance and testing of the substation equipment, does it not?

A. It includes generic recommendations.

Q. Are you aware that the company does indeed have a company-specific schedule?

A. Well, if they do, they didn't provide it. I mean, what they provided was a sheet of paper which listed categories such as transformers, 77,000, circuit

breakers, 8,000, circuit switches, 9,000. There was no comparison between what they currently are spending, what they think they have to spend, and what the benefit of increasing the spending was. It was just, "Here's a list of numbers, and this is how we got to here."

That's not -- that doesn't justify increasing these maintenance expenses by 154 percent. All it is is a request with no substantiation. There was no step-by-step, detailed plan with costs associated with it compared to what done in prior years and a justification line by line of why that increase is necessary. It's a generic, "Give us this amount of money," and that's why we're objecting to it, why I'm objecting to it.

Q. Let's move to another subject, Mr. Larkin, uncollectibles. On page 43 of your testimony, I believe you address the uncollectible accounts.

A. Yes.

Q. And I believe you say the bad debt expense should be $71,179; correct? That's on page 44, line 17.

A. Yes.

Q. Now, in your testimony there, you include a portion of a response to Interrogatory Number 115, and that's on page 43. Do you see that?

A. Yes.

Q. Do you recall if there was some more information in that interrogatory?

A. There was -- there might have been.

Q. You don't remember if you considered any of that explanation?

A. Well, I certainly did consider it. I read the whole thing and considered it. But the direct question was, how come you made a calculation and said here's the bad debt expense, and it should be 144,563, but then when you go to the work paper or the company's expense, it's 216,664? Their calculation didn't agree with what they put in the expense.

And this answer -- when we asked why is that so, we get this answer back that is -- I want to be charitable, but it doesn't make any sense at all. It's a gobbledygook answer that doesn't make any sense on the way bad debt is accounted for. But that was just to show that the company's number was wrong to start out with, the wrong number is in there to start out with.

Then I did a calculation comparing their actual bad debt write-offs net of recoveries. Now, the company didn't use the recoveries. They just used what they wrote off and arrived at a percentage. I used the recoveries or the write-offs net of recoveries and compared that to the annual revenue and arrived at a

percentage, which I'm trying to find. And it's that percentage that I applied to the company's projected revenues to arrive at the $71,000.

And the $71,000 -- the exhibit is C-4. The $71,000 is comparable to what the company's net write-offs were from 2000 to 2006. I used 71,000. In 2006, the net write-offs were 58,000. In 2005, they were 58,000. In 2004, they were 48,000. In 2003, they were 46,000. In 2002, they were 37,000. How do you go from net write-offs in 2006 of $58,000 to $212,000? There's no reasonality in the numbers. There's no comparability, no sense to it.

Q. Don't you think the recent fuel increases might have impacted that?

A. Well, the fuel would have been considered when I take the average recovery and apply it to the projected revenue, because the projected revenue includes the increase in fuel. I applied 11.52 percent to $62 million, which is the number that the company -- 61,760,000, that's the number that the company projected to be the 2008 revenues before the rate increase. So I went from actual 58,000 in 2006 to 71,000 in 2008, and I think that's a reasonable projection or progression of what has happened with the numbers.

Q. Now, Mr. Larkin, I think we're going to agree

to disagree on some of what you said, but let me move to another topic, and that would be tree replacement. Do you recall the tree replacement program?

A. Yes, yes.

Q. And isn't that proposal to -- wouldn't that be a least-cost approach to some of the vegetation issues, clearing and maintaining the line right-of-way?

A. Well, I suppose you could look at it that way, but I don't think it's the overall ratepayers' responsibility to go into individual customers' property and remove trees and replace those trees at the expense of all the ratepayers.

Now, when you plant a tree, common sense and most cities will tell you you have to keep the tree so many feet away from the right-of-way. And if they've done that, then they've complied with the law. And if the tree continues to grow, then it's either their responsibility to take it down, or the company has a tree trimming program that will cut those back out of the right-of-way. But I just don't see providing 30,000 every year to go around and do landscaping for people.

Q. Well, how do the owners know that they should not be planting in the right-of-way? You phrase it, I think, that they can't plant in right-of-ways. How do they know that?

A. Well, it seems to me that most city ordinances -- at least where I live, there are ordinances about where you can plant trees and how far away they have to be from the property line.

Q. How does a property owner know about that?

A. Well, he knows that by asking the city.

Q. Do you think that's something that might be communicated by the company to the customers?

A. You could do that, yes.

Q. That would be something included in the information that the company says that they need to communicate to their customers?

A. They could do that, yes.

Q. And something they're seeking additional cost for? That could be covered by that, could it not, the cost in this proceeding?

A. Yes. I've left money in for communicating with the company -- customers, rather.

Q. Okay. Just a final clarification question. You recently provided some discovery responses to the company. Do you have a copy of that with you?

A. I do.

Q. Would you look at number 41, please, sir.

A. Yes.

Q. All right. I think that asks if you knew the

ratio of employees, and you said the ratio of employees to customers --

A. To customers was --

Q. Customers to employees was 85, or 84.59?

A. Right.

Q. That's the ratio of electric customers to electric employees?

A. I believe so.

Q. You referenced Interrogatory 43.7; correct?

A. Yes.

Q. Would you agree that that shows total company employees?

A. Well, I wasn't aware of that. Then that calculation would be wrong.

Q. Okay. This is one you did real quickly and submitted a response to?

A. This is, yes, one that I got the information, part of the information myself, and part of the information I got over the phone.

MR. HORTON: Okay. Thank you. I have no further questions.

CHAIRMAN CARTER: Commissioners? Commissioner Argenziano, you're recognized.

COMMISSIONER ARGENZIANO: Yes. Just a quick question. And I probably need you to go over it one

more time, because I'm not sure I got it right. But you had claimed that in the rate case there were costs that were not substantiated. Could you tell me again what those costs were?

THE WITNESS: Which costs?

COMMISSIONER ARGENZIANO: I remember -- I just grabbed it out as you were saying it, and you said that they had not substantiated.

THE WITNESS: Well, one of the costs is --

COMMISSIONER ARGENZIANO: Maintenance?

THE WITNESS: One type of cost is the maintenance of the distribution and transmission transformers. I mean, they have a page of numbers, but as I explained to Mr. Horton, that's not a justification. You can't just type a number on a page and say, "Here's what we want." You have to have a specific program that the ratepayers represented, us, can look at and see that there's actually a benefit to the ratepayer by paying this extra money. And if there isn't and there's no justification, we're obligated to take that -- or to suggest to the Commission that that's not substantiated and it ought to be taken out.

The storm damage is another example. They just said, "Well, we want a storm damage reserve that's 5 percent of the transmission and distribution

investment." Well, that's about -- I think it's like 3-1/2 million, or maybe 3.8 million. They've never had damages of $3.8 million. I mean, the most they ever had was in 2004, and I believe it was $800,000. And the year before 2004, the reserve was well over 2 million. The reserve is now $1.8 million. We just don't think there's a necessity to increase or have ratepayers pay additional storm damage costs when the company is not likely to incur those types of expenses in the normal scenario of storms.

And one thing I should point out. This is what is called an unfunded storm reserve. That means that when you -- when the company collects this money from the ratepayers for storm costs, they don't put it away in their pocket, or they don't put it in a bank that's earning interest. They're using that in the company. It's unfunded. That means what it represents is a promise to the ratepayer that when there is a storm, we won't come to you for this level of storm that we've already collected from you; we'll go out and borrow the money or we'll get the money somewhere else. But there's no money there. There is no money there. They're using that money in day-to-day operations, which is okay.

But when the numbers don't substantiate, the

numbers don't say to me -- the worst-case scenario in 19 years had been $810,000. Then I say what we're doing now is just fine, let's just continue with what we're doing.

COMMISSIONER ARGENZIANO: Thank you.

THE WITNESS: And the bad debt expense is another thing. They took the bad debts -- what you do is, you estimate, you look at your receivables and you say, "Well, of the sales I had this year, maybe one-tenth of 1 percent is not going to be paid," and you set that up. And then you debit the reserve and you credit the expense, and this is what the ratepayer pays, this expense. But then after the customer leaves the system or fails to pay, you take that receivable and you give it to a collection agency, and they're getting, you know, maybe a third of that money back, but they didn't count that in making their calculation, and that's what I tried to take into consideration.

I guess I could go on and on, but there are other things like those that I think are necessary and should be adjusted.

COMMISSIONER ARGENZIANO: Thank you. Mr. Chair.

CHAIRMAN CARTER: You're recognized.

COMMISSIONER ARGENZIANO: Maybe the company

could respond that as well as our staff.

CHAIRMAN CARTER: Sure. No problem. Mr. Horton.

MR. HORTON: If it's --

CHAIRMAN CARTER: Do you have one of your witnesses there --

MR. HORTON: What I was going to say is, if it's appropriate, I would rather have one of the witnesses respond to that.

CHAIRMAN CARTER: Not a problem.

COMMISSIONER ARGENZIANO: And staff also.

CHAIRMAN CARTER: While you're getting a witness, let's turn to staff. Do we have technical staff? Thank you.

MS. BROWN: Commissioner Argenziano, we are going to file a written recommendation on these matters to you at the conclusion of the hearing for your determination and post-hearing recommendation agenda. So since we have no staff witnesses for the hearing, I'm a little hesitant to have them testify at the hearing, but I don't want -- if you really want some answer from us now, he's right here.

COMMISSIONER ARGENZIANO: Mr. Chair, I don't want to do anything that jeopardizes things at the hearing stage. And coming from the legislative process,

I'm having quite an adjustment learning what you can blurt out and what you can't. But in trying to make a determination, I don't want to hear about unsubstantiated costs. I would like some type of defense for that, or if we are dealing with unsubstantiated costs, how we deal with that, have we done that before, and if that's even correct. I don't know.

That's part of what I need ultimately at some point, because at the beginning of the storm hardening for this particular smaller company, I was concerned that we were maybe asking them to do too much for the previous year showing that they hadn't had that much of a problem, and I didn't want the ratepayer to have to suffer because we're asking them to do too much. And now it seems like maybe I'm hearing that maybe some of the numbers are based on -- I'm not sure what, and that's what I need some way.

CHAIRMAN CARTER: Okay. Why don't we do this, Commissioner. We'll defer hearing from staff until later, and Mr. Horton can get one of his professional witnesses to speak to that.

COMMISSIONER ARGENZIANO: Great.

MR. HORTON: We'll be happy to, with the initial observation that this is the first time that

this has ever occurred in a hearing, but we're happy to provide that response. And I'm going to ask Ms. Martin to respond to a portion of it, and Mr. Cutshaw is also available, so --

MS. CHRISTENSEN: Commissioner --

CHAIRMAN CARTER: One moment. Ms. Christensen.

COMMISSIONER ARGENZIANO: Well, Mr. Chair, may I just say something?

CHAIRMAN CARTER: Yes, ma'am.

COMMISSIONER ARGENZIANO: Is the first time it has ever happened because I'm here? Am I doing something wrong?

MR. HORTON: No, Commissioner. I probably -- we're happy to give you all the information. We want to give you all the information and responses appropriate, recognizing that this is a legal proceeding. So I kind of figured --

COMMISSIONER ARGENZIANO: If you'll just bear in mind I'm not an attorney, so that -- you know, that's where I need help.

CHAIRMAN CARTER: Okay. Ms. Christensen.

MS. CHRISTENSEN: Might I suggest, since this is coming up in my witness's prefiled testimony, Mr. Cutshaw and Ms. Martin will also be up to address

the rebuttal testimony, and when they're up here for the rebuttal testimony, Commissioner, that question I think -- you know, they'll be sworn in and under oath at that time, and that probably would be the cleanest and most standard way to address your question with the way we've done these proceedings in the past. And then any follow-up questions you have for those and anything else that comes up during Mr. Larkin's testimony, Ms. Merchant's testimony, or Mr. Woolridge's testimony can be addressed when their witnesses come up for rebuttal.

CHAIRMAN CARTER: Commissioner Argenziano.

COMMISSIONER ARGENZIANO: That would be fine, since I've never been known to be too standard. But not knowing the process really here in a legal proceeding is where I want to be careful, so that's --

CHAIRMAN CARTER: I understand, Commissioner, because the language that you heard was kind of new to all of us. So what we'll do is, obviously, we'll ask the parties as we come back on rebuttal, when we get to that point, Ms. Christensen, maybe you could have Mr. Horton --

MR. HORTON: We'll be prepared to respond.

CHAIRMAN CARTER: -- deal with that, because even though we are formalized and all that, I do believe

in allowing the Commissioners to ask whatever questions that are interesting to you, and I think I can find some basis and justification for that. But I think based upon where we are now, we can just defer and deal with it in the rebuttal portion of the case, although I would like to caution or just kind of give a gentle reminder to the attorneys on either side to just kind of -- when we get to that point, because there's going to be a lot of other stuff happening, that we would like to talk about that. All right?

MS. CHRISTENSEN: We'll see if we can remind Commissioner Argenziano she may have some questions for the witness.

CHAIRMAN CARTER: Okay. Good deal. Staff?

Wait a minute. Commissioner McMurrian, you're recognized.

COMMISSIONER McMURRIAN: Thank you. Mr. Larkin, in the exchange earlier with Mr. Horton about bad debt expense, he asked about the effect of the recent fuel rate increases on bad debt expense.

THE WITNESS: Yes.

COMMISSIONER McMURRIAN: Can you help me -- I know you answered him then, but can you help me understand your answer maybe a little bit in more detail about how you accounted for the fuel rate increase in

your analysis? And if there's a schedule to point me to -- I think we looked at one earlier, but I can't remember where.

THE WITNESS: If you look at my Schedule C-4, and if you look at the columns, in the year 2000, the company wrote off $75,000, 75,649. They recovered either part of that, or from prior years, 38,495, for a net write-off of 37,154.

Now, I took each year and I totaled those, and then I got a relationship for that five-year period of the net write-offs, which is 249,000 to 216,377. So the relationship between what they billed for base rates and fuel over the five-year period is a loss of .001152, or less than a percentage point.

Now, if -- and historically, these things tend to stay in relationship. So if we apply that write-off or that loss factor to a revenue figure that included the increase in fuel, then we get the right number. And what I did was go to the company's MFRs and went to the year 2008, and I said, "What does the company say the total revenues for 2008 will be?" And they said the total revenues for 2008 would be $61,786,961, excluding this base rate increase here. And I'll explain why that should be excluded.

So I took the factor that had been the

historical relationship of these losses and applied it to the new number, which included the high increase in the cost of fuel and energy, and got a higher number. And that's why I've accounted for the fuel, because I've used their projected revenue number, but used my calculation of what I think the write-offs will be.

Now, the revenue conversion factor -- what that 61 million doesn't include is whatever additional revenue you will give them in this hearing. Now, that's accounted for in the conversion factor. So when we start out with a net income number, we gross that number up for taxes, bad debt write-off, franchise taxes, to get this lower number to a higher number, which then goes into the rates. And that's how they collect the increase in bad debts associated with the increase in revenue we're going to give them, you're going to give them, I'm not going to give them.

COMMISSIONER McMURRIAN: One follow-up, Mr. Chairman?

CHAIRMAN CARTER: Absolutely.

COMMISSIONER McMURRIAN: Okay. That helps. That helps me understand how you calculated the bad debt factor. You don't think that the bad debt factor itself might go up with the more recent fuel increases that have happened in the last year or two?

THE WITNESS: Well, that's a possibility, but you only have history to look at, you know, unemployment, the economy should go bad. But, you know, if the rest of the people in Marianna and Fernandina Beach have to deal with their incomes going down, I mean, we shouldn't factor in and protect the utility by giving them a little extra because they might get some write-offs. We should be looking at the poor people that can't pay these bills. They're the ones we should be concerned about and not -- you know, the utility can come back and they can ask again if we make a mistake.

COMMISSIONER McMURRIAN: Thank you, Mr. Larkin. I think we are concerned about those customers, definitely.

CHAIRMAN CARTER: Commissioners, any further questions? Staff?

MS. BROWN: No questions.

CHAIRMAN CARTER: Ms. Christensen.

MS. CHRISTENSEN: Just a few brief redirect questions.

REDIRECT EXAMINATION

BY MS. CHRISTENSEN:

Q. On the topic of the last -- or the last topic that we were discussing, the uncollectible percentage factor, have you seen any documentation or explanation

from the company, other than their statement that new fuel rates have gone into effect, that explains why they -- that a higher percentage ratio should be applied to uncollectibles?

A. Well, the one reason that their rate was higher is that they never accounted for the subsequent collections. They just took the write-offs and got the relationship between revenues and the write-offs and forgot about they're collecting some of these bad debts when they send it to a collection agency. That's why they got 2 percent and I got 1.1 percent.

Q. Okay. Now, let me ask you, in your -- I think you were asked some questions regarding the low-growth tree replacement program for replacing trees that are not in the right-of-way, but are on the private homeowner's property. And I think Mr. Horton had asked you about whether or not this was information that should be provided by the company. Do you recall that discussion?

A. Yes.

Q. Would an economical way to provide that information to FPU's customers be to place that information in their website?

A. Yes. That's another way to do it, yes.

Q. Okay. Excuse me. And I believe you were

asked some questions about rate case expense and the fixed contract for Christensen Associates and the request for additional moneys above and beyond the fixed contract?

A. Yes.

Q. Mr. Larkin, what's your understanding of what a fixed contract is supposed to do?

A. My understanding is that a fixed contract is that you agree to do an amount of work for that dollar amount, regardless of -- to do certain tasks for that amount of money, and regardless of whether the tasks take you more time or less time, then that's the maximum you can get. You can't get any more if you misjudge and agree to a bad fixed rate contract.

Q. Okay. And are you aware -- and you may not be, but are you aware of whether or not Christensen Associates provided any other assistance in this rate case other than MFR preparation and preparation for cost of capital issues in this case?

A. I'm not aware of any.

Q. Now, in your summary you listed some of the issues that you discuss in your testimony. Did you intend to be all-inclusive in your summary of all the adjustments that you recommended in your testimony?

A. No. I just tried to hit the large ones. I

didn't list every one, and I wasn't aware of every one that was stipulated, so I tried to skip the ones that were stipulated that I understood, so I didn't touch everything.

Q. And finally, you were talking about the cash that the company has requested, and you had mentioned that they could transfer the cash to an investment type --

A. Account, yes.

Q. Account. If they were to transfer the moneys to an investment type account, would they earn a return on that money?

A. Well, presumably, yes.

MS. CHRISTENSEN: Okay. I have no further questions.

CHAIRMAN CARTER: Okay. Thank you. Let's deal with our exhibits now.

MS. CHRISTENSEN: I would ask to move Mr. Larkin's exhibits, Appendix 1, HL-1 and HL-2 into the record.

CHAIRMAN CARTER: Those are marked on the comprehensive exhibit list as --

MS. CHRISTENSEN: I'm sorry. Twenty-seven, 28, and 29.

CHAIRMAN CARTER: Twenty-seven, 28, and 29,

Commissioners, on your comprehensive exhibit list. Any objection from any of the parties? Show it done.

(Exhibit Numbers 27, 28, and 29 were admitted into the record.)

CHAIRMAN CARTER: Now, will Mr. Larkin also be available for rebuttal?

MS. CHRISTENSEN: I believe --

CHAIRMAN CARTER: Or actually, for -- go ahead.

MS. CHRISTENSEN: I believe this is all the testimony that he has filed in this case.

CHAIRMAN CARTER: Okay. So then he can be excused.

MS. CHRISTENSEN: Yes. I was going to ask you that, Commissioner, if I can have my witness excused.

CHAIRMAN CARTER: Absolutely.

MS. CHRISTENSEN: Thank you.

CHAIRMAN CARTER: You may call your next witness.

MS. CHRISTENSEN: The next witness Office of Public Counsel would like to call is Dr. Woolridge.

Thereupon,

J. RANDALL WOOLRIDGE

was called as a witness on behalf of the Citizens of the State of Florida and, having been first duly sworn, was

examined and testified as follows:

DIRECT EXAMINATION

BY MS. CHRISTENSEN:

Q. Dr. Woolridge, can you please state your name and business address for the record?

A. Yes. My name is the initial J. Randall Woolridge, W-o-o-l-r-i-d-g-e. My business address is 120 Haymaker Circle, State College, Pennsylvania.

Q. And, Dr. Woolridge, did you cause to be filed in this proceeding prefiled direct testimony?

A. Yes.

Q. And do you have any corrections to your testimony?

A. I have one correction. Actually, there are two numbers that need correcting. If you look at page 11 of my testimony on line 17, I'm putting -- I'm there simply stating debt cost amounts and capitalization amounts and ratios on line 17. The table below that has the correct numbers. I've adopted the company's cost rates for long-term debt and preferred stock. On line 17, instead of 6.05, that should be 7.96, and instead of 4.81, it should be 4.75.

Q. With those corrections to your prefiled testimony, if I were to ask you those questions today, would your answers be the same?

A. Yes.

MS. CHRISTENSEN: I would ask to have Dr. Woolridge's testimony entered into the record as though read.

CHAIRMAN CARTER: The prefiled testimony will adopted into the record as though read.

BY MS. CHRISTENSEN:

Q. Dr. Woolridge, did you also attach exhibits to your prefiled testimony, Appendix A and Exhibits JRW-1 through JRW-16?

A. Yes.

Q. Do you have any corrections to make to any of your exhibits?

A. No.

(Exhibit Numbers 30 - 46 were marked for identification.)

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

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

I. SUBJECT OF TESTIMONY AND SUMMARY OF RECOMMENDATIONS

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

A. I have been asked by the Florida Office of Public Counsel to provide to provide an opinion as to the overall fair rate of return or cost of capital for Florida Public Utilities Company ("FPU" or "Company") and to evaluate FPU's rate of return testimony in this proceeding.

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND FINDINGS CONCERNING THE RATE OF RETURN THAT SHOULD BE UTILIZED IN SETTING RATES FOR FPU IN THIS PROCEEDING.

A. In developing my recommendation, I have primarily reviewed the testimony and recommendations of FPU witnesses Ms. Doreen Cox and Mr. Robert Camfield. In developing my recommended rate of return, I have used the Company's proposed capital structure. I have made a minor adjustment to the short-term debt cost rate to reflect today's lower interest rates. The major area of contention in this case is the proposed equity cost rate for FPU. I have applied the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM") to two groups of publicly-held utility companies. My analysis indicates an equity cost rate of 9.15% for FPU. Using my inputs, I am recommending an overall fair rate of return of 7.09% for FPU. This recommendation is summarized in Exhibit No.__(JRW-1).

As discussed in my testimony, my equity cost rate recommendation is consistent with the current economic environment. Long-term capital costs are at historical low levels. The yields on long-term Treasury bonds have been in the 4-5 percent range for several years. Prior to this cyclical decline in rates in 2002, these yields had not been this low over an extended period of time since the 1960s. Long-term capital costs are also low due to the decline in the equity risk premium and the *Jobs and Growth Tax Relief Reconciliation Act of 2003* which reduced the tax rates on dividend income and capital gains.

Mr.Camfield's equity cost rate estimate is 11.5%. My analysis indicates an equity cost rate of 9.15% is appropriate for FPU. Mr. Camfield uses four methods -- Discounted Cash Flow (DCF) model, Capital Asset Pricing Model (CAPM), Risk Premia - Size-Adjusted (RP) approach, and Realized Market Returns (RMR) approach. Overall, his approaches produce an inflated equity cost rate for FPU. I have employed the DCF and CAPM methodologies. I have applied these approaches to Mr. Camfield's two groups of electric utility and gas distribution companies. Mr. Camfield and I also disagree on the need for a size premium and an issuance or flotation cost adjustment in determining an equity cost rate for FPU.

In the end, the most significant areas of disagreement between Mr. Camfield and myself with respect to the cost of equity are (1) the importance of the DCF model and its results in determining an equity cost rate for the Company, and (2) the measurement and magnitude of the equity risk premium. I believe that the DCF model provides a good indication of equity cost rates for public utilities and have placed heavy reliance on these results in this proceeding. With respect to the measurement of an equity risk premium and expected stock returns, Mr. Camfield relies solely on historical stock and bond returns. As I discuss in my testimony, there are three procedures for estimating an equity risk premium – averages of historical returns, surveys of market professionals, and models of expected market returns. I provide evidence that risk premiums based on historic returns series are upwardly biased measures of expected equity risk premiums. I employ an equity risk

premium which (1) uses all three approaches to estimating an equity premium and (2) employs the results of many studies of the equity risk premium. As I detail later in my testimony, my equity risk premium is consistent with the equity risk premiums (1) advanced in recent academic studies by leading finance scholars, (2) employed by leading investment banks and management consulting firms, and (3) developed in surveys of financial forecasters and corporate CFOs.

II. CAPITAL COSTS IN TODAY'S MARKETS

Q. PLEASE DISCUSS CAPITAL COSTS IN TODAY'S MARKETS.

A. Long-term capital cost rates for U.S. corporations are currently at their lowest levels in more than four decades. Corporate capital cost rates are determined by the level of interest rates and the risk premium demanded by investors to buy the debt and equity capital of corporate issuers. The base level of long-term interest rates in the US economy is indicated by the rates on ten-year U.S. Treasury bonds. The rates are provided in Exhibit No.__(JRW-2) from 1953 to the present. As indicated, prior to the decline in rates that began in the year 2000, the 10-year Treasury yield had not consistently been in the 4-5 percent range over an extended period of time since the 1960s.

The second base component of the corporate capital cost rates is the risk premium. The risk premium is the return premium required by investors to purchase riskier securities. Risk premiums for bonds are the yield differentials between different bond classes as rated by agencies such as Moody's and Standard and Poor's. The yield differential between Baa-rated corporate bonds and 10-year Treasuries is shown in Exhibit No.__(JRW-2). This yield differential peaked at 350 basis points (BPs) in 2002 and has declined significantly since that time. This is an indication that the market price of risk has declined and therefore the risk premium has declined in recent years.

The equity risk premium is the return premium required to purchase stocks as opposed to bonds. Since the equity risk premium is not readily observable in the markets (as are bond risk premiums), and there are alternative approaches to estimating the equity premium, it is the subject of much debate. One way to estimate the equity risk premium is to compare the mean returns on bonds and stocks over long historical periods. Measured in this manner, the equity risk premium has been in the 5-7 percent range. But recent studies by leading academics indicate the forward-looking equity risk premium is in the 3-4 percent range. These authors indicate that historical equity risk premiums are upwardly biased measures of expected equity risk premiums. Jeremy Siegel, a Wharton finance professor and author of the

book *Stocks for the Long Term*, published a study entitled "The Shrinking Equity Risk Premium."[1] He concludes:

> The degree of the equity risk premium calculated from data estimated from 1926 is unlikely to persist in the future. The real return on fixed-income assets is likely to be significantly higher than estimated on earlier data. This is confirmed by the yields available on Treasury index-linked securities, which currently exceed 4%. Furthermore, despite the acceleration in earnings growth, the return on equities is likely to fall from its historical level due to the very high level of equity prices relative to fundamentals.

Even Alan Greenspan, the former Chairman of the Federal Reserve Board, indicated in an October 14, 1999, speech on financial risk that the fact that equity risk premiums have declined during the past decade is "not in dispute." His assessment focused on the relationship between information availability and equity risk premiums.

> There can be little doubt that the dramatic improvements in information technology in recent years have altered our approach to risk. Some analysts perceive that information technology has permanently lowered equity premiums and, hence, permanently raised the prices of the collateral that underlies all financial assets.
>
> The reason, of course, is that information is critical to the evaluation of risk. The less that is known about the current state of a market or a venture, the less the ability to project future outcomes and, hence, the more those potential outcomes will be discounted.
>
> The rise in the availability of real-time information has reduced the uncertainties and thereby lowered the variances that we employ to guide portfolio decisions. At least part of the observed fall in equity premiums in

[1] Jeremy J. Siegel, "The Shrinking Equity Risk Premium," *The Journal of Portfolio Management* (Fall, 1999), p. 15.

> our economy and others over the past five years does not appear to be the result of ephemeral changes in perceptions. It is presumably the result of a permanent technology-driven increase in information availability, which by definition reduces uncertainty and therefore risk premiums. This decline is most evident in equity risk premiums. It is less clear in the corporate bond market, where relative supplies of corporate and Treasury bonds and other factors we cannot easily identify have outweighed the effects of more readily available information about borrowers.[2]

In sum, the relatively low interest rates in today's markets as well as the lower risk premiums required by investors indicate that capital costs for U.S. companies are the lowest in decades. In addition, the 2003 tax law further lowered capital cost rates for companies, as further set forth below.

Q. HOW DID THE *JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003* REDUCE THE COST OF CAPITAL FOR COMPANIES?

A. On May 28, 2003, President Bush signed the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. The primary purpose of this legislation was to reduce taxes to enhance economic growth. A primary component of the new tax law was a significant reduction in the taxation of corporate dividends for individuals. Dividends have been described as "double-taxed." First, corporations pay taxes on the income they earn before they pay dividends to investors, then investors pay taxes on the dividends that they receive from corporations. One of the implications of the double taxation of dividends is

[2] Alan Greenspan, "Measuring Financial Risk in the Twenty-First Century," Office of the Comptroller of the Currency Conference, October 14, 1999.

that, all else equal, it results in a higher cost of raising capital for corporations. The tax legislation reduced the effect of double taxation of dividends by lowering the tax rate on dividends from the 30 percent range (the average tax bracket for individuals) to 15 percent.

Overall, the 2003 tax law reduced the pre-tax return requirements of investors, thereby reducing corporations' cost of equity capital. This is because the reduction in the taxation of dividends for individuals enhances their after-tax returns and thereby reduces their pre-tax required returns. This reduction in pre-tax required returns (due to the lower tax on dividends) effectively reduces the cost of equity capital for companies. The 2003 tax law also reduced the tax rate on long-term capital gains from 20% to 15%. The magnitude of the reduction in corporate equity cost rates is debatable, but it could be as large as 100 basis points.

III. COMPARISON GROUP SELECTION

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

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

Q. PLEASE DESCRIBE YOUR GROUP OF UTILITY COMPANIES.

A. I am using Mr. Camfield's two groups of eight electric utility and nine natural

gas distribution companies.[3] Summary financial statistics for the groups are provided in Exhibit No.__(JRW-3). For the electric utility proxy group, the average revenues and net plant are $2,190.6M and $2,626.9M, respectively. The group has an average common equity ratio and current earned return on common equity of 48%, and of 9.0%, respectively. The gas distribution proxy group has average revenues and net plant of $2,214.0M and $1,989.0M, respectively. This group has an average common equity ratio and current earned return on common equity of 52%, and of 13.6%, respectively. FPU, with revenues and net plant of $134.5M and 137.0M, is much smaller than the average of the electric and gas companies in the two groups. In addition, FPU's common equity ratio (45%) and return on common equity (6.8%) is below the averages for the two groups. Nonetheless, FPU's Moody's bond Rating of Aaa is above the average bond ratings for the electric (A2) and gas (Baa1) proxy group.

On page 2 of Exhibit No.__(JRW-3), I have assessed the riskiness of FPU relative to the average of the two proxy groups using six different risk measures published by *Value Line*. These measures include Beta, Safety, Financial Strength, Stock Price Stability, Price Growth Persistence, and Earnings Predictability. Compared to the electric utility group, FPU's lower Beta and higher Price Growth Persistence suggests that it is lower in risk, but FPU's slightly lower Safety, Financial Strength, Stock Price Stability, and Earnings Predictability ratings indicate that FPU is riskier than the group. Compared to the gas proxy group, FPU's Beta is the only risk rating which

[3] Cascade Natural Gas Company has been acquired and no longer trades.

indicates FPU is less risky than the group. However, FPU's risk ratings which suggest that FPU is riskier than the gas proxy group (Safety, Financial Strength, Stock Price Stability, Price Growth Persistence, and Earnings Predictability) are quite close to the average rating of the group. Overall, these results suggest that FPU is comparable in risk to the electric utility proxy group, and a little riskier than the gas distribution proxy group.

IV. CAPITAL STRUCTURE RATIOS AND DEBT COST RATES

Q. PLEASE DISCUSS THE RECOMMENDED AND ACTUAL CAPITAL STRUCTURE OF THE COMPANY.

A. The Company's recommended conventional capital structure ratios are provided in Panel A of Exhibit No.__(JRW-4). These ratios represent a 2008 13-month average capitalization and include a projected common stock offering in 2008. The average common equity ratio of the conventional capital structure is 50.41%. In Panel B of Exhibit No.__(JRW-4) I show the average capital structure ratios for the companies in the electric utility proxy group. The average common equity ratio is 48.04%. As such, FPU's recommended conventional capital structure, with the pro forma equity offering, includes slightly less financial risk than the average of the electric utility proxy group. Nonetheless, I believe that it falls within a zone of reasonableness relative to the electric utility proxy group and, therefore, I will use FPU's recommended conventional capital structure. Likewise, I will also

use FPU's capital inputs for regulatory capital structure, which includes customer deposits, deferred taxes, and investment tax credits.

Q. ARE YOU ALSO USING FPU'S RECOMMENDED SENIOR CAPITAL COST RATES?

A. Yes, with the exception of the Company's short-term debt cost rate. As shown in Exhibit DC-RC-4 and discussed on page 33 of the Cox-Camfield testimony, the Company's projected short-term debt cost rate of 6.81% is based on a Federal Funds rate of 5.25%. Since the testimony was prepared, the Federal Reserve Board has reduced the Federal Funds rate. On December 11, the Federal Funds Target Rate was reduced to 4.25%. Using this rate, and including FPU's adjustments, I will use a short-term debt cost rate of 5.81%.

Q. PLEASE SUMMARIZE YOUR RECOMMENDED CAPITAL STRUCTURE AND SENIOR CAPITAL COST RATES.

A. My recommended capital structure and senior capital cost rates are summarized below. I have used the Company's long-term debt cost and preferred stock cost rates of ~~6.05~~ 7.96% and ~~4.81~~ 4.75%, respectively. My proposed capitalization and debt cost rates are listed below:

FPU	Capitalization Amounts	Cost Rate
Short-Term Debt	5.62%	5.81%
Long-Term Debt	43.45%	7.96%
Preferred Stock	0.52%	4.75%
Common Equity	50.41%	
Total Capital		

V. THE COST OF COMMON EQUITY CAPITAL

A. Overview

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

A. In a competitive industry, the return on a firm's common equity capital is determined through the competitive market for its goods and services. Due to the capital requirements needed to provide utility services, however, and to the economic benefit to society from avoiding duplication of these services, some public utilities are monopolies. It is not appropriate to permit monopoly utilities to set their own prices because of the lack of competition and the essential nature of the services. Thus, regulation seeks to establish prices which are fair to consumers and at the same time are sufficient to meet the operating and capital costs of the utility, i.e., provide an adequate return on capital to attract investors.

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

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

Normative economic models of the firm, developed under very restrictive assumptions, provide insight into the relationship between firm performance or profitability, capital costs, and the value of the firm. Under the economist's ideal model of perfect competition where entry and exit is costless, products are undifferentiated, and there are increasing marginal costs of production, firms produce up to the point where price equals marginal cost. Over time, a long-run equilibrium is established where price equals average cost, including the firm's capital costs. In equilibrium, total revenues equal total costs, and because capital costs represent investors' required return on the firm's capital, actual returns equal required returns and the market value and the book value of the firm's securities must be equal.

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

James M. McTaggart, founder of the international management consulting firm Marakon Associates, has described this essential relationship

between the return on equity, the cost of equity, and the market-to-book ratio in the following manner:[4]

> Fundamentally, the value of a company is determined by the cash flow it generates over time for its owners, and the minimum acceptable rate of return required by capital investors. This "cost of equity capital" is used to discount the expected equity cash flow, converting it to a present value. The cash flow is, in turn, produced by the interaction of a company's return on equity and the annual rate of equity growth. High return on equity (ROE) companies in low-growth markets, such as Kellogg, are prodigious generators of cash flow, while low ROE companies in high-growth markets, such as Texas Instruments, barely generate enough cash flow to finance growth.
>
> A company's ROE over time, relative to its cost of equity, also determines whether it is worth more or less than its book value. If its ROE is consistently greater than the cost of equity capital (the investor's minimum acceptable return), the business is economically profitable and its market value will exceed book value. If, however, the business earns an ROE consistently less than its cost of equity, it is economically unprofitable and its market value will be less than book value.

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

[4] James M. McTaggart, "The Ultimate Poison Pill: Closing the Value Gap," *Commentary* (Spring 1988), p. 2.

Q. PLEASE PROVIDE ADDITIONAL INSIGHTS INTO THE RELATIONSHIP BETWEEN RETURN ON EQUITY AND MARKET-TO-BOOK RATIOS?

A. This relationship is discussed in a classic Harvard Business School case study entitled "A Note on Value Drivers." On page 2 of that case study, the author describes the relationship very succinctly:[5]

> For a given industry, more profitable firms – those able to generate higher returns per dollar of equity – should have higher market-to-book ratios. Conversely, firms which are unable to generate returns in excess of their cost of equity should sell for less than book value.

Profitability	*Value*
If ROE > K	*then Market/Book > 1*
If ROE = K	*then Market/Book =1*
If ROE < K	*then Market/Book < 1*

To assess the relationship by industry, as suggested above, I have performed a regression study between estimated return on equity and market-to-book ratios using natural gas distribution, electric utility and water utility companies. I used all companies in these three industries which are covered by *Value Line* and who have estimated return on equity and market-to-book ratio data. The results are presented in Panels A, B, and C of Exhibit No.__(JRW-5).

The average R-squares for the electric, gas, and water companies are 0.70, 0.64, and 0.93. This demonstrates the strong positive relationship between ROEs and market-to-book ratios for public utilities.[6]

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

Q. WHAT ECONOMIC FACTORS HAVE AFFECTED THE COST OF EQUITY CAPITAL FOR PUBLIC UTILITIES?

A. Exhibit No.__(JRW-6) provides indicators of public utility equity cost rates over the past decade. Page 1 shows the yields on 10-year, 'A' rated public utility bonds. These yields peaked in the 1990s at 8.5%, then declined and again hit the 8.0 percent range in the year 2000. They subsequently declined, hovering in the 4.5 to 5.0 percent range between 2003 and 2005. They increased to 6.0% in June of 2006, and have since retreated to the 5.50 percent range. Page 2 provides the dividend yields for the fifteen utilities in the Dow Jones Utilities Average over the past decade. These yields peaked in 1994 at 7.2%. Since that time they have declined and were at 3.5% as of 2006.

Average earned returns on common equity and market-to-book ratios are given on page 3 of Exhibit No.__(JRW-6). Over the past decade, earned returns on common equity have consistently been in the 10.0-13.0 percent range. The high point was 13.45% in 2001, and they subsequently decreased before recovering in 2005 and 2006. As of 2006, the average was 13.1%. Over the past decade, market-to-book ratios for this group have increased gradually, but with several ups and downs. The market-to-book average was 1.75 as of 2001, declined to 1.45 in 2003, and increased to 2.10 as of 2006.

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

The indicators in Exhibit No.__(JRW-6), coupled with the overall decrease in interest rates, suggest that capital costs for the Dow Jones Utilities have decreased over the past decade.

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

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

Q. HOW DOES THE INVESTMENT RISK OF ELECTRIC UTILITY COMPANIES COMPARE WITH THAT OF OTHER INDUSTRIES?

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

Nonetheless, the overall investment risk of public utilities is below most other industries.

Exhibit No.__(JRW-7) provides an assessment of investment risk for 100 industries as measured by beta, which according to modern capital market theory is the only relevant measure of investment risk that need be of concern for investors. These betas come from the *Value Line Investment Survey* and are compiled by Aswath Damodoran of New York University.[7] The study shows that the investment risk of public utilities is relatively low. The average beta for electric utility companies (Electric Utility – West, Central, East) of 0.93 is below the Value Line average of 1.14. As such, the cost of equity for the electric utility industry is below the average of all industries in the U.S.

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

A. The costs of debt and preferred stock are normally based on historical or book values and can be determined with a great degree of accuracy. The cost of common equity capital, however, cannot be determined precisely and must instead be estimated from market data and informed judgment. This return to the stockholder should be commensurate with returns on investments in other enterprises having comparable risks.

[7] They may be found on the Internet at http:// www.stern.nyu.edu/~adamodar.

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

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

Q. HOW DO YOU PLAN TO ESTIMATE THE COST OF EQUITY CAPITAL FOR THE COMPANY?

A. I rely primarily on the DCF model to estimate the cost of equity capital. Given the investment valuation process and the relative stability of the utility business, I believe that the DCF model provides the best measure of equity cost rates for public utilities. I have also performed a CAPM study, but I give these results less weight because I believe that risk premium studies, of which

the CAPM is one form, provide a less reliable indication of equity cost rates for public utilities. This is discussed at length later in this testimony.

B. Discounted Cash Flow Analysis

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

A. According to the discounted cash flow model, the current stock price is equal to the discounted value of all future dividends that investors expect to receive from investment in the firm. As such, stockholders' returns ultimately result from current as well as future dividends. As owners of a corporation, common stockholders are entitled to a pro-rata share of the firm's earnings. The DCF model presumes that earnings that are not paid out in the form of dividends are reinvested in the firm so as to provide for future growth in earnings and dividends. The rate at which investors discount future dividends, which reflects the timing and riskiness of the expected cash flows, is interpreted as the market's expected or required return on the common stock. Therefore this discount rate represents the cost of common equity. Algebraically, the DCF model can be expressed as:

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

where P is the current stock price, D_n is the dividend in year n, and k is the cost of common equity.

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

A. Yes. Virtually all investment firms use some form of the DCF model as a valuation technique. One common application for investment firms is called the three-stage DCF or dividend discount model ("DDM"). The stages in a three-stage DCF model are presented in Exhibit No.__(JRW-8) and discussed below. This model presumes that a company's dividend payout progresses initially through a growth stage, then proceeds through a transition stage, and finally assumes a steady-state stage. The dividend-payment stage of a firm depends on the profitability of its internal investments, which, in turn, is largely a function of the life cycle of the product or service. These stages are depicted in the graphic in JRW-8 labeled the Three-Stage DCF Model.[8]

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

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

[8] This description comes from William F. Sharpe, Gordon J. Alexander, and Jeffrey V. Bailey, *Investments* (Prentice-Hall, 1995), pp. 590-91.

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

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

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

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

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

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

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

The economics of the public utility business indicate that the industry is in the steady-state or constant-growth stage of a three-stage DCF. The economics include the relative stability of the utility business, the maturity of the demand for public utility services, and the regulated status of public utilities (especially the fact that their returns on investment are effectively set through the ratemaking process). The DCF valuation procedure for companies in this stage is the constant-growth DCF. In the constant-growth version of the DCF model, the current dividend payment and stock price are directly observable. Therefore, the primary problem and controversy in applying the DCF model to estimate equity cost rates entails estimating investors' expected dividend growth rate.

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

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

current economic developments and other information available to investors, to accurately estimate investors' expectations.

Q. PLEASE DISCUSS EXHBIIT NO.__(JRW-9).

A. My DCF analysis is provided in Exhibit No.__(JRW-9). The DCF summary is on page 1 of this Exhibit and the supporting data and analysis for the dividend yield and expected growth rate are provided on the following pages.

Q. WHAT DIVIDEND YIELDS ARE YOU EMPLOYING IN YOUR DCF ANALYSIS FOR YOUR PROXY GROUP OF ELECTRIC UTILITY COMPANIES?

A. The dividend yields on the common stock for the companies in the electric utility proxy group are provided on page 2 of Exhibit No.__(JRW-9) for the six-month period ending December, 2007. Over this period, the average monthly dividend yields for the group of electric utility companies was 4.3%. As of December, 2007, the mean dividend yield for the group was also 4.3%. For the DCF dividend yields for the group, I use the average of the six month and December, 2007 dividend yields, or 4.3%.

Q. WHAT DIVIDEND YIELDS ARE YOU EMPLOYING IN YOUR DCF ANALYSIS FOR YOUR PROXY OF GAS DISTRIBUTION COMPANIES?

A. The dividend yields on the common stock for the companies in the gas proxy group are also provided on page 2 of Exhibit No.__(JRW-9) for the six-month

period ending December, 2007. The average monthly dividend yields for the gas group over this six-month period and December, 2007, was 3.4%. Therefore, I employ a DCF dividend yield of 3.4% for the gas proxy group.

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

A. According to the traditional DCF model, the dividend yield term relates to the dividend yield over the coming period. As indicated by Professor Myron Gordon, who is commonly associated with the development of the DCF model for popular use, this is obtained by: (1) multiplying the expected dividend over the coming quarter by 4, and (2) dividing this dividend by the current stock price to determine the appropriate dividend yield for a firm, which pays dividends on a quarterly basis.[9]

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

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

The appropriate adjustment to the dividend yield is further complicated in the regulatory process when the overall cost of capital is applied to a projected rate base. The net effect of this application is an overstatement of the equity cost rate estimate derived from the DCF model. In the context of the constant-growth DCF model, both the adjusted dividend yield and the growth component are overstated. The overstatement results from applying an equity cost rate computed using current market data to a future or test-year-end rate base which includes growth associated with the retention of earnings during the year. In other words, an equity cost rate times a future, yet to be achieved rate base, results in an inflated dividend yield and growth rate.

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

A. I will adjust the dividend yield by one-half (1/2) the expected growth so as to reflect growth over the coming year.

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

A. There is much debate as to the proper methodology to employ in estimating the growth component of the DCF model. By definition, this component is investors' expectation of the long-term dividend growth rate. Presumably, investors use some combination of historical and/or projected growth rates for

earnings and dividends per share and for internal or book value growth to assess long-term potential.

Q. WHAT GROWTH DATA HAVE YOU REVIEWED FOR THE GROUPS OF ELECTRIC UTILITY AND GAS DISTRIBUTION COMPANIES?

A. I have analyzed a number of measures of growth for the electric utility and gas distribution companies. I have reviewed *Value Line's* historical and projected growth rate estimates for earnings per share (EPS), dividends per share (DPS), and book value per share (BVPS). In addition, I have utilized the average EPS growth rate forecasts of Wall Street analysts as provided by Zacks, Reuters, and First Call. These services solicit five-year earnings growth rate projections from securities analysts and compile and publish the averages of these forecasts on the Internet. Finally, I have also assessed prospective growth as measured by prospective earnings retention rates and earned returns on common equity.

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

A. Historical growth rates for EPS, DPS, and BVPS are readily available to virtually all investors and presumably an important ingredient in forming expectations concerning future growth. However, one must use historical growth numbers as measures of investors' expectations with caution. In some cases, past growth may not reflect future growth potential. Also, employing a

single growth rate number (for example, for five or ten years), is unlikely to accurately measure investors' expectations due to the sensitivity of a single growth rate figure to fluctuations in individual firm performance as well as overall economic fluctuations (i.e., business cycles). However, one must appraise the context in which the growth rate is being employed. According to the conventional DCF model, the expected return on a security is equal to the sum of the dividend yield and the expected long-term growth in dividends. Therefore, to best estimate the cost of common equity capital using the conventional DCF model, one must look to long-term growth rate expectations.

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

Q. PLEASE DISCUSS THE HISTORICAL GROWTH OF THE COMPANIES IN THE ELECTRIC UTILITY GROUP AS PROVIDED IN THE *VALUE LINE INVESTMENT SURVEY.*

A. Historic growth rates for the companies in the electric utility group, as published in the *Value Line Investment Survey*, are provided on page 3 of Exhibit No.__(JRW-9). Due to the presence of outliers among the historic growth rate figures, both the mean and medians are used in the analysis. The historical growth measures in EPS, DPS, and BVPS for the group, as measured by the means and medians, range from 1.0% to 5.0%, with an average of 2.6%.

Q. PLEASE SUMMARIZE *VALUE LINE'S* PROJECTED GROWTH RATES FOR THE GROUP OF ELECTRIC UTILITY COMPANIES.

A. *Value Line's* projections of EPS, DPS, and BVPS growth for the group are shown on page 4 of Exhibit No.__(JRW-9). As above, due to the presence of outliers, both the mean and medians are used in the analysis. For the group, the central tendency measures range from 0.5% to 4.5%, with an average of 2.9%.

Also provided on page 4 of Exhibit No.__(JRW-9) is prospective internal growth for the group as measured by *Value Line*'s average projected retention rate and return on shareholders' equity. The average prospective internal growth rate for the group is 3.5%.

Q. PLEASE ASSESS GROWTH FOR THE ELECTRIC UTILITY PROXY GROUP AS MEASURED BY ANALYSTS' FORECASTS OF EXPECTED 5-YEAR GROWTH IN EPS.

A. Zacks, First Call, and Reuters collect, summarize, and publish Wall Street analysts' five-year EPS growth rate forecasts for companies. These forecasts are provided for the companies in the group of electric utility companies on page 5 of Exhibit No.__(JRW-9). The mean of the analysts' projected EPS growth rates for the group is 4.9%.[10]

Q. PLEASE SUMMARIZE YOUR ANALYSIS OF THE HISTORICAL AND PROSPECTIVE GROWTH OF THE ELECTRIC UTILITY PROXY GROUP.

A. The summary DCF growth rate indicators for the group of electric utility companies are presented on page 6 of Exhibit No.__(JRW-9). For the group, the average of *Value Line*'s historical mean and median growth rate measures in EPS, DPS, and BVPS is 2.6%. *Value Line*'s average projected growth rate for EPS, DPS, and BVPS is 2.9%. The average internal growth rate is 3.5%, and the mean projected EPS growth rate for companies in the group is 4.9%. Given greater weight to the projected growth rate figures of Wall Street analysts, an expected growth rate in the 4.75 percent range is reasonable for the group.

[10] Since there is considerable overlap in analyst coverage between the three services, and not all of the companies have forecasts from the different services, I have averaged the expected five-year EPS growth rates from the three services for each company to arrive at an expected EPS growth rate by company.

Q. PLEASE DISCUSS YOUR ANALYSIS OF THE HISTORICAL AND PROSPECTIVE GROWTH OF THE GAS DISTRIBUTION PROXY GROUP.

A. Page 6 of Exhibit No.__(JRW-9) shows the summary DCF growth rate indicators for the proxy group of gas distribution companies. The average of *Value Line*'s historical growth rate measures in EPS, DPS, and BVPS is 5.4%. *Value Line*'s average projected growth rate for EPS, DPS, and BVPS is 4.4%. The average internal growth rate is 5.2%, and the mean projected EPS growth rate for companies in the gas distribution group is 5.4%. Given greater weight to the projected growth rate figures of Wall Street analysts, an expected growth rate in the 5.25% range is reasonable for the group.

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

A. My DCF-derived equity cost rate for the group is:

$$\text{DCF Equity Cost Rate (k)} = \frac{D}{P} + g$$

	Dividend Yield	½ Growth Adjustment	DCF Growth Rate	Equity Cost Rate
Electric Group	4.3%	1.02375	4.75%	9.15%
Gas Group	3.4%	1.02625	5.25%	8.74%

These results are summarized on page 1 of Exhibit No.__(JRW-9).

C. Capital Asset Pricing Model Results

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

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

$$k = R_f + RP$$

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

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

$$K = (R_f) + \beta_i * [E(R_m) - (R_f)]$$

Where:

- K represents the estimated rate of return on the stock;
- $E(R_m)$ represents the expected return on the overall stock market. Frequently, the 'market' refers to the S&P 500;
- (R_f) represents the risk-free rate of interest;
- $[E(R_m) - (R_f)]$ represents the expected equity or market risk premium—the excess return that an investor expects to receive above the risk-free rate for investing in risky stocks; and
- *Beta*—$(ß_i)$ is a measure of the systematic risk of an asset.

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

Q. PLEASE DISCUSS EXHIBIT NO.__(JRW-10).

A. Exhibit No.__(JRW-10) provides the summary results for my CAPM study. Page 1 shows the results, and the pages following it contain the supporting data.

Q. PLEASE DISCUSS THE RISK-FREE INTEREST RATE.

A. The yield on long-term Treasury bonds has usually been viewed as the risk-free rate of interest in the CAPM. The yield on long-term Treasury bonds, in turn, has been considered to be the yield on Treasury bonds with 30-year maturities. However, when the Treasury's issuance of 30-year bonds was interrupted for a period of time in recent years, the yield on 10-year Treasury bonds replaced the yield on 30-year Treasury bonds as the benchmark long-term Treasury rate. The 10-year Treasury yields over the past five years are shown on page 2 of Exhibit No.__(JRW-10). These rates hit a 60-year low in the summer of 2003 at 3.33%. They increased with the rebounding economy and fluctuated in the 4.0-4.50 percent range over the past three years until advancing to 5.0% in early 2006 in response to a strong economy and increases in energy, commodity, and consumer prices. In late 2006, long-term interest rates retreated to the 4.5 percent area as commodity and energy prices declined and inflationary pressures have subsided. These rates rebounded to the 5.0% level as the economy has remained strong in 2007. However, the mid-summer housing and sub-prime mortgage issues have caused these rates to once again fall below 5.0 percent.

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

A. The U.S. Treasury began to issue the 30-year bond in the early 2000s as the U.S. budget deficit increased. As such, the market has once again focused on its yield as the benchmark for long-term capital costs in the U.S. As noted

above, the yields on the 10- and 30- year Treasuries have increased and have decreased to below 5.0% in response to the sub-prime mortgage and housing concerns. As of December 18, 2007, as shown page 2 of Exhibit No.__(JRW-10), the rates on 10- and 30- Treasury Bonds were 4.14% and 4.56%, respectively. Given this recent range and recent movement, I will use 4.75% as the risk-free rate, or R_f, in my CAPM.

Q. WHAT BETAS ARE YOU EMPLOYING IN YOUR CAPM?

A. Beta (ß) is a measure of the systematic risk of a stock. The market, usually taken to be the S&P 500, has a beta of 1.0. The beta of a stock with the same price movement as the market also has a beta of 1.0. A stock whose price movement is greater than that of the market, such as a technology stock, is riskier than the market and has a beta greater than 1.0. A stock with below average price movement, such as that of a regulated public utility, is less risky than the market and has a beta less than 1.0. Estimating a stock's beta involves running a linear regression of a stock's return on the market return as shown on page 3 of Exhibit No.__(JRW-10).

The slope of the regression line is the stock's ß. A steeper line indicates the stock is more sensitive to the return on the overall market. This means that the stock has a higher ß and greater than average market risk. A less steep line indicates a lower ß and less market risk.

Numerous online investment information services, such as Yahoo and Reuters, provide estimates of stock betas. Usually these services report

different betas for the same stock. The differences are usually due to (1) the time period over which the ß is measured and (2) any adjustments that are made to reflect the fact that betas tend to regress to 1.0 over time. In estimating an equity cost rate for the group of electric utility companies, I am using the betas for the companies as provided in the *Value Line Investment Survey*. As shown on page 4 of Exhibit No.__(JRW-10), the average beta for the electric utility and gas distribution proxy groups are 0.81 and 0.86.

Q. PLEASE DISCUSS THE OPPOSING VIEWS REGARDING THE EQUITY RISK PREMIUM.

A. The equity or market risk premium—$[E(R_m) - R_f]$: is equal to the expected return on the stock market (e.g., the expected return on the S&P 500 ($E(R_m)$) minus the risk-free rate of interest (R_f). The equity premium is the difference in the expected total return between investing in equities and investing in "safe" fixed-income assets, such as long-term government bonds. However, while the equity risk premium is easy to define conceptually, it is difficult to measure because it requires an estimate of the expected return on the market.

Q. PLEASE DISCUSS THE ALTERNATIVE APPROACHES TO ESTIMATING THE EQUITY RISK PREMIUM.

A. Page 5 of Exhibit No.__(JRW-10) highlights the primary approaches to, and issues in, estimating the expected equity risk premium. The traditional way to measure the equity risk premium was to use the difference between historical average stock and bond returns. In this case, historical stock and bond returns,

also called ex post returns, were used as the measures of the market's expected return (known as the ex ante or forward-looking expected return). This type of historical evaluation of stock and bond returns is often called the "Ibbotson approach" after Professor Roger Ibbotson who popularized this method of using historical financial market returns as measures of expected returns. Most historical assessments of the equity risk premium suggest an equity risk premium of 5-7 percent above the rate on long-term Treasury bonds. However, this can be a problem because (1) ex post returns are not the same as ex ante expectations, (2) market risk premiums can change over time, increasing when investors become more risk-averse, and decreasing when investors become less risk-averse, and (3) market conditions can change such that ex post historical returns are poor estimates of ex ante expectations.

The use of historical returns as market expectations has been criticized in numerous academic studies.[11] The general theme of these studies is that the large equity risk premium discovered in historical stock and bond returns cannot be justified by the fundamental data. These studies, which fall under the category "Ex Ante Models and Market Data," compute ex ante expected returns using market data to arrive at an expected equity risk premium. These studies have also been called "Puzzle Research" after the famous study by

[11] The problems with using ex post historical returns as measures of ex ante expectations will be discussed at length later in my testimony.

Mehra and Prescott in which the authors first questioned the magnitude of historical equity risk premiums relative to fundamentals.[12]

Q. PLEASE BRIEFLY SUMMARIZE SOME OF THE ACADEMIC STUDIES THAT DEVELOP EX ANTE EQUITY RISK PREMIUMS.

A. Two of the most prominent studies of ex ante expected equity risk premiums were by Eugene Fama and Ken French (2002) and James Claus and Jacob Thomas (2001). The primary debate in these studies revolves around two related issues: (1) the size of expected equity risk premium, which is the return equity investors require above the yield on bonds; and (2) the fact that estimates of the ex ante expected equity risk premium using fundamental firm data (earnings and dividends) are much lower than estimates using historical stock and bond return data. Fama and French (2002), two of the most preeminent scholars in finance, use dividend and earnings growth models to estimate expected stock returns and ex ante expected equity risk premiums.[13] They compare these results to actual stock returns over the period 1951-2000. Fama and French estimate that the expected equity risk premium from DCF models using dividend and earnings growth to be between 2.55% and 4.32%. These figures are much lower than the ex post historical equity risk premium produced from the average stock and bond return over the same period, which was 7.40%.

---

[12] Rahnish Mehra and Edward Prescott, "The Equity Premium: A Puzzle," *Journal of Monetary Economics* (1985).

[13] Eugene F. Fama and Kenneth R. French, "The Equity Premium," *The Journal of Finance*, (April 2002).

Fama and French conclude that the ex ante equity risk premium estimates using DCF models and fundamental data are superior to those using ex post historical stock returns for three reasons: (1) the estimates are more precise (a lower standard error); (2) the Sharpe ratio, which is measured as the [(expected stock return – risk-free rate)/standard deviation], is constant over time for the DCF models but varies considerably over time and more than doubles for the average stock-bond return model; and (3) valuation theory specifies relationships between the market-to-book ratio, return on investment, and cost of equity capital that favor estimates from fundamentals. They also conclude that the high average stock returns over the past 50 years were the result of low expected returns and that the average equity risk premium has been in the 3-4 percent range.

The study by Claus and Thomas of Columbia University provides direct support for the findings of Fama and French.[14] These authors compute ex ante expected equity risk premiums over the 1985-1998 period by (1) computing the discount rate that equates market values with the present value of expected future cash flows, and (2) then subtracting the risk-free interest rate. The expected cash flows are developed using analysts' earnings forecasts. The authors conclude that over this period the ex ante expected equity risk premium is in the range of 3.0%. Claus and Thomas note that, over this period, ex post historical stock returns overstate the ex ante expected

[14] James Claus and Jacob Thomas, "Equity Risk Premia as Low as Three Percent? Empirical Evidence from Analysts' Earnings Forecasts for Domestic and International Stock Market," *Journal of Finance*. (October 2001).

equity risk premium because, as the expected equity risk premium has declined, stock prices have risen. In other words, from a valuation perspective, the present value of expected future returns increase when the required rate of return decreases. The higher stock prices have produced stock returns that have exceeded investors' expectations and therefore ex post historical equity risk premium estimates are biased upwards as measures of ex ante expected equity risk premiums.

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

A. Derrig and Orr (2003) and Fernandez (2007) have completed the most comprehensive reviews to date of the research on the equity risk premium.[15] Derrig and Orr's study evaluated the various approaches to estimating equity risk premiums as well as the issues with the alternative approaches, and summarized the findings of the published research on the equity risk premium. Fernandez examined four alternative measures of the equity risk premium – historical, expected, required, and implied. He also reviewed the major studies of the equity risk premium and presented the summary equity risk premium results. Page 6 of Exhibit No.__(JRW-10) provides a summary of the results of the primary risk premium studies reviewed by Derrig and Orr and Fernandez. In developing Page 6 of Exhibit No.__(JRW-10), I have

[15] Richard Derrig and Elisha Orr, "Equity Risk Premium: Expectations Great and Small," Working Paper (version 3.0), Automobile Insurers Bureau of Massachusetts, August 28, 2003, and Pablo Fernandez, "Equity Premium: Historical, Expected, Required, and Implied," IESE Business School Working Paper, 2007.

categorized the studies as discussed on page 6 of Exhibit No.__(JRW-10). I have also included the results of the "Building Blocks" approach to estimating the equity risk premium, including a study I performed which is presented below. The Building Blocks approach is a hybrid approach employing elements of both historic and ex ante models.

Q. PLEASE DISCUSS YOUR DEVELOPMENT OF AN EQUITY RISK PREMIUM COMPUTED USING THE BUILDING BLOCKS METHODOLOGY.

A. Ibbotson and Chen (2003) evaluate the ex post historical mean stock and bond returns in what is called the Building Blocks approach.[16] They use 75 years of data and relate the compounded historical returns to the different fundamental variables employed by different researchers in building ex ante expected equity risk premiums. Among the variables included were inflation, real EPS and DPS growth, ROE and book value growth, and P/E ratios. By relating the fundamental factors to the ex post historical returns, the methodology bridges the gap between the ex post and ex ante equity risk premiums. Ilmanen (2003) illustrates this approach using the geometric returns and five fundamental variables – inflation (CPI), dividend yield (D/P), real earnings growth (RG), repricing gains (PEGAIN) and return interaction/reinvestment (INT).[17] This is shown on page 7 of Exhibit No.__(JRW-10). The first

[16] Roger Ibbotson and Peng Chen, "Long Run Returns: Participating in the Real Economy," *Financial Analysts Journal*, January 2003.

[17] Antti Ilmanen, Expected Returns on Stocks and Bonds," *Journal of Portfolio Management*, (Winter 2003), p. 11.

column breaks the 1926-2000 geometric mean stock return of 10.7% into the different return components demanded by investors: the historical Treasury bond return (5.2%), the excess equity return (5.2%), and a small interaction term (0.3%). This 10.7% annual stock return over the 1926-2000 period can then be broken down into the following fundamental elements: inflation (3.1%), dividend yield (4.3%), real earnings growth (1.8%), repricing gains (1.3%) associated with higher P/E ratios, and a small interaction term (0.2%).

Q. HOW ARE YOU USING THIS METHODOLOGY TO DERIVE AN EX ANTE EXPECTED EQUITY RISK PREMIUM?

A. The third column in the graph above shows current inputs to estimate an ex ante expected market return. These inputs include the following:

CPI – To assess expected inflation, I have employed expectations of the short-term and long-term inflation rate. As shown on page 8 of Exhibit No.__(JRW-10), the expected annual inflation rate according to consumers, as measured by the CPI, over the coming year. This survey is published monthly by the University of Michigan Survey Research Center. In the most recent report, the expected one-year inflation rate was 3.4%.

Longer term inflation forecasts are available in the Federal Reserve Bank of Philadelphia's publication entitled *Survey of Professional*

Forecasters.[18] This survey of professional economists has been published for almost 50 years. While this survey is published quarterly, only the first quarter survey includes long-term forecasts of GDP growth, inflation, and market returns. In the first quarter, 2007 survey, published on February 13, 2007, the median long-term (10-year) expected inflation rate as measured by the CPI was 2.35% (see page 9 of Exhibit No.__(JRW-10).

Given these results, I will use the average of the University of Michigan and Philadelphia Federal Reserve's surveys (3.4% and 2.35%), or 2.9%.

D/P – As shown on page 10 of Exhibit No.__(JRW-10), the dividend yield on the S&P 500 has decreased significantly over the past two decades. It bottomed out at 1.1% in 1999, and has since increased to the 1.5-1.9 percent range. Today, it is far below its average of 4.3% over the 1926-2000 time period. It is currently at 1.9% which I use in the ex ante risk premium analysis.

RG – To measure expected real growth in earnings, I use (1) the historical real earnings growth rate for the S&P 500, and (2) expected real GDP growth. The S&P 500 was created in 1960. It includes 500 companies which come from ten different sectors of the economy. Over the 1960-2006 period,

[18]Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters,* February 13, 2007. The *Survey of Professional Forecasters* was formerly conducted by the American Statistical Association (ASA) and the National Bureau of Economic Research (NBER) and was known as the ASA/NBER survey. The survey, which began in 1968, is conducted each quarter. The Federal Reserve Bank of Philadelphia, in cooperation with the NBER, assumed responsibility for the survey in June 1990.

nominal growth in EPS for the S&P 500 was 7.38%. On page 11 of Exhibit No.__(JRW-10), real EPS growth is computed using the CPI as a measure of inflation. As indicated by Ibbotson and Chen, real earnings growth over the 1926-2000 period was 1.8%. The real growth figure over 1960-2006 period for the S&P 500 is 3.0 %.

The second input for expected real earnings growth is expected real GDP growth. The rationale is that over the long-term, corporate profits have averaged a relatively consistent 5.50% of US GDP.[19] Real GDP growth, according to McKinsey, has averaged 3.5% over the past 80 years. Expected GDP growth, according to the Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters,* is 3.0% (see page 9 of Exhibit No.__(JRW-10).

Given these results, I will use the average of the historical S&P EPS real growth and the projected real GDP growth (as reported by the Philadelphia Federal Reserve Survey) -- 3.0% and 3.0% -- or 3.0%, for real earnings growth.

PEGAIN – PEGAIN is the repricing gain associated with an increase in the P/E ratio. It accounted for 1.3% of the 10.7% annual stock return in the 1926-2000 period. In estimating an ex ante expected stock market return, one issue is whether investors expect P/E ratios to increase from their current levels. The graph on page 12 of Exhibit No.__(JRW-10) shows the P/E ratio

[19]Marc. H. Goedhart, et al, "The Real Cost of Equity," *McKinsey on Finance* (Autumn 2002), p.14.

for the S&P 500 since 1962. The P/E ratios for the S&P 500 peaked in 1999 at over 30 and have since declined. As of December, 2007 the P/E for the S&P 500, is 18.9 according to www.standardandpoors.com.

Given the current economic and capital markets environment, I do not believe that investors expect even higher P/E ratios. Therefore, a PEGAIN would not be appropriate in estimating an ex ante expected stock market return. There are two primary reasons for this. First, the average historical S&P 500 P/E ratio is 15 – thus the current P/E exceeds this figure. Second, as previously noted, interest rates are at a cyclical low not seen in almost 50 years. This is a primary reason for the high current P/Es. Given the current market environment with relatively high P/E ratios and low relative interest rates, investors are not likely to expect to get stock market gains from lower interest rates and higher P/E ratios.

Q. GIVEN THIS DISCUSSION, WHAT IS YOUR EX ANTE EXPECTED MARKET RETURN AND EQUITY RISK PREMIUM USING THE "BUILDING BLOCKS METHODOLOGY"?

A. My expected market return is represented by the last column on the right in the graph entitled "Decomposing Equity Market Returns: The Building Blocks Methodology" set forth on page 7 of Exhibit No.__(JRW-10). As shown, my expected market return of 7.80% is composed of 2.9% expected inflation, 1.90% dividend yield, and 3.00% real earnings growth rate.

Q. GIVEN THAT THE HISTORICAL COMPOUNDED ANNUAL MARKET RETURN IS IN EXCESS OF 10%, WHY DO YOU BELIEVE THAT YOUR EXPECTED MARKET RETURN OF 7.80% IS REASONABLE?

A. As discussed above in the development of the expected market return, stock prices are relatively high at the present time in relation to earnings and dividends and interest rates are relatively low. Hence, it is unlikely that investors are going to experience high stock market returns due to higher P/E ratios and/or lower interest rates. In addition, as shown in the decomposition of equity market returns, whereas the dividend portion of the return was historically 4.3%, the current dividend yield is only 1.9%. Due to these reasons, lower market returns are expected for the future.

Q. IS YOUR EXPECTED MARKET RETURN OF 7.80% CONSISTENT WITH THE FORECASTS OF MARKET PROFESSIONALS?

A. Yes. In the first quarter, 2007 survey, published on February 13, 2007, the median long-term expected return on the S&P 500 was 7.50% (see page 9 of of Exhibit No.__(JRW-10). This is consistent with my expected market return of 7.80%.

Q. IS YOUR EXPECTED MARKET RETURN CONSISTENT WITH THE EXPECTED MARKET RETURNS OF CORPORATE CHIEF FINANCIAL OFFICERS (CFOS)?

A. Yes. John Graham and Campbell Harvey of Duke University conduct a quarterly survey of corporate CFOs. The survey is a joint project of Duke University and *CFO Magazine.* In the December 2007 survey, the average expected return on the S&P 500 over the next ten years is 8.34%.[20]

Q. GIVEN THIS EXPECTED MARKET RETURN, WHAT IS YOUR EX ANTE EQUITY RISK PREMIUM USING THE BUILDING BLOCKS METHODOLOGY?

A. As shown in the December 18, 2007, as shown in the U. S. Treasury Yield Chart on page 2 of Exhibit No.__(JRW-10), the current 30-year Treasury yield is 4.56%. My ex ante equity risk premium is simply the expected market return from the Building Blocks methodology minus this risk-free rate:

Ex Ante Equity Risk Premium = 7.80% - 4.56% = 3.24%

Q. GIVEN THIS DISCUSSION, HOW ARE YOU MEASURING AN EXPECTED EQUITY RISK PREMIUM IN THIS PROCEEDING?

A. As discussed above, page 6 of Exhibit No.__(JRW-10) provides a summary of the results of the equity risk premium studies that I have reviewed. These include the results of (1) the various studies of the historical risk premium, (2) ex ante equity risk premium studies, (3) equity risk premium surveys of CFOs, Financial Forecasters, as well as academics, and (4) the Building Block approaches to the equity risk premium. There are results reported for thirty

[20] The survey results are available at www.cfosurvey.org.

studies, and the average equity risk premium is 4.52%, which I will use as the equity risk premium in my CAPM study.

Q. IS YOUR EX ANTE EQUITY RISK PREMIUM CONSISTENT WITH THE EQUITY RISK PREMIUMS OF LEADING INVESTMENT FIRMS?

A. Yes. One of the first studies in this area was by Stephen Einhorn, one of Wall Street's leading investment strategists.[21] His study showed that the market or equity risk premium had declined to the 2.0 to 3.0 percent range by the early 1990s. Among the evidence he provided in support of a lower equity risk premium is the inverse relationship between real interest rates (observed interest rates minus inflation) and stock prices. He noted that the decline in the market risk premium has led to a significant change in the relationship between interest rates and stock prices. One implication of this development was that stock prices had increased higher than would be suggested by the historical relationship between valuation levels and interest rates.

The equity risk premiums of some of the other leading investment firms today support the result of the academic studies. An article in *The Economist* indicated that some other firms like J.P. Morgan are estimating an equity risk premium for an average risk stock in the 2.0 to 3.0 percent range above the interest rate on U.S. Treasury Bonds.[22]

---

[21] Steven G. Einhorn, "The Perplexing Issue of Valuation: Will the Real Value Please Stand Up?" *Financial Analysts Journal* (July-August 1990), pp. 11-16.

[22] For example, see "Welcome to Bull Country," *The Economist* (July 18, 1998), pp. 21-3, and "Choosing the

Q. IS YOUR EX ANTE EQUITY RISK PREMIUM CONSISTENT WITH THE EQUITY RISK PREMIUMS USED BY CORPORATE CHIEF FINANCIAL OFFICERS (CFOS)?

A. Yes. In the previously-referenced December, 2007 CFO survey conducted by *CFO Magazine* and Duke University, the average expected 10-year equity risk premium was 4.24%.

Q. IS YOUR EX ANTE EQUITY RISK PREMIUM CONSISTENT WITH THE EX ANTE EQUITY RISK PREMIUMS OF PROFESSIONAL FORECASTERS?

A. Yes. The financial forecasters in the previously-referenced Federal Reserve Bank of Philadelphia survey project both stock and bond returns. As shown on page 9 of Exhibit No.__JRW-10, the median long-term expected stock and bond returns were 7.50% and 5.00%, respectively. This provides an ex ante equity risk premium of 2.50%.

Q. IS YOUR EX ANTE EQUITY RISK PREMIUM CONSISTENT WITH THE EQUITY RISK PREMIUMS USED BY THE LEADING CONSULTING FIRMS?

A. Yes. McKinsey & Co. is widely recognized as the leading management consulting firm in the world. They recently published a study entitled "The Real Cost of Equity" in which they developed an ex ante equity risk premium for the US. In reference to the decline in the equity risk premium, as well as

---

Right Mixture," *The Economist* (February 27, 1999), pp. 71-2.

what is the appropriate equity risk premium to employ for corporate valuation purposes, the McKinsey authors concluded the following:

> We attribute this decline not to equities becoming less risky (the inflation-adjusted cost of equity has not changed) but to investors demanding higher returns in real terms on government bonds after the inflation shocks of the late 1970s and early 1980s. We believe that using an equity risk premium of 3.5 to 4 percent in the current environment better reflects the true long-term opportunity cost of equity capital and hence will yield more accurate valuations for companies.[23]

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

A. The results of my CAPM study for the group of electric utility companies are provided below:

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

Electric Utility Proxy Group **K = 4.75 + (0.81) * (4.52%) = 8.41%**

Gas Distribution Proxy Group **K = 4.75 + (0.86) * (4.52%) = 8.64%**

V. EQUITY COST RATE SUMMARY

Q. PLEASE SUMMARIZE YOUR EQUITY COST RATE STUDY.

A. The results for my DCF and CAPM analyses for the group of electric utility companies are indicated below:

	DCF	CAPM
Electric Group	**9.15%**	**8.41%**
Gas Group	**8.74%**	**8.64%**

[23] Marc H. Goedhart, et al, "The Real Cost of Equity," *McKinsey on Finance* (Autumn 2002), p. 15.

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

A. I conclude that the equity cost rate for the group of electric utility companies is in the 8.41-9.15 percent range. Given these results and the discussion of the riskiness of FPU relative to the electric and gas proxy groups, and focusing on the DCF results for the electric group, I will use 9.15% as my equity cost rate for FPU. This is at the top end of the range for the proxy groups, and recognizes that FPU's riskiness is at the high end of the range of the two groups.

Q. ISN'T THIS RATE OF RETURN LOW BY HISTORICAL STANDARDS?

A. Yes it is, and appropriately so. My rate of return is low by historical standards for three reasons. First, as discussed above, current capital costs are very low by historical standards, with interest rates at a cyclical low not seen since the 1960s. Second, the 2003 tax law, which reduces the tax rates on dividend income and capital gains, lowers the pre-tax return required by investors. And third, as discussed below, the equity or market risk premium has declined.

Q. FINALLY, PLEASE DISCUSS YOUR RATE OF RETURN IN LIGHT OF RECENT YIELDS ON 'A' RATED PUBLIC UTILITY BONDS.

A. In recent months the yields on long-term public utility bonds have been in the 5.50-6.00 percent range (see page 1 of Exhibit No. __(JRW-6). My rate of return may appear to be too low given these yields. However, as previously

noted, my recommendation must be viewed in the context of the significant decline in the market or equity risk premium. As a result, the return premium that equity investors require over bond yields is much lower today. This decline was previously reviewed in my discussion of capital costs in today's markets.

Q. HOW DO YOU TEST THE REASONABLENESS OF YOUR COST OF EQUITY AND OVERALL RATE OF RETURN RECOMMENDATION?

A. To test the reasonableness of my equity cost rate recommendation, I examine the relationship between the return on common equity and the market-to-book ratios for the companies in the two proxy groups of electric utility and gas distribution companies.

Q. WHAT DO THE RETURNS ON COMMON EQUITY AND MARKET-TO-BOOK RATIOS FOR THE PROXY GROUPS OF ELECTRIC UTILITY AND GAS DISTRIBUTION COMPANIES INDICATE ABOUT THE REASONABLENESS OF YOUR RECOMMENDATION?

A. Page 1 of Exhibit No.__(JRW-3) provides financial performance and market valuation statistics for the two proxy groups of electric utility and gas distribution companies. The median current return on equity and market-to-book ratios for the group are summarized below:

	Current ROE	Market-to-Book Ratio
Electric Group	**9.0%**	**1.65**
Gas Group	**13.6%**	**2.06**

These results indicate that, on average, these companies are earning returns on equity above their equity cost rates. As such, this observation provides evidence that my recommended equity cost rate is reasonable and fully consistent with the financial performance and market valuation of the group of electric utility companies.

VI. CRITIQUE OF FPU'S RATE OF RETURN TESTIMONY

Q. PLEASE SUMMARIZE FPU'S OVERALL RATE OF RETURN RECOMMENDATION.

A. FPU's rate of return of return recommendation is provided by of FPU witnesses Ms. Doreen Cox and Mr. Robert Camfield. Ms. Cox has prepared the capital structure and debt cost rate recommendations, and Mr. Camfield has made the common equity cost rate recommendation. Ms. Cox's conventional capital structure includes capital structure ratios of 43.45% long-term debt, 5.62% short-term debt, 0.52% preferred stock, and 50.41% common equity with a long-term and short-term debt cost rates of 7.96% and 6.81%, a preferred stock cost rate of 4.75%, and an equity cost rate of 11.50%. FPU's overall recommendation is summarized below:

Capital Source	Ratio	Cost Rate	Weighted Cost Rate
S-T Debt	5.62%	6.81%	0.38%
L-T Debt	43.45%	7.96%	3.46%
Preferred Stock	0.520%	4.75%	0.02%
Common Equity	50.41%	11.50%	5.80%

Total	100.00%	9.67%

Q. WHAT ARE THE ERRORS IN COMPANY'S RATE OF RETURN POSITION?

A. FPU's proposed rate of return is excessive due to an inflated short-term debt cost rate and, primarily, an overstated common equity cost rate. The short-term debt cost rate issue was discussed on page 11 of my testimony. The excessive equity cost rate recommendation is discussed below.

Q. PLEASE REVIEW MR. CAMFIELD'S EQUITY COST RATE APPROACHES.

A. Mr. Camfield estimates an equity cost rate of 11.50% for FPU by applying DCF, CAPM, RP, and RMR models to a group of eight electric utility companies and a group of ten natural gas distribution companies. He makes a flotation cost adjustment to his equity cost rate estimates. His results are summarized in Exhibit No.__(JRW-11).

Q. HOW ARE YOU ORGANIZING YOUR CRITIQUE OF MR. CAMFIELD'S EQUITY COST RATE STUDIES?

A. I will initially address the issue of issuance or flotation cost since a flotation cost adjustment is included in all of Mr. Camfield's equity cost rate results. I will then evaluate a major common error in Mr. Camfield's CAPM, RP, and

RMR approaches. This issue involves his use of historic stock and bond returns as measures of expected returns and the equity risk premium. This error is the most serious of his errors in cost of capital testimony. I will then address specific issues in his DCF, CAPM, RP, and RMR approaches.

Flotation Cost Adjustment

Q. PLEASE EVALUATE MR. CAMFIELD'S ISSUANCE OR FLOTATION COST ADJUSTMENT.

A. Mr. Camfield's equity cost rate approaches include an explicit issuance or flotation cost adjustment of 6%. In Exhibit 55.1, Mr. Camfield provided projected issuance costs which include a gross spread of 4.85% and other fees of 1.15%. Mr. Camfield has provided no justification, documentation, or source documents to support these fees (as he was requested), and therefore this adjustment should be rejected outright. Nonetheless, flotation cost adjustments are commonly requested by utilities in rate cases, but the issue remains as to what and how equity flotation costs can and should be recovered.

Q. PLEASE DISCUSS THE ISSUES OF AN EQUITY ISSUANCE OR FLOTATION COST ADJUSTMENT IN A RATE CASE PROCEEDING?

A. It is common for rate of return analysts to adjust equity cost rates upwards for issuance or flotation costs, even if a utility does not intend to issue equity in

the near future. Such flotation cost adjustments are not always necessary. The argument is usually made that a flotation cost adjustment is necessary to prevent the dilution of the existing shareholders. It is justified by reference to bonds and the manner in which issuance costs are recovered by including the amortization of bond flotation costs in annual financing costs. However, this is incorrect for several reasons:

(1) If an equity flotation cost adjustment is similar to a debt flotation cost adjustment, the fact that the market-to-book ratios for utility companies are nearly 2.0 actually suggests that there should be a flotation cost reduction (and not increase) to the equity cost rate. This happens when (a) a bond is issued at a price in excess of face or book value, and (b) the difference between market price and the book value is greater than the flotation or issuance costs, then the cost of that debt lower is than the coupon rate of the debt. The amount by which market values of electric utility companies are in excess of book values is much greater than flotation costs. Hence, if common stock flotation costs were exactly like bond flotation costs, and one was making an explicit flotation cost adjustment to the cost of common equity, the adjustment would be downward;

(2) It is argued that a flotation cost adjustment is needed to prevent dilution of existing stockholders' investment. However, the reduction of the book value of stockholder investment associated with flotation costs can occur only when a company's stock is selling at a market price at/or below its book value. As noted above, utility companies are selling at market prices well in excess of

book value. Hence, when new shares are sold, existing shareholders realize an increase in the book value per share of their investment, not a decrease;

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

(4) Flotation costs, in the form of the underwriting spread, are a form of a transaction cost in the market. They represent the difference between the price paid by investors and the amount received by the issuing company. Whereas Mr. Camfield believes that the Company should be compensated for these transactions costs, he does not account for other market transaction costs in determining a cost of equity for the Company. Most notably, brokerage fees that investors pay when they buy shares in the open market which are another market transaction cost. Brokerage fees increase the effective stock price paid by investors to buy shares. If brokerage fees or transaction costs are included

in a DCF analyses, the higher effective stock prices paid for stocks would lead to lower dividend yields and equity cost rates. To be fair then, if one is making an upward adjustment for transaction costs in the form of flotation costs, they also should have made a downward adjustment for transaction costs in the form of brokerage fees.

Q. GIVEN THIS DISCUSSION, WHAT IS YOUR OPINION ON FPU'S REQUEST FOR AN ISSUANCE OR FLOTATION COST ADJUSTMENT TO ITS EQUITY COST RATE?

A. First, given the lack of documentation of the 6% issuance expenses, I believe that FPU should not receive any compensation for these costs. However, even if FPU has documented out-of-pocket expenses associated with a projected equity issuance, then it should request reimbursement of these expenses as a cost of service. But, given the discussion above, there should not be a straight equity cost rate adjustment to recover undocumented issuance costs. As discussed above, on a per share basis, the underwriting or gross spread is the difference between the price the investment banker receives from investors and the price the investment banker pays to the company. Hence, these are not out-of-pocket expenses that must be recovered through the regulatory process. Furthermore, the underwriting spread is known to the investors who are buying the new issue of stock, who are well aware of the difference between the price they are paying to buy the stock and the price that the Company is receiving. Finally, if the issuance costs are added to the estimated equity cost rate, the Company will effectively receive an annual

annuity in the form of higher revenues and returns since there are no annual out-of-pocket expenses for issuance costs.

Using Historic Returns as Measures of Expected Returns

Q. PLEASE DISCUSS MR. CAMFIELD'S USE OF HISTORIC RETURNS IN HIS CAPM, RP, AND RMR APPROACHES.

A. The primary problem with Mr. Camfield's CAPM, PR, and RMR approaches is his use of historic stock and bond returns as measures of expected returns and the expected equity risk premium. In the case of the CAPM and RP approaches, Mr. Camfield uses historic stock and bond market returns from the 1950-2005 to measure expected equity risk and size premiums. In the RMR method, Mr. Camfield uses the historic returns for the companies in the electric utility and gas distribution proxy groups over the 1996-2005 period to gauge the investors' expected returns on these stocks. The discussion below highlights the many problems and errors associated with using historic returns to measure an expected equity risk premium (as in Mr. Camfield's CAPM and RP approaches) and expected stock returns (as in Mr. Camfield's RMR approach).

Q. PLEASE PROVIDE INSIGHTS INTO THE ERRORS IN THE USE OF HISTORIC RETURNS TO COMPUTE A FORWARD-LOOKING OR EX ANTE RISK PREMIUM OR STOCK RETURN.

A. Using the historic relationship between stock and bond returns to measure an ex ante equity risk premium is erroneous and, especially given current market conditions, overstates the true market equity risk premium and expected stock return. The equity risk premium and the expected stock return is based on expectations of the future and when past market conditions vary from the present, historic data does not provide a realistic or accurate barometer of expectations of the future. At the present time, using historic returns to measure the ex ante equity risk premium and/or stock return ignores market conditions and masks the changes in the markets. This change suggests that the equity risk premium has declined and the expected stock return is lower that it has been in the past.

Q. PLEASE DISCUSS THE ERRORS IN USING HISTORIC STOCK AND BOND RETURNS TO ESTIMATE AN EX ANTE EQUITY RISK PREMIUM.

A. There are a number of flaws in using historic returns over long time periods to estimate expected equity risk premiums and expected stock returns. These issues include:

(A) Biased historic bond returns;

(B) The arithmetic versus the geometric mean return;

(C) Unattainable and biased historic stock returns;

(D) Survivorship bias;

(E) The "Peso Problem;"

(F) Market conditions today are significantly different than the past; and

(G) Changes in risk and return in the markets.

These issues will be addressed in order.

Biased Historic Bond Returns

Q. HOW ARE HISTORIC BOND RETURNS BIASED?

A. An essential assumption of these historic equity risk premium studies is that over long periods of time investors' expectations are realized. However, the experienced returns of bondholders in the past violate this critical assumption. Historically, bond returns are biased downward as a measure of expectancy because of capital losses suffered by bondholders in the past. As such, risk premiums derived from this data are biased upwards.

The Arithmetic versus the Geometric Mean Return

Q. PLEASE DISCUSS THE ISSUE RELATING TO THE USE OF THE ARITHMETIC VERSUS THE GEOMETRIC MEAN RETURNS IN MEASURING HISTORIC RETURNS.

A. The measure of investment return has a significant effect on the interpretation of the risk premium results. When analyzing a single security price series over time (i.e., a time series), the best measure of investment performance is the geometric mean return. Using the arithmetic mean overstates the return experienced by investors. In a study entitled "Risk and Return on Equity: The Use and Misuse of Historical Estimates," Carleton and Lakonishok make the

following observation: "The geometric mean measures the changes in wealth over more than one period on a buy and hold (with dividends invested) strategy."[24] Since Mr. Camfield's study covers more than one period (and he assumes that dividends are reinvested), he should be employing the geometric mean and not the arithmetic mean.

Q. PLEASE PROVIDE AN EXAMPLE DEMONSTRATING THE PROBLEM WITH USING THE ARITHMETIC MEAN RETURN.

A. To demonstrate the upward bias of the arithmetic mean, consider the following example. Assume that you have a stock (that pays no dividend) that is selling for $100 today, increases to $200 in one year, and then falls back to $100 in two years. The table below shows the prices and returns.

Time Period	Stock Price	Annual Return
0	$100	
1	$200	100%
2	$100	-50%

The arithmetic mean return is simply (100% + (-50%))/2 = 25% per year. The geometric mean return is $((2 * .50)^{(1/2)}) - 1 = 0\%$ per year. Therefore, the arithmetic mean return suggests that your stock has appreciated at an annual rate of 25%, while the geometric mean return indicates an annual return of 0%. Since after two years, your stock is still only worth $100, the geometric mean return is the appropriate return measure. For this reason, when stock

[24] Willard T. Carleton and Josef Lakonishok, "Risk and Return on Equity: The Use and Misuse of Historical Estimates," *Financial Analysts Journal* (January-February, 1985), pp. 38-47.

returns and earnings growth rates are reported in the financial press, they are generally reported using the geometric mean. This is because of the upward bias of the arithmetic mean.

As further evidence as to the appropriate mean return measure, the U.S. Securities and Exchange Commission requires equity mutual funds to report historical return performance using geometric mean and not arithmetic mean returns.[25] Therefore, Mr. Camfield's arithmetic mean return measures are biased and should be disregarded.

Unattainable and Biased Historic Stock Returns

Q. YOU NOTE THAT HISTORIC STOCK RETURNS ARE BIASED USING THE HISTORIC RETURNS METHODOLOGY. PLEASE ELABORATE.

A. Returns developed using historic returns methodology (1) cannot be reflective of expectations because these returns are unattainable to investors, and (2) produce biased results. This methodology assumes (a) monthly portfolio rebalancing and (b) reinvestment of interest and dividends. Monthly portfolio rebalancing presumes that investors rebalance their portfolios at the end of each month in order to have an equal dollar amount invested in each security at the beginning of each month. The assumption would obviously generate extremely high transaction costs and, as such, these returns are unattainable to investors. In

[25] U.S. Securities and Exchange Commission, Form N-1A.

addition, an academic study demonstrates that the monthly portfolio rebalancing assumption produces biased estimates of stock returns.[26]

Transaction costs themselves provide another bias in historic versus expected returns. The observed stock returns of the past were not the realized returns of investors due to the much higher transaction costs of previous decades. These higher transaction costs are reflected through the higher commissions on stock trades, and the lack of low cost mutual funds like index funds.

Survivorship Bias

Q. HOW DOES SURVIVORSHIP BIAS TAINT MR. CAMFIELD'S HISTORIC EQUITY RISK PREMIUM?

A. Using historic data to estimate an equity risk premium or stock return suffers from survivorship bias. Survivorship bias results when using returns from indexes like the S&P 500. The S&P 500 includes only companies that have survived. The fact that returns of firms that did not perform so well were dropped from these indexes is not reflected. Therefore these stock returns are upwardly biased because they only reflect the returns from more successful companies.

The "Peso Problem"

[26] See Richard Roll, "On Computing Mean Returns and the Small Firm Premium," *Journal of Financial Economics* (1983), pp. 371-86.

Q. WHAT IS THE "PESO PROBLEM" AND HOW DOES IT AFFECT HISTORIC RETURNS AND EQUITY RISK PREMIUMS?

A. Mr. Camfield's use of historic return data also suffers from the so-called "peso problem." This issue involves the fact that past stock market returns were higher than were expected at the time because despite war, depression, and other social, political, and economic events, the US economy survived and did not suffer hyperinflation, invasion, and the calamities of other countries. Built into historical stock prices is a market risk premium for such calamities. Therefore, historic stock returns are overstated as measures of expected returns.

Market Conditions Today are Significantly Different than in the Past

Q. FROM AN EQUITY RISK PREMIUM OR EXPECTED STOCK RETURN PERSPECTIVE, PLEASE DISCUSS HOW MARKET CONDITIONS ARE DIFFERENT TODAY.

A. The equity risk premium or expected stock return is based on expectations of the future. When past market conditions vary significantly from the present, historic data does not provide a realistic or accurate barometer of expectations of the future. As noted previously, stock valuations (as measured by P/E) are relatively high and interest rates are relatively low, on a historic basis. Therefore, given the high stock prices and low interest rates, expected returns are likely to be lower on a going forward basis.

Changes in Risk and Return in the Markets

Q. PLEASE DISCUSS THE NOTION THAT HISTORIC EQUITY RISK PREMIUM STUDIES DO NOT REFLECT THE CHANGE IN RISK AND RETURN IN TODAY'S FINANCIAL MARKETS.

A. The historic equity risk premium methodology is unrealistic in that it makes the explicit assumption that risk premiums do not change over time based on market conditions such as inflation, interest rates, and expected economic growth. Furthermore, using historic returns to measure the equity risk premium masks the dramatic change in the risk and return relationship between stocks and bonds. The nature of the change, as I will discuss below, is that bonds have increased in risk relative to stocks. This change suggests that the equity risk premium has declined in recent years.

Page 1 of Exhibit No.__(JRW-12) provides the yields on long-term U.S. Treasury bonds from 1926 to 2006. One very obvious observation from this graph is that interest rates increase dramatically from the mid-1960s until the early 1980s, and since have returned to their 1960 levels. The annual market risk premiums for the 1926 to 2006 period are provided on page 2 of Exhibit No.__(JRW-12). The annual market risk premium is defined as the return on common stock minus the return on long-term Treasury Bonds. There is considerable variability in this series and a clear decline in recent decades. The high was 54% in 1933 and the low was -38% in 1931. Evidence of a change in the relative riskiness of bonds and stocks is provided on page 3 of Exhibit No.__(JRW-12) which plots the standard deviation of

monthly stock and bond returns since 1930. The plot shows that, whereas stock returns were much more volatile than bond returns from the 1930s to the 1970s, bond returns became more variable than stock returns during the 1980s. In recent years stocks and bonds have become much more similar in terms of volatility, but stocks are still a little more volatile. The decrease in the volatility of stocks relative to bonds over time has been attributed to several stock related factors: the impact of technology on productivity and the new economy; the role of information (see former Federal Reserve Chairman Greenspan's comments referred to earlier in this testimony) on the economy and markets; better cost and risk management by businesses; and several bond related factors; deregulation of the financial system; inflation fears and interest rates; and the increase in the use of debt financing. Further evidence of the greater relative riskiness of bonds is shown on page 4 of Exhibit No.__(JRW-12), which plots real interest rates (the nominal interest rate minus inflation) from 1926 to 2006. Real rates have been well above historic norms during the past 10-15 years. These high real interest rates reflect the fact that investors view bonds as riskier investments.

The net effect of the change in risk and return has been a significant decrease in the return premium that stock investors require over bond yields. In short, the equity or market risk premium has declined in recent years. This decline has been discovered in studies by leading academic scholars and investment firms, and has been acknowledged by government regulators. As such, using a historic equity risk premium analysis is simply outdated and not

reflective of current investor expectations and investment fundamentals.

Q. DO YOU HAVE ANY OTHER THOUGHTS ON THE USE OF HISTORICAL RETURN DATA TO ESTIMATE EQUITY RISK PREMIUMS AND STOCK RETURNS?

A. Yes. Jay Ritter, a Professor of Finance at the University of Florida, identified the use of historical returns to estimate a forward-looking equity risk premium as one of the "Biggest Mistakes" taught by the finance profession.[27] His argument is based on the theory behind the equity risk premium, the excessive results produced by historical returns, and the previously-discussed errors of such as survivorship bias in historical data.

DCF Approach

Q. PLEASE SUMMARIZE MR. CAMFIELD'S DCF ESTIMATES.

A. In Exhibit DC-RC-7, Mr. Camfield estimates an equity cost rate of 9.63% for his electric utility proxy group and 9.46% for his gas distribution company proxy group. These figures include base DCF estimates of 9.30% (electrics) and 9.20% (gas companies) plus a 33 basis points adjustment to the indicated equity cost rates to account for flotation costs. Mr. Camfield's DCF estimates are listed in Exhibit No.__(JRW-13).

[27] Jay Ritter, "The Biggest Mistakes We Teach," *Journal of Financial Research* (Summer 2002).

Q. PLEASE EXPRESS YOUR CONCERNS WITH MR. CAMFIELD'S DCF STUDIES.

A. I have three major concerns with Mr. Camfield's DCF equity cost rate studies: (1) an excessive dividend yield, including the full year's growth rate adjustment to the dividend yield, and (2) an inflated DCF growth rate, and (3) the previously-discussed issuance or flotation cost adjustment.

Q. PLEASE DISCUSS THE EXCESSIVE DIVIDEND YIELD.

A. Mr. Camfield's dividend yields of 5.11% for the electric proxy group and 4.01% are excessive and not reflective of the dividend yields for the two groups. As I show, the more current and representative dividend yields for the two groups are 4.3% and 3.4%. Mr. Camfield's dividend yields are excessive because they (1) reflect stale data (2006), (2) used only a two month window for stock prices, and (3) include a full-year's growth rate adjustment.

Q. WHY IS IT NOT APPROPRIATE TO ADJUST THE DIVIDEND YIELD BY A FULL YEAR OF GROWTH IN THE DCF MODEL?

A. As previously discussed, the appropriate growth rate adjustment to the dividend yield in the DCF model is complicated in the regulatory process when the overall cost of capital is applied to a projected or end-of-future-test-year rate base. Using a full year's growth rate, as Mr. Camfield has done, results in an overstated equity cost rate because growth is already reflected in

the projected rate base. Because of this, I have adjusted the dividend yield for the groups by 1/2 the expected growth rate.

Q. PLEASE DISCUSS MR. CAMFIELD'S EXCESSIVE DCF GROWTH RATE.

A. Mr. Camfield's DCF dividend yield and expected growth rate reflect data which is rather stale. My updated dividend yield and growth rate data, as presented in Exhibit No__(JRW-9), is more appropriate and representative for the two groups.

CAPM

Q. PLEASE SUMMARIZE MR. CAMFIELD'S CAPM EQUITY COST RATES.

A. In Exhibit DC-RC-6, Mr. Camfield develops CAPM equity cost rate estimates for FPU of 11.27% for his electric utility proxy group and 11.28% for his gas distribution company proxy group. These results are summarized in Exhibit No.__(JRW-14).

Q. WHAT CONCERNS DO YOU HAVE WITH MR. CAMFIELD'S CAPM ANALYSES?

A. I have three major concerns with Mr. Camfield's CAPM analyses: (1) his risk-free rate of 4.73%, (2) most significantly, his equity or market risk premium

of 8.27%, and (3) the previously-discussed issuance or flotation cost adjustment.

Q. WHAT IS THE PROBLEM WITH MR CAMFIELD'S RISK-FREE RATE OF 4.73%?

A. Mr. Camfield's CAPM analysis employs a risk-free rate of 4.73%. This rate is based on the yields on ten-year Treasuries. As shown on page 2 of Exhibit No__(JRW-10), the current yield on ten-year Treasuries is only 4.14%. Hence, Mr. Camfield's risk-free rate exceeds the current market yield by 59 basis points.

Q. PLEASE DISCUSS MR CAMFIELD'S EQUITY RISK PREMIUM OF 8.27%?

A. Mr. Camfield's equity or market risk premium of 8.27% is computed as the expected stock market return (13.0%) minus his risk-free interest rate (4.73%). The 13.0% expected market return is computed as the arithmetic mean return on the S&P 500 from 1950-2005. I have discussed at length the myriad of empirical issues and errors in using historic returns as measures of expected returns. In short, using historic returns as measures of expected returns is subject to a myriad of empirical biases which results in an overstatement of the expected stock return and equity risk premium. These empirical issues include measuring returns with arithmetic as opposed to geometric mean returns, survivorship bias, unattainable returns (since the

returns are measured from stock indexes), the change in market conditions (stock prices are relatively high and interest rates are relatively low), and the documented decline in the equity risk premium.

Q. IS MR CAMFIELD'S EXPECTED STOCK MARKET RETURN ON 13.0% CONSISTENT WITH THE EXPECTATIONS OF MARKET PROFESSIONALS?

A. No. There are only two surveys that I am aware in which market professionals project long-term stock market returns. These are the *Survey of Professional Forecasters* (SPF) and the *CFO Magazine* – Duke University Survey of Corporate CFOs which were previously cited. In both cases, the respondents are asked for the expected return on the S&P 500 over the next ten years. In the most recent SPF, published on February 13, 2007, the median long-term expected return on the S&P 500 was 7.50%. In the most recent CFO survey (December 2007), the average expected return on the S&P 500 over the next ten years was 8.34%. Hence, Mr. Camfield's expected market return on 13.0% is well out-of-line with that of market professionals.

Q. IS MR CAMFIELD'S RESULTING EQUITY RISK PREMIUM OF 8.27% CONSISTENT WITH THE RESEARCH STUDIES ON THE EQUITY RISK PREMIUM?

A. No, it is vastly overstated compared to the many studies which have evaluated the equity risk premium. On page 6 of Exhibit No.__(JRW-10), I have

presented the results of thirty studies of the equity risk premium which have been authored by many of the leading scholars in the field. None of these studies have discovered an equity risk premium as high as 8.27%.

RP Results

Q. PLEASE SUMMARIZE MR. CAMFIELD'S RP EQUITY COST RATES.

A. In Exhibit DC-RC-8, Mr. Camfield develops equity cost rate estimates for FPU using the RP results for his proxy groups of electric utilities and gas distribution companies. These results are summarized in Exhibit No.__(JRW-15).

Q. WHAT CONCERNS DO YOU HAVE WITH MR. CAMFIELD'S RP ANALYSIS?

A. I have four major concerns with Mr. Camfield's RP analyses: (1) his risk-free rate of 4.7% (midpoints of 3.3% + 1.4%) (2) most significantly, his equity or market risk premium of 7.5% (midpoint 12.2%- midpoint 4.7%), (3) his small cap premium of 2.2%, and (4) the previously-discussed issuance or flotation cost adjustment.

Q. PLEASE DISCUSS MR CAMFIELD'S RISK-FREE RATE OF 4.7%?

A. Mr. Camfield's RP CAPM analysis uses a ten-year Treasury risk-free rate of 4.7%. As shown on page 39, the current yield on ten-year Treasuries is only

4.14%. Hence, Mr. Camfield's risk-free rate exceeds the current market yield by over ½ percent or 50 basis points.

Q. PLEASE DISCUSS MR CAMFIELD'S EQUITY RISK PREMIUM OF 7.5%.

A. Mr. Camfield's equity of 7.5% is computed as the expected stock market return (12.2%) minus his a risk-free interest rate (4.7%). This equity risk premium is based on the historic difference between stock and bond returns. Above I have discussed at length the myriad of empirical issues and errors in using historic returns as measures of expected returns. These will not be repeated here.

The fact is that Mr. Camfield's RP equity risk premium of 7.50%, like his CAPM equity risk premium of 8.27%, is excessive compared to the many studies which have evaluated the equity risk premium. In fact, none of thirty studies of the equity risk premium which I present on page 6 of Exhibit No. __(JRW-10) have discovered an equity risk premium as high as 7.50%. In addition, the expected market return of 12.2%, which provides the basis for this equity risk premium, is well in excess of the expectations of market professionals as found in the most-recent *Survey of Professional Forecasters* (SPF) and the *CFO Magazine* – Duke University Survey of Corporate CFOs.

Q. FINALLY PLEASE ADDRESS MR. CAMFIELD'S ADJUSTMENT FOR THE SIZE OF THE COMPANY.

A. Mr. Camfield adjusts his RP equity cost rate results to account for the size of the Company. He supports his size premium on the basis of a historical return analysis performed by Ibbotson Associates. As discussed above, there are numerous errors in using historical market returns to compute risk premiums. These errors provide inflated estimates of expected risk premiums. Among the errors are the well-known survivorship bias (only successful companies survive – poor companies do not survive) and unattainable return bias (the Ibbotson procedure presumes monthly portfolio rebalancing). In fact, Richard Roll found that ½ of the small firm effect disappears if you correct for monthly portfolio rebalancing.[28] The net result is that Ibbotson's size premiums are poor measures for any risk adjustment to account for the size of the Company.

Finally, and most significantly, Professor Annie Wong has tested for a size premium in utilities and concluded that, unlike industrial stocks, utility stocks do not exhibit a significant size premium.[29] As explained by Professor Wong, there are several reasons why such a size premium would not be attributable to utilities. Utilities are regulated closely by state and federal agencies and commissions and hence their financial performance is monitored on an ongoing basis by both the state and federal governments. In addition, public utilities must gain approval from government entities for common financial transactions such as the sale of securities. Furthermore, unlike their industrial

[28] See Richard Roll, "On Computing Mean Returns and the Small Firm Premium," *Journal of Financial Economics* (1983), pp. 371-86.

[29] Annie Wong, "Utility Stocks and the Size Effect: An Empirical Analysis," *Journal of the Midwest Finance Association*, 1993, PP. 95-101.

counterparts, accounting standards and reporting are fairly standardized for public utilities. And finally, a utility's earnings are predetermined to a certain degree through the ratemaking process in which performance is reviewed by state commissions and other interested parties. Overall, in terms of regulation, government oversight, performance review, accounting standards, and information disclosure, utilities are much different than industrials, which could account for the lack of a size premium.

RMR Results

Q. PLEASE SUMMARIZE MR. CAMFIELD'S RMR EQUITY COST RATES.

A. Mr. Camfield develops equity cost rate estimates for FPU his RMR approach in Exhibit DC-RC-9. These results are summarized in Exhibit No.__(JRW-16).

Q. WHAT ISSUES DO YOU HAVE WITH MR. CAMFIELD'S RMR ANALYSIS?

A. I have two major concerns with Mr. Camfield's RMR analyses: (1) his use of historic returns and the 1996-2005 time period, and (2) the previously-discussed issuance or flotation cost adjustment.

Q. PLEASE DISCUSS THE ERRORS IN USING HISTORIC RETURNS IN MR. CAMFIELD'S RMR ANALYSIS?

A. Mr. Camfield's RMR analyses involves computing historic stock returns over the 1996-2005 time period for the companies in the electric utility and gas distribution proxy groups. These are several major issues with this approach. First, the errors in using historic returns as measures of expected returns. This issue has been addressed at length in my testimony. Second, Mr. Camfield has not provided any empirical support for the selection of the 1996-2005 period as the appropriate time frame to provide guidance concerning expectations of the future. A key issue here is whether conditions in the markets today are reflected in the historic time period selected. I do not believe that this is true. A key driver of the increase in the stock market over the past decade has been the decline in interest rates. In 1996, the base period of Mr. Camfield's analysis, the average yield on ten-year Treasury bonds was 6.44%. In the year 2007, the average yield on ten-year Treasury bonds has been 4.68%. Therefore, Mr. Camfield's historic RMR results are conditioned on a further decline in interest rates to 2-3 percent level to support his RMR returns. Mr. Camfield has provided no evidence that long-term U. S. Treasury yields are projected to decline to the 2-3 percent level.

Q. ARE MR. CAMFIELD'S RMR RETURNS CONSISTENT WITH THE FORECASTS OF MARKET PROFESSIONALS?

A. No. In the previously-cited *Survey of Professional Forecasters* (SPF) and the *CFO Magazine* – Duke University Survey of Corporate CFOs, the expected returns over the next ten years are 7.50% and 8.24% for the S&P 500,

respectively. Mr. Camfield's RMR returns range from 10.0% to 11.86% for electric and gas utility stocks are clearly out-of-line with these expectations. In my opinion, this is because of: (1) the much-discussed errors in using historic returns as measures of market return expectations and (2) the fact that market professionals take into account current market conditions such as interest rates and the economy in making their forecasts.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

BY MS. CHRISTENSEN:

Q. Dr. Woolridge, can you please summarize your testimony?

A. Yes. Mr. Camfield previously had identified and talked about the cost of capital or rate of return and its importance in utility rate setting, so I'm not going to repeat that.

A major theme of my testimony is that capital costs for companies in the United States today are really at historic lows. If you look at -- there's three components to capital costs, and primarily if you look at -- what has happened is that interest rates have declined, obviously. The equity risk premium that you add to that to get an equity cost rate has declined. And the tax rate on investment income has gone down, which means that investors' required return is lower than it has been in the past.

Now, if you just focus on interest rates real quickly, you know, the long-term Treasury rates have been in the 4 to 5 percent range over the last five years. Prior to that time, this time period, we haven't seen long-term Treasury rates as low as 4 and 5 percent since the early 1960s. So to give you a time frame, that's some 40 to 45 years. In fact, you almost have to go back to '61 to '64, where we find a time period when

interest rates have been that low.

The major contention in this case is obviously the cost of equity. Mr. Camfield has estimated the company's cost of equity at 11-1/2 percent. My studies indicate it's 9.15 percent.

Now, in establishing a cost of equity for the company, Mr. Camfield has used two proxy groups of electric and gas companies, and I've used those companies. I've performed a risk study of the companies and compared it to FPU and find that FPU and the electric companies are rather comparable in risk, whereas FPU appears a little riskier than the gas companies.

Now, the major issue, as I said, is what is the equity cost rate. There are several primary issues between Mr. Camfield and myself. Number one is, Mr. Camfield gives very little weight to his DCF results, in my opinion. Second of all, and I think a primary contention, is his exclusive use of historic stock and bond returns to establish what the risk premium is.

Now, in addition to those two issues, he has included an issuance or flotation cost, and in certain approaches, he has applied a premium for the size of the company, which I haven't. I haven't included those, and

I explain that in my testimony.

Now, just very briefly talking about the cost rate approaches, his DCF approach provides equity cost rates prior to issuance cost of 9.3 percent and 9.2 percent for the two groups. Those are very close to my numbers, and especially if you update his figures for the more recent data, we have pretty much the same DCF equity cost rates. On his capital asset pricing model, his risk premium, and his realized market return approaches, basically these are all risk premium approaches. You take a risk-free rate and you add a risk premium. Since he filed his testimony, interest rates have come down, of course, so the cost rates will be lower today. But the big issue is, he has relied exclusively on historic stock and bond returns to come up with an equity risk premium. For example, in his capital asset pricing model approach, he uses an expected stock market return based off of historic figures of 13 percent.

Now, surveys of CFOs and financial forecasters today, no one expects to have a stock return in the future of 13 percent. It's just unrealistic given today's conditions. In fact, if you look at the company's pension plan, their expected return on pension assets doesn't include a stock return of 13 percent.

It's just unrealistic. Historically, equity cost rates have been slightly higher than projected rates, and as I explain in my testimony, there's a lot of empirical reasons for that.

Anyhow, based off that expected stock market return, he comes up with an equity risk premium of 8.27 percent. And in my testimony on schedule -- or Exhibit JRW-10, page 6, I lay out all the studies I've been able to find on the equity risk premium in the last 10 years, and none of those figures are as high as 8.27 percent.

And in fact, if you look at the more recent approaches, because there are different approaches to apply to find an equity risk premium, a common way is to look at surveys of CFOs. CFOs use this stuff every day. In December of 2007, the CFO survey of 500 CFOs, the average indicated an equity risk premium of 4.24 percent. Again, they use this type of data all the time in making investing and financing decisions. Again, these figures are so much lower than the equity risk premiums used by Mr. Camfield just because he relies strictly on historic data.

So in summary, the major theme is that historic cost rates for capital for companies are low today compared to the past, and my 9.15 percent

recommendation reflects this really low cost rate environment for companies for capital.

MS. CHRISTENSEN: I tender Dr. Woolridge for cross-examination.

CHAIRMAN CARTER: Just one second, Mr. Horton.

Mr. Woolridge, you said that capital costs are extremely low; right?

THE WITNESS: Yes.

CHAIRMAN CARTER: Now, this is an issue that I've been following real closely lately too. And from reading the Wall Street Journal and listening to CNBC, what they're saying is that the rates are low, but the loans are not readily available. Does that line up with what you've been reading and studying?

THE WITNESS: Well, that's obviously a factor, what has happened since the mid-summer, where there has been somewhat of a credit crisis going upon because of the defaults on the real estate. A lot of the financial products created by Wall Street has created a credit squeeze to some degree, especially in the riskier environments, and that's tied primarily to, you know, the mortgage -- you know, the run-up in housing prices, the mortgage going to the subprime market and that sort of thing. That's where most of that's tied to.

CHAIRMAN CARTER: But this has nothing to do

with what you're talking about? Is that what you're saying?

THE WITNESS: I think what has happened is, since maybe last year, we've seen risk premiums go up, say, since mid-summer or so last year tied to this. If you look at the yield spreads on corporate bonds, they've gone up somewhat. But they're still at relatively low levels compared to, say, the last 30 or 40 or 50 years.

CHAIRMAN CARTER: I was just interested in hearing what you had to say, because from what I was reading, they were saying that while the Feds have lowered the rates, but because of a number of things that have happened within the financial community within the last year or so, that the funds for loans are not necessarily readily available by either corporate or individual borrowers.

THE WITNESS: Well, what has happened is, in segments of the market, in particular the riskier segments of the market, that's where it's tougher to get a loan, just because there's so much lending going on, and a lot of these financial institutions have gotten burned lending in those portions of the market. Plus when you had housing prices crashing and people just forfeiting on their loans because their loans are at

500,000 and their house is worth 400,000, that's where a lot of the lenders got in trouble.

CHAIRMAN CARTER: Okay. Commissioners? Commissioner Skop.

COMMISSIONER SKOP: Thank you, Chairman Carter. Just a quick question to the witness with respect to the capital asset pricing model.

I guess from what I hear, you're advocating basing the -- or discarding historical market returns in favor of CFO type data or what their consensus is on an appropriate return. And why -- again, a historic approach I think is what I've always seen used for that model, but why wouldn't it be more appropriate in your eyes to use data over a shorter time period, and what type of impact would that have if, you know, we went through a different economic time where we had significant inflation and rates suddenly increased?

THE WITNESS: Well, you're incorrect. I did use historic returns. If you look at my schedule, page 6 of Schedule 10, there's three approaches to developing a equity risk premium. One is using historic returns. Another is using what they call ex ante models, and these are the studies that have been done over the last decade using expected return models to compute. And these have been done by the best academics out there.

And the third way is to use surveys.

Obviously, I give equal weight to all these, so I use historic returns. I look at -- you know, there's just not one historic return. They compute historic returns using different measures over different time periods, that sort of thing. So at the top of Exhibit JRW-10, page 6, those are all the historic return studies I can find. Some of them go back to 1802, like the one by -- well, Goyal and Welch went back to 1872. So I did use historic returns. I also used ex ante models, such as some of the models were commissioned by the office of the chief actuary of the Social Security Administration. And then I used surveys.

The survey of CFOs I highlight, first of all, CFOs are well aware of what historic returns are. I mean, every CFO has taken a finance course and has seen the Ibbotson data. Yet as recently as December of this past year when they were asked what's their expected equity risk premium, the average of over 500 CFOs is 5 -- what is it? 4.24 percent. I mean, these people use that sort of data every day, and they're well aware of what historic returns are. So as I say, it reflects what the current market environment is.

COMMISSIONER SKOP: Mr. Chair, just a quick

follow-up with respect to the surveys, the 500 CFOs. I imagine that was through diversified industry and not specific to utilities; would that be correct?

THE WITNESS: Exactly.

COMMISSIONER SKOP: All right. Thank you.

CHAIRMAN CARTER: Thank you, Commissioners. I appreciate that. I just wanted to get that out while it was on my brain before I forgot. And we still may have other questions, but at this point in time, Mr. Horton, you're recognized.

MR. HORTON: Yes, sir. Thank you, Mr. Chairman.

CROSS-EXAMINATION

BY MR. HORTON:

Q. Mr. Woolridge, in your summary, I think you made reference to the pension return.

A. Yes.

Q. And that would not all be equity, would it? That would be a mix? That return would be a mix of various things, equity, fixed income, cash?

A. Yes. I didn't see the breakdown, but I'm sure if I found -- I looked through the data requests, and I did not see a breakdown for equity versus debt. It was just overall at 8-1/2 percent. And I'm 100 percent certain it doesn't include an equity return of

13 percent.

Q. Okay. Turn to page 1 of 3 of JRW-3, if you would, please, sir.

A. Yes.

Q. And on that page, you list a number of electric and gas utilities, and those are the sample companies that you used, are they not?

A. Yes.

Q. All right. I think I heard what you said earlier, but I want to make sure. How did you select those companies?

A. Generally, they were the companies that Mr. Camfield used.

Q. Okay. You didn't do any separate risk analysis or any separate -- you just used the same ones he did?

A. Pretty much so, yes.

Q. Okay. I'm through with that exhibit.

In discovering through your studies equity return recommendations in other proceedings, have you used the same sample that you employ in this present proceeding?

A. Excuse me. I don't understand your question.

Q. Have you used different sample companies in other proceedings?

A. Yes.

Q. Are there any particular reasons why you would use different sample companies in other proceedings?

A. Generally if a witness likes one group -- I mean, you look at companies that have certain characteristics. The number of gas companies is rather limited, so you're pretty much -- and water companies, the sample is pretty limited. You have a larger number of electric companies to use. I've used as many as 30 electric companies in a study.

Q. The methods that you employ in other proceedings for your cost of capital -- excuse me, cost of equity methods, I'm sorry, are the methods that you employ in other proceedings similar to those that you've taken in this proceeding?

A. Generally, yes.

Q. And that includes the DCF and CAPM model; correct?

A. Yes.

Q. So you've advanced the DCF and CAPM models in your testimony in those other proceedings?

A. Yes, as a general approach. I feel that especially the DCF model, because of the nature of the business of providing electric service, I believe it provides a good indication of a capital cost for, in

this case, FPU.

MR. HORTON: Can I have just one second?

CHAIRMAN CARTER: You're recognized. While you're doing that, let me -- Commissioners, with your indulgence, since you're already on this Exhibit JR2-3, on this chart, I was looking just trying to draw some kind of comparison or some kind of conclusion with the electrical versus the gas in terms of the comparison for FPUC, FPU, Florida Public Utilities.

What does -- I mean, I'm trying to draw -- what kind of conclusion do you draw from the two of these? Because it seems to me that you've got -- if you go down to the gas one, you're showing probably one of the lowest market-to-book ratios and one of the highest PE ratios, and then you've got a lower service territory, if you will. Do those correlate, or am I looking at apples and grapefruits?

THE WITNESS: Well, I think if you compare these two groups -- and again, Mr. Camfield really provided the emphasis to use two different groups. I mean, I think one thing you see, I believe, is that the gas companies are less risky than these electric companies. And actually, the basis of that goes over to page 2 of 3 of Exhibit JRW-3, where I've looked at various risk metrics provided by Value Line, and on most

of those risk metrics, it appears that the gas companies are a little less risky than the electric companies, and the gas companies are a little less risky than FPU, whether you're talking about how predictable their earnings are, their stock price stability in the case of -- for example, the average for the gas companies is 98 out of 100. The average for the electrics is 91 out of 100. So I just look at different risk metrics to see which one appears to be less risky, and I would say from this that the gas companies are performing a little better. They have higher average return on equities, that sort of thing, and they have slightly lower risk, in this time.

CHAIRMAN CARTER: And because of that factor, is there a premium on the risk for electric companies versus the risk on gas companies?

THE WITNESS: No. I think where you see it is, if you look at the average market-to-book ratio, the average market-to-book ratio for the gas companies is 2.06. The average for the electric companies is 1.65. So you see that because of this, they have a higher valuation. They're priced higher relative to the book value of their equity. And that's where you really see this relationship, especially for regulated companies.

CHAIRMAN CARTER: So then there's no cost

associated with what you see? There's a higher risk for the electric companies versus the gas companies?

THE WITNESS: I would say there's a higher risk for -- right now if you look at these two groups, I would say, yes, the risk is a little bit higher for the electrics than the gas.

CHAIRMAN CARTER: And would that not be priced as such in terms of the financial markets?

THE WITNESS: Well, it's priced in terms of their market-to-book ratios, yes. They sell at a premium, a higher market-to-book ratio.

CHAIRMAN CARTER: Okay. Mr. Horton.

BY MR. HORTON:

Q. Yes. Mr. Woolridge, that same page you were referring to, page 2 of 3 of that exhibit.

A. Yes.

Q. Aren't the Betas for all of the companies in those two samples higher than the Beta for Florida Public Utilities?

A. Yes.

Q. With respect to your DCF analysis, for estimates of growth, you appear to rely on analysts' expectations for 2007 for some period in the future. Would you agree with that? Is that correct?

A. That's one of the inputs; that's correct.

Q. Over what forward time frame does the analysts' projections cover?

A. Three to five years.

Q. If you were to sample the analysts today, would you expect the estimates would be above or below analysts' expectations of 2007?

A. Well, these were collected in December of 2007, and if I look at today, which is two months later -- I was just looking at some gas data, and they're a little bit lower. But I've studied these things and have studies on the accuracy of these things. They tend to be a little upwardly biased. I think it's pretty well known in the financial community that analysts' projected earning per share growth rates are high, and the further out you go, the more upwardly biased they are.

CHAIRMAN CARTER: Mr. Horton, I see some smoke coming out of your ears right there, and your wheels are probably turning. Would this be an appropriate time for us to kind of take a little break and come back in?

MR. HORTON: That would be fine.

CHAIRMAN CARTER: Because you're on this financial area here, and I think -- it looked like you needed a couple of minutes to get your notes together.

MR. HORTON: To be honest with you, he

actually answered some of our questions earlier on, and I was trying to eliminate some of those.

CHAIRMAN CARTER: Well, I'll tell you what. We'll give you an opportunity to look over your notes and be sure on that. Commissioners, I'm looking at 3:26. Let's come back at 3:36. I don't know how to calibrate that with the clocks on the wall. Ten minutes, just go with 10 minutes, wherever you can find it. We're on recess.

(Short recess.)

CHAIRMAN CARTER: We are back on the record, and the last time we left, Mr. Horton was looking at his notes to ensure that he had asked the appropriate questions on cross-examination. Mr. Horton, you're recognized, sir.

MR. HORTON: Thank you, sir.

BY MR. HORTON:

Q. Mr. Woolridge, in your observation over recent years of regulatory agencies, would you agree that regulatory agencies have generally settled on allowed rate of return levels around 8 percent average?

A. Allowed rate of return?

Q. Yes, sir.

A. About 8 percent?

Q. Yes, sir.

A. Does that include debt? I mean, overall rates of return; correct?

Q. Overall.

A. I don't know. I would say 7-1/2 to 8-1/2 percent. I don't know. I mean, I look probably more at the allowed equity return more than the allowed overall return.

Q. Okay. With respect to interest rates, I think in your testimony -- and I'm sorry. I don't have a page cite, but let me ask the question. You have reviewed the short-term -- have you reviewed the short-term Treasury yields, intermediate-term Treasury yields, or the average yields on Baa and AAA corporate debt?

A. I've looked at long-term Treasuries. Obviously, I do an analysis between Treasuries and corporate -- Treasuries and utility bonds. But primarily, most of my observations are based off of Treasury securities, and that's because that's what the market focuses on. You know, if you turn on CNBC, they show you the rate on the 10-year Treasury or the 30-year Treasury. That's what the market really focuses on, is long-term Treasury rates.

Q. What does the empirical record indicate regarding yields on debt?

A. What do you mean? I don't understand your

question. I mean, the yields on debt, if you look over the last -- as I explain in my testimony, we haven't seen Treasury rates this low since the 1960s. Long-term Treasury -- and it's been since -- you know, they really declined to this level in the 2002, 2003 time period, but they've stayed that low, and they've stayed that low for an extended period of time. We would have to go back to the '50s and '60s to see long-term Treasury rates that low.

Q. Do you know what the current yield on Baa corporate debt is?

A. The current yield on Baa -- what maturity?

Q. I'm sorry?

A. What maturity?

Q. Longer than 20 years.

A. Long-term. It's in the vicinity of 6 percent or so. I can't give you the exact number today. I would have to look it up.

MR. HORTON: Thank you. I have no other questions.

CHAIRMAN CARTER: Thank you. Staff.

MS. BROWN: We have no questions.

CHAIRMAN CARTER: Mr. Christensen, any redirect?

MS. CHRISTENSEN: Thank you.

REDIRECT EXAMINATION

BY MS. CHRISTENSEN:

Q. Dr. Woolridge, you were explaining earlier the market-to-book ratio and how the gas companies' market-to-book ratio is higher than the electric companies'. Can you explain a little bit more what the market-to-book ratio shows?

A. Well, I think I explain that in my testimony, and actually, I lay it out in an exhibit. I demonstrate the relationship, and it's fairly strong for utilities. It's very strong for financial companies as well. If you look at Exhibit JRW-5, I show the relationship between expected returns on equity and market-to-book ratios for electric utilities, for natural gas companies, and for water companies, and it's very strong. Companies that have higher expected returns on equity have higher market-to-book ratios. And as I explain in my testimony, the reason I use that relationship is because, you know, basic economics tells us that if your expected return on equity is greater than your cost of equity, your market-to-book ratio is greater than 1. And I use it and in my testimony explain why -- part of why my recommendation is very reasonable given these statistics. Obviously, returns on equity for these companies are higher than the cost

of equity, and that's why their market-to-book ratios are greater than 1.

Q. And Dr. Woolridge, if you know -- I think you were asked if you knew what the average rate of return for electric companies was for 2007, and you said you had looked and were more familiar with returns on equities. Do you know what that would be for 2007?

A. Well, I mean, the average returns on equity allowed have been coming down over the last three to four years, I think, as commissions have recognized that equity cost rates are lower because of the reasons I said, that capital costs are at historic lows. I mean, if you look at more recent data, I was just in a case in Connecticut, Connecticut Light & Power, and their allowed return was 9.4 percent. The fact is, I think commissions are finally realizing that capital costs are indeed low and that the cost of equity has been coming down as well.

Q. And the Connecticut case you're referencing, that would be a distribution and transmission type of company?

A. Yes. And the decision was like January 28th. It was a very recent decision.

MS. CHRISTENSEN: Okay. Thank you. I have no further questions.

CHAIRMAN CARTER: Okay. Thank you very much. Let's deal with our exhibits.

MS. CHRISTENSEN: I would ask to have Dr. Woolridge's exhibits, and that would be Number 30 through 46, moved into the record.

CHAIRMAN CARTER: Thirty through 46. Any objections? Without objection, show it done.

(Exhibit Numbers 30 through 46 were admitted into the record.)

CHAIRMAN CARTER: And Mr. Woolridge may be excused. Call your next witness.

MS. CHRISTENSEN: Office of Public Counsel would like to call Patricia Merchant to the stand.

Thereupon,

PATRICIA W. MERCHANT

was called as a witness on behalf of the Citizens of the State of Florida and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. CHRISTENSEN:

Q. Ms. Merchant, can you please state your name and business address for the record, please.

A. My name is Patricia W. Merchant, and I'm employed by the Office of Public Counsel, and my address is 111 West Madison Street, Tallahassee, Florida, 32301.

Q. Ms. Merchant, did you cause to be filed prefiled testimony in this docket?

A. Yes, I did.

Q. And do you have any corrections to your testimony?

A. No, I do not.

Q. If I were to ask you the same questions today, would your answers be the same?

A. Yes, they would.

MS. CHRISTENSEN: I would ask that Ms. Merchant's prefiled testimony be entered into the record as though read.

CHAIRMAN CARTER: The prefiled testimony will be entered into the record as though read.

BY MS. CHRISTENSEN:

Q. Ms. Merchant, do you have exhibits attached to your prefiled testimony labeled PM-1 through PM-3?

A. Yes, I do.

Q. Do you have any corrections to those exhibits?

A. No.

DIRECT TESTIMONY

OF

PATRICIA W. MERCHANT, CPA

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 070304-EI

and

Docket No. 070300-EI

Introduction

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Patricia W. Merchant. My business address is Room 812, 111 West Madison Street, Tallahassee Florida, 32399-1400.

Q. BY WHOM ARE YOU EMPLOYED AND WHAT IS YOUR POSITION?

A. I am a Certified Public Accountant licensed in the State of Florida and employed as a Senior Legislative Analyst with the Office of Public Counsel (OPC). I began my employment with OPC in March, 2005.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. In 1981, I received a Bachelor of Science degree with a major in accounting from Florida State University. In that same year, I was employed by the

Florida Public Service Commission (PSC) as an auditor in the Division of Auditing and Financial Analysis. In 1983, I joined the PSC's Division of Water and Sewer as an analyst in the Bureau of Accounting. From May, 1989 to February, 2005 I was a regulatory supervisor in the Division of Water and Wastewater which evolved into the Division of Economic Regulation.

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

A. Yes, I have testified numerous times before the PSC. I have also testified before the Division of Administrative Hearings as an expert witness.

Q. ARE YOU SPONSORING ANY EXHIBITS IN THIS CASE?

A. Yes. I am sponsoring Exhibit PWM-1, a summary of my regulatory experience and qualifications, which is attached to my testimony. I also have attached Exhibits PWM-2 and PWM-3, which support calculations for some of my recommended adjustments.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to address accounting issues and adjustments in this docket that the Office of Public Counsel believes are necessary in order to establish base rates for Florida Public Utilities Company, Inc. (FPU) on a going forward basis. I am also providing testimony on several of the storm hardening initiatives that FPU has proposed that have rate case impacts.

Q. ARE ANY ADDITIONAL WITNESSES APPEARING ON BEHALF OF

THE FLORIDA OFFICE OF PUBLIC COUNSEL IN THIS CASE?

A. Yes. Hugh Larkin, Jr. of Larkin & Associates, and J. Randall Woolridge are also presenting testimony.

Recommended Adjustments

Q. WOULD YOU PLEASE DISCUSS EACH OF THE ADJUSTMENTS TO FPU'S FILING YOU ARE SPONSORING?

A. Yes, I will address each adjustment I am sponsoring below.

Capital Additions for Storm Hardening Plan

Q. WHAT ISSUES ARE YOU ADDRESSING FOR CAPITAL IMPROVEMENTS RELATED TO FPU'S STORM HARDENING PLAN?

A. I am addressing the Company's request to replace its existing 190 wood poles on its 69 KV transmission system in it Northeast division with concrete poles. Related to this issue, is the Company's request to receive advanced recovery of the total cost of replacing the 190 poles through a pro forma amortization expense for the 2008 test year. The last issue in this section that I will address is the Company proposed 2007 and 2008 capital improvements related to extreme wind loading for distribution facilities.

Replacement of Wood Transmission Poles with Concrete

Q. PLEASE EXPLAIN THE COMPANY'S STORM HARDENING REQUEST FOR REPLACEMENT OF THE EXISTING WOOD POLES

IN ITS 69 KV TRANSMISSION SYSTEM WITH CONCRETE.

A. In Section 2.4 of the Company's Storm Hardening Plan dated June 2007, the initial plan included a fifteen-year replacement for these structures. However, in Docket No. 070304-EI, the Company proposed to extend this to a twenty-year schedule. In Order No. PSC-06-0781-PAA-EI, issued September 19, 2006, in Docket No. 060198-EI, the Commission addressed the storm preparedness plans for each of the electric investor-owned utilities (IOUs). Under Initiative 4, on page 10, the Commission required each electric IOU to provide a plan, a timeline for implementation, costs, and rate impacts to implement a plan to upgrade and replace existing transmission structures. Specific flexibility for each utility was provided. Further, "the plan shall include the scope of activity, any limiting factors, and the criteria used for selecting transmission upgrades and replacements."

Addressing the specifics for FPU, the Commission acknowledged that FPU plans to replace its wooden transmission plies with concrete poles as necessary and economically practicable. The Order also stated that FPU's timeline for completing the pole change-outs was not yet established because the poles are currently sound, and transmission line upgrades that may require stronger poles at that time had not been scheduled.

Q. DID ORDER NO. PSC-06-0781-PAA-EI REQUIRE FPU TO REPLACE ITS POLES OVER A 20-YEAR PERIOD?

A. No it did not. The Order only required FPU to develop a plan that was necessary and economically practicable. The Order also required the utilities

to provide the criteria used for selecting transmission upgrades and replacements. In response to OPC's Interrogatory No. 1 in Docket No. 070300-EI, FPU stated that there is no technical basis or requirement on which the Company is relying to hasten the replacement of the wood poles. In response to Interrogatory No. 8, (Docket No. 070300-EI) FPU stated that the 69 KV wood poles would be in compliance with the storm hardening standards if the poles were replaced as needed for construction requirements or integrity concerns and not hastened in the replacement with concrete. Regarding bracing or guying, the Company stated that these options were available but that purchasing easements might present an obstacle. However, the Company did not investigate the cost of bracing or guying options. (Response to OPC Interrogatory No. 8, Docket No. 070300-EI). Finally, the Company was asked if the poles were replaced when needed as opposed to the stepped-up policy requested in FPU's storm plan, how many poles would be replaced each year. The Company replied that only 10 wood poles in the next ten years would need to be replaced. Only seven of the 69 KV poles have been replaced with concrete poles since 1998. (Response to OPC Interrogatory No. 9, Docket No. 070300-EI)

Q. BASED ON THE COMPANY'S RESPONSE TO DISCOVERY IN DOCKET NO. 070300-EI, WHAT IS YOUR RECOMMENDATION REGARDING THE COMPANY'S TRANSMISSION WOOD POLE REPLACMENT PROGRAM?

A. I believe that the Company's storm hardening proposal regarding an accelerated pole replacement program is unreasonable and uneconomical.

Accelerated pole replacement is not necessary to comply with the Commission's rule or orders. Furthermore, accelerated pole replacement denies the rate payer the benefit of using the existing poles that have no integrity concerns or other construction requirements to be retired prior to the expiration of the useful lives. While I believe that it is certainly prudent to repair or replace a pole that has integrity concerns, I believe that the Company has not made a showing that repairing or guying a line, rather than full replacement, is cost-effective. Further, the Company's past practice has been that it has needed to replace 1 pole a year. Thus, I believe that the Company's existing policy should be maintained of replacing the wood transmission poles when needed (approximately one per year), and not on an accelerated basis.

Q. WHAT IS THE DOLLAR AMOUNT THAT YOU RECOMMEND FOR POLE REPLACEMENT TO BE ALLOWED FOR RATEMAKING PURPOSES?

A. I believe that one pole can be assumed to be replaced in 2008. However, I do not believe that the Company has sufficiently documented what the total cost of replacing a wood pole with concrete would be in 2008. In Exhibit 27.1 submitted in response to OPC POD No. 27, the Company included an estimated cost of $21,500 to purchase and install a spun concrete pole. This exhibit reflects 3 components for the materials and 2 components for labor.

OPC has requested but not received any invoices, bids or contracts to support these estimated amounts. Since none have been provided, I am left to assume that no such documents exist. The verbal answer that I have received from the Company has been that the estimates are prepared by employees in

the Northeast and Northwest division offices, these employees know about such replacement costs, and the Company relied upon these employees' estimates. On Exhibit 27.1 there is a footnote that the installation labor was based on a conversation with Robert Jones, Southeast Power.

Q. WHAT IS THE DOLLAR AMOUNT THAT YOU BELIEVE SHOULD BE USED FOR THE REPLACEMENT OF ONE POLE FOR 2008?

A. I believe that a conservative adjustment would be to allow the Company to add the cost of its unsupported estimate at 75%, or $16,125. I acknowledge that there is a cost for replacing a pole; however, the Company failed to obtain reasonable bids or provide other sufficient supporting documentation for such costs. As such, I believe that a 25% reduction in the estimated cost is appropriate. I recommend that this pole replacement should be added in June, 2008, which would reflect an $8,683 addition to plant on a thirteen-month average basis. I am recommending that a 40-year life is appropriate for a concrete pole (per Mr. Cutshaw in his deposition page 75). Even though the Company, in Late-filed Deposition Exhibit 4 (Cutshaw/Myers panel deposition), responded that it used a remaining life depreciation rate of 26.3 years or 3.8% for account 1010.355 for transmission poles, I am using the full depreciable life for this new pole based on the expected useful life as stated by Mr. Cutshaw in his deposition. Based on the above, the increase to depreciation expense would be $235 (7 months) and the 13-month average increase to accumulated depreciation would be $126.

Advanced Recovery of 20 years of Pole Replacements

Q. PLEASE EXPLAIN THE COMPANY'S REQUEST FOR ADVANCED RECOVERY OF THE TRANSMISSION POLE REPLACEMENT PLAN.

A. In its MFRs, the Company requested that it receive advanced recovery of the total cost of $7,092,000 of replacing the 190 wood poles with concrete for the 69 KV transmission system. To get the annual expense amortization of $354,600, the Company divided the total cost by 20 years. In his direct testimony, Mr. Mesite stated that the Company included this special recovery amortization because "it directly benefits the customers through increased reliability, and delays the need for future rate increases that would typically result from these capital expenditures." (Mesite direct testimony, page 11)

Q. CAN YOU EXPLAIN HOW THE COMPANY DERRIVED ITS TOTAL COST OF REPLACING THE WOOD POLES?

A. Yes, to some degree. The Company prepared an estimate of what it believed was the cost to replace one wood pole with concrete, as I have discussed above as detailed in Exhibit 27.1 attached to the Company's response to OPC Production of document No. 27. The materials and labor for one pole totaled $21,500 and the Company proposed that it would replace 9 to 10 poles each year over the 20-year replacement period. It multiplied the 9.5 poles per year times the 2007 cost per pole estimate times an annual escalation factor of 5%. Thus, for 2008, the pole replacement cost was projected to be $214,463 (9.5 poles x $21,500 x 1.05 escalation factor). For each succeeding year, the calculation was similar except that the escalation factor was applied

exponentially. The Company then added up each of the years and rounded out the total escalated cost to be $7,092,000.

Q. DO YOU AGREE WITH THIS RECOVERY MECHANISM?

A. Certainly not. Essentially what the Company is suggesting is that the rate payers pre-pay for the full cost of the new poles before the Company even purchases or has the poles installed. A transmission pole is a capital asset that is recorded in plant in service and depreciated over the life of the asset for which it provides service. The utility is required to invest in utility plant, however, in turn, it is allowed to earn a reasonable rate of return on its investment and recover its prudent operating expenses such as depreciation expense, maintenance, and taxes. The Company states that this methodology benefits ratepayers, but I disagree completely with that theory. This is similar to going to a car dealer and stating that you want to buy a car in 5 years but you want to pay them in advance a pro rata share on an annual basis of what you predict the car might cost five years from today. No reasonably minded person would do this but this is exactly what FPU wants its customers to do in this case. The Company's request, as outlandish as it is, flies in the face of traditional ratemaking in that the Company wants full recovery of the total cost even before it has spent any money. Full cost recovery received in advance is not fair, just or reasonable and should be denied outright.

Q. DO YOU HAVE VERIFICATION CONCERNS WITH THE COMPANY'S PROPOSAL?

A. Yes, I do. Other problems that exist with this request are that, upon conclusion of the rate case, the Commission would lose the means to be assured that the plant items that the customers are fully funding for a twenty-year period have actually been spent. Additionally, under the storm hardening requirements, the companies are allowed to revise the plans as needs arise, and technology or operational changes could substantially impact the cost or need to continue with its pole replacement policy. As evidenced in this case, it is difficult to project costs out 1 to 2 years, let alone projecting costs for a 20-year period.

Q. WHAT OTHER CONCERNS DO YOU HAVE WITH THE COMPANY'S REQUESTED RECOVERY MECHANISM FOR ITS TRANSMISSION POLE REPLACEMENT POLICY?

A. FPU's request creates intergenerational inequities that I believe are unfair to the current generation of ratepayers. This recovery scheme would require the current generation of customers to pay the full cost of this long-term asset in advance that will provide benefits to customers for forty years. This is an extreme example of intergenerational inequity that the Commission should deny outright.

Q. WHAT ADJUSTMENT TO THE COMPANY'S FILING IS APPROPRIATE FOR YOUR POSITION ON THE ADVANCED AMORTIZATION FOR THE POLE REPLACEMENT POLICY?

A. I believe that the Company's requested annual amortization of $354,000 should be removed from test year expenses. The Company states that this

amount was removed from rate base through the reserve accounts for depreciation on Schedule B-9 of the MFRs; however, I was unable to verify that the Company actually made this adjustment. Until such time as the Company can reflect the calculation showing that it did credit the reserve, I am not recommending any further adjustment to rate base.

Extreme Wind Loading Improvements to Critical Infrastructure

Q. WHAT HAS THE COMPANY INCLUDED IN ITS RATE CASE FILING RELATED TO COSTS ASSOCIATED WITH EXTREME WIND LOADING?

A. The Company did not include any capital improvements in its minimum filing requirements (MFRs) related to these proposed projects. In its Storm Hardening Plan, the Company included proposed projects for 2007 through 2009 related to extreme wind loading distribution facilities. The plan stated that in 2007, the Company would rebuild the 0.5 mile main feeder providing service to the Northwest Prison/H.S. Shelter at a cost of $62,500. For 2008, the plan proposed that the Company would rebuild the feeders to the Northwest Sewer Treatment (1.1 miles) at a cost of $141,600 and the Northeast Hospital (1.2 miles) at $154,500. In its response to OPC's Interrogatory No. 95 (Exhibit 95.1), the Company stated that it had included $296,000 of capital improvements for extreme wind loading in its Storm Hardening Plan but included zero in the rate case MFRs. The "Updated" column of this exhibit reflected that the Company had revised its capital improvements for this category down to $142,000. This exhibit also had a footnote included for this line item that stated the Company had inadvertently

omitted the costs from the rate case and had revised its budget amount for 2008. This amount corresponds to the feeder for the Northwest Sewer Treatment Plant.

Q. DID THE COMPANY STATE WHEN THE REVISED BUDGET AMOUNT FOR 2008 WOULD BE PLACED IN SERVICE?

A. Yes, in the joint panel deposition (page 74-75), Mr. Myers stated that the Company would not begin construction on the feeder to the sewer treatment plant until the third quarter of 2008, with completion in the last quarter.

Q. SINCE THE COMPANY HAS NOT INCLUDED ANY OF THESE AMOUNTS IN THE MFRS FOR THIS CASE, WHY ARE YOU ADDRESSING THIS ISSUE?

A. In responses to discovery, the Company has revised its estimates on many of its projected costs and it appears that this would be another area where the Company would like to add costs to the rate case that were not originally included. Based on the number of times that these plant improvements have changed, it appears to me the Company still is unsure whether these projects will be completed in 2008. Regardless, the Company has not submitted any documentation to support these rough estimates. Based on the above, I believe that it is improper to include these estimates for rate recovery at this time; therefore, no adjustment is necessary to the Company's rate base or operating income.

13-Month Average of 2008 Transformer Addition

Q. PLEASE DESCRIBE YOUR ADJUSTMENT RELATED TO THE TRANSFORMER PLANT ADDITION.

A. In its filing, the Company requested that it be allowed to recover the full cost of a transformer addition that would be added in 2008 as if the transformer had been placed in service in December, 2007. This has the effect of considering the plant on a year-end basis as opposed to a required 13-month average basis consistent with its test year. Witness Mesite on page 11 (lines 4-11) of the accounting panel direct testimony stated that circumstances outside of the Company's control contributed to this item not being placed in service until after December 2007. He stated that it is appropriate to include the transformer in rate base for a full year because this item is significant to operations and delays if any will be beyond the Company's control. Further, he stated, if full recovery is not allowed, the Company's need for a future rate case would be accelerated, thus increasing the overall cost to customers for an additional rate case.

Q. DO YOU AGREE WITH WITNESS MESITE'S ARGUMENT THAT THIS PLANT ITEM SHOULD RECEIVE FULL RECOVERY EVEN THOUGH IT WILL NOT BE IN SERVICE FOR THE WHOLE TEST YEAR?

A. No, I do not. While I agree that the transformer is necessary, I do not believe that the Company has justified why this one particular item should be given full recovery. The statement that a future case might be necessitated if full recovery is not allowed is a veiled threat. The Company has ample

opportunity to recover all items that it projects will be in service for the test year and has not justified why such an exception should be made for this one item. The problem with allowing this one item to be brought into rate base without other matching items that might reduce the revenue requirement calculation violates the test year concept.

The Company is projecting that the plant will be placed in service in February 2008, with an estimated cost of $790,000. The full year of depreciation expense and accumulated depreciation requested are $23,700 and $11,850, respectively. The 13-month average plant and accumulated depreciation are $668,462 and $8,356, respectively, and the depreciation expense would be $19,750. (See Exhibit 97.1 submitted in response to OPC Interrogatory No. 97). My recommended adjustments to plant and accumulated depreciation are decreases of $121,538 and $3,494, respectively, and a corresponding decrease to depreciation expense of $3,950. The calculations of my adjustments are shown on Schedule No. A-1, in my attached Exhibit PWM-2.

In Exhibit 97.1, the Company also stated that it would no longer incur the cost of a temporary rental of a transformer at a monthly cost of $2,140 for the AIP substation. In their panel deposition, witnesses Myers and Cutshaw (page 80-81) stated that the rental cost began in 2005 and will continue through 2008 until the transformer is placed in service. Further, Mr. Cutshaw stated that the Company did not make any adjustment to remove the annual rental expense that would go away when the new transformer is placed in service. Accordingly, I recommend that it is appropriate to remove $25,680 plus the Company's projected escalation factor of 1.1130 for 2007 and 2008

for a total expense decrease of $28,582 for the test year. In the event the Commission disagrees with my recommendation that the 13-month basis should be used, an expense reduction of $24,302 is appropriate to recognize that only two months of the rental expense at a cost of $2,140 per month (or $4,280 total for the year) should be allowed in the 2008 test year. The calculations are also reflected on Exhibit PWM-2, entitled Transformer Plant Adjustment.

Missing Invoices (Staff Audit Finding 1)

Q. WHAT ADJUSTMENTS ARE YOU RECOMMENDING BASED ON THE STAFF AUDIT FINDING NO. 1?

A. As discussed in the staff audit report dated December 13, 2007, the utility was unable to provide invoices and supporting documentation for numerous plant additions recorded in 2003 through 2005. Because the utility was unable to support these items, the auditors recommended that these plant additions should be removed from rate base. The Company could not support allocated plant additions to the electric system of $100,186.39 for 2003, $780,730.58 for 2004, and $19,622.40 for 2005. This resulted in a total amount of unsupported plant of $900,539.37 for the electric system.

The auditors recommended that the utility's electric system general ledger be corrected to reflect the removal of these plant items and corresponding adjustments. The following adjustments should be made: plant in service should be decreased by $900,539.34, accumulated depreciation should be decreased by $125,449.15, depreciation expense should be decreased by $43,391.26, and retained earnings should be decreased by

$818,481.48. The impact on the rate case filing is as follows: the 13-month average balance of plant and accumulated deprecation should be reduced by $900,539.37 and $125,449.15, respectively. Depreciation expense should also be reduced by $43,391.26. I agree with the staff auditors that these amounts should be removed as unsupported plant additions. Recovery should not be allowed unless and until the Company can provide sufficient documentary support, such as invoices and/or contracts showing that these amounts were properly recorded.

Accumulated Depreciation

Q. WHAT ADJUSTMENTS DO YOU HAVE REGARDING ACCUMULATED DEPRECIATION?

A. I am recommending that the adjustments that are approved in the Company's current depreciation study in Docket No. 070382-EI should be made to the rate case. The staff's report on the Company's depreciation study was filed on December 18, 2007, and the proposed agency action recommendation is due to be filed on January 16, 2008, with the Commission vote scheduled for January 29, 2008. I would like to reserve the right to file rebuttal testimony on any rate case impact, if we find that a protest of the Commission's decision in the depreciation study docket is necessary.

Construction Work In Progress

Q. SHOULD THE COMMISSION ALLOW ANY CONSTRUCTION WORK IN PROGRESS (CWIP) IN RATE BASE?

A. No, it should not. CWIP, as the titles designates, is not plant that is completed and providing service to ratepayers. It is neither used nor useful in generating, transmitting, or delivering current service to ratepayers. The ratemaking process is predicated on an examination of the operations of a utility to ensure that the assets upon which ratepayers are required to provide the utility with a rate of return are, in fact, reasonably priced and are both used and useful in providing services on a current basis to ratepayers. Facilities in the process of being constructed cannot be used or useful. Their total cost and the basis on which they were constructed cannot be examined in the context of providing service to ratepayers. The ratemaking process, therefore, excludes, in most instances all CWIP from earning a current rate of return or being included in rate base until such time as projects are completed and providing services to ratepayers.

To allow CWIP in rate base is to predetermine that costs are reasonable and that the project will be used and useful in providing service to ratepayers. As a general ratemaking principle, CWIP should be excluded from rate base and excluded from the ratemaking process until such time that it is actually providing service to ratepayers.

Q. HAS THE FLORIDA PUBLIC SERVICE COMMISSION INCLUDED CWIP IN RATE BASE IN SOME INSTANCES?

A. Yes, it has. However, in those instances of which I am aware, the particular utility was in the midst of a large construction program, and there was a likelihood that the interest coverage ratio would decline below the coverage ratios required by bond indenture covenants. In Florida Power and Light's

(FPL) last litigated rate case, Docket No. 830465-EI, the Florida Public Service Commission stated the following:

> As announced repeatedly in our more recent electric rate cases, our decision to include CWIP in rate base has been founded on our overriding concern of providing the particular utility with an opportunity to achieve and maintain adequate financial integrity.
>
> In this case, we have determined that even without the inclusion of any CWIP in rate base, FPL should be able to maintain its financial integrity in 1984 and 1985. Accordingly, we find that it is not necessary to include any CWIP or Nuclear Fuel in Process (NFP) in rate base in either 1984 or 1985 in order to maintain FPL's financial integrity.
>
> (Docket No. 830465-EI, p. 14. Decision Nos. 13537 and 13948).

Q. DID FPU ACCRUE ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC) ON ITS CWIP?

A. Based on its MFRs, it did not. On its 2008 rate base, Schedule B-1, the Company included $75,000 in CWIP for the jurisdictional electric division for which no AFUDC is included. MFR Schedule B-13 also lists the various projects that make up the $75,000 in CWIP included in rate base. These amounts are unsupported estimates to which the Company has not provided any invoices, bids or contracts. The Company as of December 11, 2007, had

not completed its 2008 construction or operating budget and this document was provided to OPC on December 20, 2007, a week before our testimony was due.

Q. DO YOU KNOW WHY THE COMPANY DOES NOT ACCRUE AFUDC ON ITS CWIP?

A. No. However, but based on my review of the projects listed on MFR Schedule B-14, it appears that the projects listed are short-term in nature and would not qualify to accrue AFUDC.

Q. DOES THE COMMISSION RULE 25-6.0141, FLORIDA ADMINISTRATIVE CODE, ON THE AFUDC DETERMINE WHETHER PROJECTS ARE INCLUDED IN RATE BASE OR NOT?

A. No, it does not. The rule determines that long-term projects of a certain magnitude will accrue AFUDC and that shorter term projects will not. In my opinion, the rule recognizes the fact that projects, which are completed over a shorter period of time (i.e., less than one year) will provide the Company a return by either increasing sales or decreasing operating costs and, therefore, do not require an AFUDC return. Other more long-term projects may require the accrual of AFUDC because of the length it takes to complete these projects, but that is not the case for FPU in this rate case. Regardless, that does not dictate that these projects should be considered for inclusion in rate base. For the above reasons, I have excluded the Company's requested $75,000 in non-AFUDC CWIP from the rate base.

Vacant Position NW Operations Manager

Q. PLEASE EXPLAIN YOUR ADJUSTMENT AS IT RELATES TO THE VACANT POSITION FOR THE NW OPERATIONS MANAGER.

A. In the Over/Above Expenses Schedule under the section entitled "Expenses for Northwest Florida," the Company added an additional expense to the 2007 and 2008 expense levels for the NW division's Operation Manager position that was vacant for most of 2006 and filled on December 11, 2006. According to the Company's response to OPC Interrogatory No. 44, the position was vacated by the former manager, who was promoted to division manager in January 2006. The Company has increased the 2007 expenses by $53,552 and the 2008 projected test year by $56,497, with 100% of this expense allocated to electric operations.

Q. HAS THE COMPANY SUBMITTED INFORMATION THAT REFLECTS THE ORIGINAL OVER/ABOVE EXPENSE ADUSTMENT WAS OVERSTATED?

A. Yes, it did. In late-filed Deposition Exhibit 12 (Martin, Khojasteh, and Mesite Panel), the Company provided a calculation of the adjustment made for this position that was partially vacant during the 2006 base year. The calculation reconciled the amount paid to the person that formerly held the position with the salary included for the new employee including benefits. This exhibit reflects that the Company agrees that its original estimate based on the former manager's salary was overstated for 2008 by $5,310. Accordingly, I believe that 2008 test year salaries should be reduced by $5,310. This amount is allocated 100% to electric operations.

Training and New Positions Requested for Operations and Storm Handling

Q. PLEASE EXPLAIN YOUR ADJUSTMENTS RELATED TO THE COMPANIES REQUESTED OVER/ABOVE INCREASES FOR TRAINING AND NEW POSITIONS FOR OPERATIONS AND STORM HARDENING.

A. I have grouped together the adjustments related to the Company's proposed training program for the Northeast (NE) and Northwest (NW) divisions and the Company's requested new positions for a full time trainer, a benefits upgrade for the NE safety coordinator, a new position to handle joint use audits and pole inspections, and a new clerical position for maintaining compliance.

Training for Apprentices NE and NW Divisions

Q. PLEASE ADDRESS THE COMPANY'S OVER AND ABOVE ADJUSTMENT RELATED TO TRAINING FOR THE LINEMEN APPRENTICES.

A. In the Over/Above Expenses Schedule under the section entitled "Expenses for Northwest Florida" the Company added an additional expense to the 2007 and 2008 expense levels to train 8 apprentice linemen in both the NE and NW divisions (a total of 16 positions to be trained per year). For 2007, the Company added $25,400 and $25,127 for each division for 2007 and 2008, respectively. Thus, the total impact for the 2008 test year for incremental training costs in the MFRs was $50,254. In response to OPC Interrogatory No. 45, the Company stated that the amounts projected were based on 8

apprentices trained at each division; the estimate included 3 weeks of training ($850/week) at the Tampa Electric Company (TECO) training facility along with an additional $10,000 to cover costs associated with the State Lineman Training Program. After reviewing this response, I was unable to determine how the adjustment to training expense as originally proposed by the Company was calculated. However, in a subsequent data response (unlabeled), the Company indicated 8 employees would travel for 3 weeks per year at a cost of $850/week for a total cost of $20,400 and $5,000 was added for incidental training aides. This totals the amount of the over/above expense adjustment; however, this is not consistent with the Company's response to Interrogatory No. 45.

Q. DID THE COMPANY CHANGE ITS REQUESTED EXPENSE FOR TRAINING IN THIS INTERROGATORY RESPONSE?

Yes. In its response to Interrogatory No. 45, after briefly addressing the calculation made in the filing, the Company stated that the TECO training facility could not be used for training needs and that the Company decided to implement its own in-house training program. This program would be in addition to the Company's existing training which consists of the State Lineman Training Program, a home-study program coupled with a required number of on-the-job training hours. Through this response to Interrogatory No. 45, the Company states that it wants to now add a full-time employee as a trainer with the following annual costs:

Additional Trainer Salary and Benefits	$87,750
Travel Expense for Trainer	$9,600
Training Supplies (non-capital)	$5,150
Preparation of Training materials	$2,325
Actual materials used for Training	$11,310
State Lineman Program Materials	$11,000
Total	$127,135

Q. WHAT TYPE OF TRAINING PROGRAM DOES THE COMPANY UTILIZE CURRENTLY?

A. The Company uses the State Lineman Program, which is a home book study program. In conjunction with that program, the apprentices work under a qualified journeyman for on-the-job training hours. After an employee receives 8,000 training hours and passes all the tests, they became a journeyman lineman. In deposition, witness Cutshaw stated that most other companies are doing more formalized training. FPU wants to have a more formalized training program where the criteria and classroom are established, with more documentation and attestation that training goals are met. (Cutshaw/Myers panel deposition page 17-18).

Q. WHAT TYPE OF SUPPORT OTHER THAN THE ANSWER PROVIDED IN INTERROGATORY NO. 45 DID THE COMPANY PROVIDE TO SUPPORT THE NEED FOR THIS INCREASED TRAINING PROGRAM?

A. In Exhibit 45.1 (response to OPC Interrogatory No. 45), FPU provided a copy of a portion of a slide presentation (10 of at least 26 pages of this presentation were provided with numerous pages missing) which appears to have been authored by 3 FPU employees. This presentation includes only the benefits of

having a full-time dedicated trainer and does not include any other alternatives to hiring a full-time trainer and building a class room for a dedicated training facility. The costs included in this slide presentation are the same costs that were reflected in the response to Interrogatory No. 45 and no documentation (such as written estimates, bids, or invoices) has been provided to support these amounts. As seen throughout this case, these amounts were internally generated with no corroborating evidence.

Q. DID YOU SUBSEQUENTLY RECEIVE A COMPLETE VERSION OF THE SLIDE PRESENTATION?

A. Yes, I received a copy of a numerically numbered document that shows not only the analysis of having a full-time trainer, but other available options such as; a) having a dedicated lineman as a trainer in each division, b) a dedicated lineman as a trainer serving both divisions, c) using supervisors as trainers, and d) using all working foremen as trainers. All of these options cost less than the option reflected by the Company in its limited response in Exhibit 45.1. I would note that the complete slide presentation had a total of 27 pages, 17 more pages than the version the Company submitted in response to Interrogatory No. 45.

Q. HOW MANY APPRENTICE LINEMEN DID THE COMPANY TRAIN IN 2004, 2005 AND 2006?

A. According to the responses of witnesses Cutshaw and Myers (Cutshaw/Myers panel deposition, page 27), the NE division had 2 apprentices and the NW division had 4 training in 2006. As to how many the Company will train in

2008, both witnesses Cutshaw and Myers stated that the Company only had 8 total apprentices to be trained, then Mr. Cutshaw stated that there were 11 then 13 apprentices going through the program in 2008. Whichever number of apprentices is correct is not the 16 that were projected in the MFRs. (Cutshaw/Myers panel deposition pages 27 and 30). Based on the statements of these two witnesses, the Company has overstated its original projection of 16 apprentices that will be trained each year.

Q. DID THE COMPANY'S ADJUSTMENT INCLUDED IN ITS FILING OR ITS RESPONSE TO INTERROGATORY 45 TAKE INTO ACCOUNT THE ACTUAL LEVEL OF TRAINING THAT TOOK PLACE IN 2006 WHICH WAS ESCALATED FOR 2008?

A. No. it did not. Witnesses Cutshaw and Myers admitted that the 2006 test year did include costs associated with the materials purchased for the home study state lineman training course. (Cutshaw/Myers panel deposition, pages 20, 27-28) There is also the discrepancy between the original estimate of incremental materials cost of $5,000 per division ($10,000), which subsequently got updated to $11,000. Also, Mr. Cutshaw agree that the 2008 projected materials cost would have to be adjusted for at least 4 and possibly 12 total apprentice workbooks purchased in 2006 that were escalated into 2008. As a result, the Company's over/above adjustment for $50,800 for 2007 did not occur and the $54,354 for 2008 is overstated because the 2006 expense included some of these training materials. In addition, the TECO training program will not take place.

Q. DO YOU BELIEVE THAT THE COMPANY HAS JUSTIFIED THE NEED FOR AN ADDITIONAL DEDICATED TRAINER FOR THE NORTHWEST DIVISION?

A. No, I do not. Based on the information that I have reviewed, I cannot determine if the Company has finalized what it plans to do regarding its training program. If this training program were so essential to the Company's operations, then it should have implemented this program without waiting to see if it will be approved in the rate case. Also, based on the statements by witnesses Cutshaw and Myers, the employees that need to be trained will be completing the state home-study program and on-the-job training. Whether the number is 8, 11 or 13 apprentices to be trained, a full-time dedicated trainer for this size Company does not appear to be necessary or cost-effective.

Q. WHAT ADJUSTMENT ARE YOU PROPOSING FOR THE COMPANY'S INCREMENTAL TRAINING EXPENSE?

A. I am recommending a combination of adjustments. As I have testified above, I do not believe that the Company has shown that a full-time trainer is justified or supported. The Company does, however, need to continue to train its linemen in a way to allow for promotions and continual upgrades. First, I believe that the Company has initiated planning on how to improve its training program but I am not convinced that the best cost-effective program has been fully addressed and analyzed. I believe that the Company is still in the process of deciding which program best meets its needs and just threw together the facts and the highest program cost to see what type of approval

the Commission would give the Company in its rate case. This appears obvious because the Company changed its program in October 2007, which coincided, with the discovery period for this rate proceeding. This type of evolving and "wait and see" process of decision making is inadequate to use as a basis in setting future rates. It forces the Commission and other intervenors, such as OPC, to decipher out these changing costs and benefits without having all of the tools necessary to make a complete and adequate decision, when the responsibility of making its own case for prudence lies solely with the Company.

Further, I do not believe that the Company has justified that the over/above materials for training above the 2006 level has been adjusted out the Company's projection. Based on the above, I recommend that the Company's requested adjustment for incremental training costs be denied. As I discuss further below, I have recommended that one of the other new positions that the Company has requested be used as a part-time training coordinator. Accordingly, I recommend that the Company's expenses be reduced by the 2008 over/above adjustment of $54,354 ($27,127 x 2).

Additional Employee to Handle Joint Use Audits and Administer Pole Inspections

Q. WHAT OTHER NEW POSITIONS HAS THE COMPANY PROPOSED FOR OPERATIONS IN ITS OVER/ABOVE EXPENSE REQUEST?

A. The Company has also requested one new employee that would handle joint use audits and administer pole inspections. The salary and benefits for this position totals $76,609 with an additional travel expense for this position of

$22,838, for a total new position expense of $99,447. The Company allocated this expense between joint use audits (22% or $20,909) and pole inspections (79% or $78,538). In response to Interrogatory No. 57, the Company stated that the new employee will be used to coordinate the audits and inspections, and will be involved with data collection and submitting required reports to the Commission.

In his deposition, Mr. Cutshaw stated that this position had not been filled as of yet. He further stated that this position would ". . . be filled when we feel like we will get adequate recovery in the rate case proceeding." (Cutshaw/Myers Panel deposition page 45). Mr. Cutshaw stated that the position will handle and coordinate all the pole inspection requirements and reporting requirements, as well as other job functions. In responding to why this position was needed, Mr. Cutshaw stated that the contractors will provide the Company with the information on the inspections; however, a position is needed to coordinate and prepare reports for all the information from the wood pole inspection program, the transmission inspections, and the vegetation management program. Reports have to be submitted each year on March 1st to the Commission. (Cutshaw/Myers deposition, pages 45-46)

Q. HAS THE COMPANY DESCRIBED WHAT IMPACT THE REPORTING REQUIREMENTS WILL HAVE ON 2008 FOR THE STORM HARDENING PROGRAMS?

A. Yes, it has. On page 48 of his deposition, witness Cutshaw stated that the reporting requirements for 2008 will be very minimal because the Company has not done a lot of the storm hardening requirements in 2007. The

Company did not do the 3-year vegetation management, and did not do any joint use audits or pole inspections in accordance with the requirements. Because of this, Mr. Cutshaw stated that the 2008 reporting requirements should be fairly easy.

Benefits for Safety Coordinator Upgrade from Contract to Salaried Position

Q. HAS THE COMPANY MADE AN ADJUSTMENT TO REFLECT BENEFITS FOR A SAFETY COORDINATOR POSITION?

A. Yes. The Company also requested incremental expenses of $10,000 in 2008 to change a position from a contractual/no benefits position to a full-time position for the Company safety coordinator. In response to OPC Production of Document Request No. 79, the Company stated that the Company currently employees a retired FPU employee as the electric safety consultant on a contractual basis. The $10,000 represents the incremental benefits associated with this position so that the Company can hire another person on a full-time basis to fill this position.

Q. ARE YOU RECOMMENDING AN ADJUSTMENT TO THE BENEFITS COMPONENTS OF THE COMPANY'S ADJUSTMENT FOR THIS VACANT POSITION?

A. Yes. In all of the proposed over/above salary/payroll adjustments, the Company took the projected salary increase and escalated that amount by an overhead factor using certain percentages for payroll benefits and taxes. As reflected on the Company's response to OPC Production of Document Request No. 78.1 (relating to the NW Division), the Company calculated the

overhead factor using two components. The first component was calculated based on days of holiday, vacation and sick leave and resulted in a factor of 12%. The Company then added in 26% for taxes and insurance, for a total direct overhear factor rounded to 38% for the NE division. For the NW division, the overhead factor used was 41% (holiday/leave component 15%) and for South Florida employees the overhead rate was 37% (holiday/leave component 11%).

Q. DO YOU BELIEVE THAT IT IS APPROPRIATE TO USE A COMPONENT FOR HOLIDAYS AND LEAVE HOURS WHEN CALCULATING THE PAYROLL OVERHEAD RATE?

A. No, I do not. In her deposition, witness Martin agreed that while vacation and holiday pay is a normal benefit for all employees, those benefits are included as part of your salaries and it was a mistake to include that component as an additional part of payroll overhead. She stated that the holiday/leave component should be subtracted from the overhead factor. (See Martin/ Khojasteh/Mesite Panel Deposition, page 84-85).

Q. DO YOU HAVE A RECOMMENDED ADJUSTMENT REGARDING THIS POSITION?

A. Yes, I do. Consistent with Ms. Martin's statement regarding the payroll benefits overhead factor, I believe that the overhead adjustment is excessive. For the NE division, the overhead factor applied was 38% of which 12% should be removed for the vacation/leave component included by error. Backing out the 12% erroneous factor, leaves a proper overhead adjustment of

$6,842 ($10,000/ 38% x 26%). The necessary adjustment is a reduction to expenses of $3,158, which should be allocated 100% to electric.

Clerical Position for Maintaining Compliance

Q. HAS THE COMPANY REQUESTED ANOTHER NEW POSITION RELATED TO OPERATIONS?

A. Yes. In addition to the safety consultant, the Company has requested funding for a new position to assist in assuring that the Company stays in compliance. The cost in the over/above schedule reflected $33,280 being added in 2008 of which 28% or $9,318 was allocated to electric. In response to OPC Production of Document Request No. 80, the Company responded that this position would be responsible for coordinating training programs, tracking training, assisting in safety and training, and other research. The cost of this position was to be allocated between the gas and electric operations and would be a clerical position. As discussed below, I do not believe that the Company has justified that it needs this additional position; therefore, expenses should be reduced by the electric's allocated share of $9,318.

Q. HAS THE COMPANY FILLED THE FULL-TIME TRAINER, THE JOINT USE AUDIT/INSPECTION POSITION, OR THE CLERICAL SAFETY POSITION?

A. No, none of the positions have been filled and I believe that the evidence is clear that the Company will not fill these positions unless it receives rate recovery from the Commission. If there is such a pressing need for any of these positions, I believe it is imperative for the Company to take action on its

own and fill these positions. What assurances do the ratepayers and the Commission have that the Company in fact will in fact fill these positions if they have not even starting the hiring process as of this date? At a minimum, the positions will be filled in June or later given the timing of the rate case.

Q. DO YOU BELIEVE THAT THE COMPANY HAS SHOWN THAT IT HAS A NEED FOR THREE ADDITIONAL POSITIONS FOR STORM HARDENING, SAFETY AND TRAINING PURPOSES?

A. No, I do not. I believe that the Company has supported the need for one additional position which can handle a combination of functions; however, certainly not one position for each function. Moreover, the Company has the existing safety coordinator position that can be combined to offset some of the training and inspection coordination and reporting requirements. As addressed earlier, the Company has stated that the 2008 reporting requirements will be minimal. Thus, I believe that with the additional benefits added for the safety coordinator, that person can handle the training, safety and inspection coordination for the NE division and a new position should be added to handle the training, safety and inspection coordination for the NW division. I do not believe that the Company has justified the need for an additional clerical position.

Q. WHAT IS THE RECOMMENDED SALARY AND BENEFITS THAT YOU BELIEVE SHOULD BE ALLOWED FOR THIS COMBINED POSITION?

A. I believe that the original salary requested for the joint use/pole inspection

employee of $58,930, with benefits of $15,321 (overhead rate of 26%) should be allowed, for a combined expense of $74,251. This results in a decrease of $2,358, which is 100% allocated to electric.

Q. WHAT ADJUSTMENT DO YOU RECOMMEND FOR THE INCREMENTAL TRAVEL EXPENSES THAT THE COMPANY ADDED FOR THE NEW POSITION FOR STORM HARDENING?

A. Since I have recommended that each division receive a position for training, storm hardening and safety, I do not believe that the additional travel expense that the Company estimated for the storm hardening (joint use audits/pole inspections) will be required. Each of the service territories is limited in size and certainly an employee located in each division will not incur incremental travel costs on a regular basis as originally projected by the Company. Thus, I recommend that the Company's adjustment of $22,838 for travel be removed.

Storm Handling Contracts

Contractor to Perform Inspection of Transmission System

Q. IN ADDITION TO THE NEW POSITION FOR JOINT USE AUDITS AND POLE INSPECTIONS, HAS THE COMPANY REQUESTED AN ADDITIONAL EXPENSE FOR CONTRACTUAL LABOR RELATED TO TRANSMISSION AND DISTRIBUTION INSPECTION COSTS?

A. Yes it has. The Company included in its over/above expense schedule an adjustment for inspections for the transmission system, the distribution systems and vegetation management. I will discuss each adjustment separately below in my testimony.

Q. WHAT AMOUNT DID THE COMPANY INCLUDE IN ITS OVER/ABOVE EXPENSES RELATED TO TRANSMISSION INSPECTION EXPENSES?

A. In its over/above expense the Company included $18,540 in annual expenses related to hiring a contractor to inspect its transmission system. In response to Interrogatory No. 54, the Company based this increase on an estimated cost of $112,449 to inspect the total transmission system which would be completed in a 6-year cycle, in order to comply with the Commission's storm initiative. To date, the Company has performed only visual inspections of its transmission system and corrected items found during these inspections. However, the proposed transmission inspection program is much more detailed and has not been performed to this level in the past. The Company included 1/6 of this cost as an over/above increase for 2008.

Also, in his deposition (Cutshaw/Myers panel, pages 13-14), witness Cutshaw stated that the Company was not going to spend $18,000 each year. He indicated in some years they might spend $60,000, the next year zero, and the following year $60,000 or $70,000. He stated that the Company put the $18,540 in the test year to normalize the expense over a six-year period. Mr. Cutshaw also stated that the Company had not entered into a contract to perform these inspections and that any contract negotiations will not begin until the Company knows the outcome of the amounts allowed in the rate case.

Q. WHAT KIND OF SUPPORT DID THE COMPANY PROVIDE FOR

THIS COST ESTIMATE?

A. In support of this estimate, the Company included one letter with a written estimate from Pike Electric, Inc. dated November 7, 2006 (Interrogatory Exhibit 54.1). This was the only estimate that the Company submitted in response to OPC's discovery requests. The Company stated that it did not receive any other bids or estimates from other vendors. I would also note that the letter stated that the cost was only an estimate and that the hourly rates reflected were effective until December 31, 2006.

Q. DO YOU BELIEVE THAT THE COMMISION SHOULD SET RATES BASED ON THIS ONE ESTIMATE?

A. No, I do not. While I agree with normalizing the expense over several years, I believe that that the Company has not adequately supported what level of expense will be incurred in 2008. If the Company had solicited bids for this project or had received estimates from more than one vendor, a comparison could be made to determine if the estimate requested is reasonable. Also, the Company cannot definitively state how often the Company will inspect its system as evidenced by Mr. Cutshaw's response to questioning in his deposition. As he stated, these actual amounts to be incurred each year are unknown at this time.

Because this is an item that the Commission has required as part of the storm initiative, I believe that it is important for the Company to comply with the Commission's directives. Because the Company has not adequately justified its requested expense, I am recommending that the Commission disallow 25% of the Company's projected normalized expense for lack of

support. I believe that an expense level of $4,635 should be disallowed and that the allowed test year expense should be $13,905.

Contractor for Distribution Pole Inspections

Q. PLEASE EXPLAIN THE ADJUSTMENT THAT THE COMPANY INCLUDED FOR DISTRIBUTION POLE INSPECTIONS.

A. In its Over/Above Expenses Schedule, the Company added an incremental expense of $219,833 labeled contractor and new employee to handle distribution pole inspections. In response to Interrogatory 57, the Company separated the components of the new employee and contractual expense related to joint use audits and pole inspections (discussed earlier in my testimony). Based on that response, the Company stated that it would incur $141,367 per year in distribution pole inspections from an outside contractor ($46.35 per pole time 3,050 poles).

In Document Request No. 72(c), OPC requested all documents to support the basis of the Company's projection of the $219,833 expense adjustment. The only document that the Company provided to support the contract estimate was a document entitled "Osmose Utilities Service, Inc. Acceptance Copy". It is unclear as to the origin of this document and whether this was part of a larger document or any other estimate prepared by Osmose. At the bottom of the document, there is a date of May 17, 2007. The document included a description of items with corresponding prices and appeared to relate to pole inspections. There was a statement at the top that reads: "Approximately 3,000 Distribution Poles" before the list of items and prices. There was no total price or a total of the cost on a per pole basis that could be

used to derive the $46.35 per pole estimate used by the Company. This document contained no calculation or even a discussion of how the total inspection cost that the Company used in its filing was developed. I have attached this document as an Exhibit PWM-3, entitled: OPC Production of Documents Exh. 72.2 Osmose Estimate.

Q. HOW DID THE COMPANY DETEMINE THIS $46.35 COST PER POLE?

A. The exact calculation that was used to determine this cost per pole has not been provided. In his deposition, witness Cutshaw was asked how the $46.35 cost per pole was estimated. (Cutshaw/Myers Panel Deposition, pages 55-56). He stated that the following components on Exhibit 72.2 were used; however, he could not explain how the exact dollar amount of the cost was originally estimated. Using the Osmose estimate, Mr. Cutshaw stated that the following dollar components were included: External Treat $29.88, Sound and Bore $7.75, FastGate® Delivery $0.60, LoadCalc™ $7.26, CATV Attachments $0.60, Telephone Attachments $0.60, and GPS Reading: 3-10 Meter $0.98. These seven items total $47.67, not the $46.35 used by the Company in its response to Interrogatory No. 57(d).

Since a portion of the cost of pole inspections is increased due to joint users, any costs directly caused by joint use attachments should not be covered by the ratepayers. It is unreasonable to charge the ratepayers 100% for this expense since it benefits other users and these costs do not relate to the cost of providing electric service to the electric customers. I recognize that the current joint use agreements may not include any reimbursement or

recognition of any incremental pole or load inspection costs as these are new programs. However, we are not recommending any revenue adjustments. Regardless, the full amount of projected storm hardening expenses for these types of reimbursable costs should not be borne by the electric customers. Accordingly, I believe that the costs of LoadCalc™, CATV and Telephone attachments should be removed from the test year expenses. This totals a reduction in the per pole inspection cost of $8.46 ($7.26 + $0.60 + $0.60) per pole which should not be charged to electric ratepayers. Deducting this cost reflects a rounded cost per pole inspection of $38.

Q. WHAT CONCERNS DO YOU HAVE WITH THE COMPANY'S ADJUSTMENT BASED ON JUST ONE ESTIMATE?

A. I am concerned that this estimate is very preliminary and that the Company has not even decided what inspection parameters that it wants to pursue. As stated by Mr. Cutshaw in his deposition (page7-9), the Company has not done a competitive bid process, which would only take about a month. He stated that there are contractors other than Osmose that they can contract with, or allow them the opportunity to bid on the project. Witness Cutshaw also stated that he did not know the specifications that would be bid, that it might be similar to the Osmose estimate; however, if the Company does not receive the recovery that they feel will allow them to accomplish the estimated tasks, it would amend its storm plan and do a different type of inspection process. Mr. Cutshaw further stated that if they did not get recovery to the extent the Company felt was appropriate, it might refile and continue doing the pole inspections as done in the past, using current employees with a quick

inspection and not going to the level of detail required or recommended in the storm hardening plan from the Commission.

Q. DO YOU RECOMMEND ANOTHER ADJUSTMENT TO RECOGNIZE THAT THE COMPANY'S ADJUSTMENT IS PRELIMINARY BASED ON JUST ONE ESTIMATE?

A. Yes, consistent with my adjustment to the distribution inspection costs, I believe that the Company should have solicited bids from more vendors. Further, the Company must determine exactly what level of inspection it intends to have performed which it has not done to date. Because this is an item that the Commission has required as part of the storm initiative, I believe that it is important for the Company to comply with the Commission's directives. Because the Company has not fully supported its requested expense, I am recommending that the Commission disallow 25% of the Company's projected expense after the adjustment is removed for the joint use components. I believe that an additional amount of $28,975 should be disallowed. This results in a per-pole inspection cost of $28.50. Accordingly, I recommended that the Company's incremental distribution pole expense should be $86,925. This is calculated by taking the Company's requested 2008 incremental expense of 141,367 and decreasing that amount by $25,467 for joint pole attachments costs and by $28,975 for unsupported costs. These reductions are allocated 100% to electric operations.

<u>Vegetation Management/Tree Trimming NW FL</u>

Q. WHAT ADJUSTMENTS DID THE COMPANY MAKE TO ITS

FILING REGARDING TREE TRIMMING?

A. The Company made two adjustments for tree trimming. The first adjustment was a normalization adjustment to the NE division to reflect 2 crews for a full year. During two months in 2006, the Company had only had 1 crew working; the rest of the year the Company had two crews trimming trees. The Company increased 2007 by $17,500 and escalated the 2008 amount by 3.5% for an over/above adjustment of $18,113. I have reviewed this adjustment and agree that it is appropriate and do not recommend any adjustment.

Q. PLEASE EXPLAIN THE SECOND ADJUSTMENT THAT THE COMPANY MADE TO ITS FILING FOR TREE TRIMMING.

A. The Company added an over/above adjustment of $352,260 to its 2008 expenses to add 3 crews in the NW division. This adjustment would provide for a total of 6 crews in the NW division. In it response to Interrogatory No. 58, the Company addressed the average miles of line trimmed per crew for the NW division to be 36 miles per crew or 108 miles per year for the three crews. The Company performed an analysis of three different mileage amounts per crew (50, 40 and 35 miles), and then took into consideration its total miles of feeders and laterals and the number of years for repeat inspection (3 years for feeders and 6 years for laterals) to calculate the necessary number of crews per year. Using this analysis the Company used the lowest number of miles per crew of 35 to support its need for 4 crews. The Company also added 1 additional tree trimming crew to address danger trees and spot trimming necessary to avoid outages related to tree conflicts. This resulted in a total

number of crews for 2008 of 5 crews, not 6 as originally requested in the MFRs. In this Interrogatory, the Company lowered its requested over/above expense adjustment from an increase of $352,260 to an increase of $234,840.

Q. DO YOU AGREE WITH THE COMPANY'S REQUESTED INCREASE IN TREE TRIMMING EXPENSE?

A. No, I do not. In OPC's Production of Document No. 73, the Company was requested to provide the study or analysis which the Company used to determine that an additional three crews were necessary. In its response in Production of Document Exhibit 73.1, the Company provided an analysis of tree trimming per year for 2004 through August 2007. During this time, the Company trimmed a total of 474.38 miles. The average per crew for this 3.67-year timeframe results in 43.09 miles per crew. Looking at just 2006, the average for the 3 crews was 47.13 miles per crew. Based on these numbers provided by the Company, I believe that the requested 35 miles per crew is understated. A more reasonable estimate is 40 miles per crew (the middle option provided by the Company) which supports the number of crews that the Company currently utilizes in its NW division. This mileage estimate supports that the Company's 2006 level of 3 tree trimming crews is sufficient to meet the needs of storm hardening.

Q. DO YOU BELIEVE THAT THE COMPANY HAS JUSTIFIED THE NEED FOR AN ADDITIONAL CREW JUST TO HANDLE DANGER TREES AND SPOT TRIMMING?

A. No, I do not. The Company has not provided any support justifying this

additional crew will be needed on a full time basis. We did not receive any information reflecting what amount of spot trimming or danger tree trimming has been used in the past. If the Company had this type of data or other analysis, it should have been provided in response to OPC's Production of Document Request No. 73.

Q. WHAT ADJUSTMENT DO YOU RECOMMEND FOR TREE TRIMMING FOR THE NW DIVISION?

A. I recommend that the Company's over/above adjustment should be removed. Accordingly, $353,260 should be removed from the 2008 expenses.

Provide Personnel to Be Located At EOC During Emergency

Q. PLEASE EXPLAIN THE COMPANY'S ADJUSTMENT TO PROVIDE PERSONNEL TO BE LOCATED AT THE COUNTY EMERGENCY OPERATIONS CENTERS (EOC).

A. In its Over/Above Expenses Schedule, the Company increased its expenses by $19,991 for costs associated with providing personnel to be located at either of the two county EOCs during storms or other emergencies. In response to Interrogatory No. 60, the Company states that this expense was based on one storm event per year and that based on its limited work force, placing an employee at the EOC during previous hurricanes was not possible. Based on witness Myers statement in his deposition, this cost included a typographical error and the amount of the increase in expense should have only been $9,991. (Cutshaw/Myers panel deposition page 77). Additionally, an assumption behind this amount was that non-electric employees of the Company would be

dispatched to the county EOC since the electric employees would be otherwise occupied doing storm planning or restoration work.

Q. IS THIS TYPE OF EXPENSE ONE THAT WOULD BE NORMALLY RECURRING AND PROPERLY INCLUDED IN THE BASE RATE DETERMINATION?

A. No. This type of expense is certainly non-recurring as the historical number of storms impacting this Company have been minimal, especially compared to the other utilities in the state. Also, to the extent that FPU does have to incur incremental costs to locate employees at a county EOC, the prudently incurred costs that are above those included in base rates would be properly recoverable through the storm reserve. Based on the above, I believe that the total $19,991 should be removed from the test year 2008 expenses.

<u>New Positions Customer Relations, Corporate Accounting & Information Technology SOX 404 IC Requirements-Customer Relations</u>

Q. PLEASE EXPLAIN THE COMPANY'S REQUESTED INCREASE FOR A NEW POSITION TO MEET THE NEW INTERNAL CONTROL REQUIREMENTS.

A. In its Over/Above Expenses Schedule, the Company included an increase in Customer Relations Expenses and labeled it a customer relations analyst/coordinator. The Company explained this position was to meet the SOX/404 internal control requirements. In response to Interrogatory No. 62, the Company stated that it needed to hire a new internal auditing position to comply with the requirements of the Sarbanes-Oxley Act of 2002 and Section

404 Management's Assessment of Internal Controls. This position will assist with the documentation requirement of Section 404, internal control testing and overall internal controls necessary for a Company. Along with the audit requirements, the work load continues to increase within the accounting department on a whole and an increase in staff is required at this time to meet the work load of the department on a whole. The total increase for this new position is $56,992 of which 30% or $17,098 was allocated to electric for 2008.

Special Audits: Inventory, Cash & Other Procedures- Corporate Accounting

Q. WHAT ADJUSTMENT DID THE COMPANY MAKE FOR SPECIAL AUDITS, INCLUDING INVENTORY, CASH AND OTHER PROCESSES?

A. Under the category Expenses for Corporate Accounting in its Over/Above Expense Schedule, the Company has also requested a new position for compliance accounting with an explanation that this position is needed for special audits including inventory, cash and other processes. The total increase for this new position is $82,200 of which 40% or $32,880 was allocated to electric for 2008. In response to Interrogatory 65, the Company similarly discusses the need for an additional accounting position to audit for internal controls, cash and inventories. Based on the responses to both Interrogatories Nos. 62 (labeled as a customer relations position) and 65 (labeled as a corporate accounting position), it appears that the Company responded to Interrogatory 62 incorrectly as that position is related to customer relations not to corporate accounting. Thus, no explanation was

provided for the need for a new customer relations position in its response to Interrogatory No. 62.

Q. HAS THE COMPANY FILLED EITHER OF THESE POSITIONS AS OF YET?

A. No. Witness Martin stated in her deposition that the Company would hire both of these positions in January 2008; however, neither position had been advertised. As mentioned several times by witness Cutshaw in his deposition, I believe that the Company will not fill either of these two positions until rate recovery is received.

Q WHAT KIND OF DOCUMENTATION HAS THE COMPANY PROVIDED TO SUPPORT THE COST AND NEED FOR EACH OF THESE TWO POSITIONS?

A. In response to OPC Production of Document Request No. 78, the Company included Exhibit 78.1 for support of its estimated cost for the new internal audit position. This adjustment was supported by an online recruiting bulletin for an accounting position in the South Florida area. Further, based on my review while at the Company's corporate offices and based on statements made by witness Martin in her deposition, the current accounting staff does work long hours and a new position is needed for the corporate accounting staff. While I agree with the annual salary level, the Company has made no movement toward hiring this position. Even though witness Martin stated that this position would be filled in January 2008, we are only days away from the end of 2007. Based on my experience, the hiring, planning, advertisement,

interviewing and decision making takes months to accomplish. I also believe that the Company will not initiate the hiring process until the rate case is completed, which will be the middle of May 2008 when the final order is scheduled to be issued. A conservative guess would be that the position would be filled in July.

Q. WHAT IS YOUR RECOMMENDED ADJUSTMENT TO BOTH OF THESE REQUESTED POSITIONS?

A. First, I believe that only half of the proposed salary for the new internal audit/accounting position should be approved. The Company should not be allowed to annualize an expense in the test year that most likely will not be filled until the middle of the year. The annual salary for this new internal auditor position is $60,000 plus benefits at 38% of $22,200, totaling $82,200 for the full year. I am also recommending that the Vacation/Leave component in the overhead factor be removed of 12%. Thus, 50% of the $60,000 salary would be $30,000 with a 26% benefits overhear factor added equals a recommended 2008 salary level of $37,800. Using the 40% allocation factor, the electric system share is $15,120. Based on the above, my recommended adjustment to electric account number 920 is a decrease of $17,760.

Q. WHAT ABOUT THE CUSTOMER RELATIONS POSITION FOR INTERNAL CONTROL?

A. I do not believe that the Company has adequately justified the need for this position. First, the Company did not respond to OPC's discovery questions sufficient to demonstrate that this position was necessary. Second, this

position has not been filled as of today. Accordingly, the over/above expense increase of $17,098 should be disallowed.

Information Technology Vacant Positions (Mislabeled SOX 404)

Q. PLEASE EXPLAIN THE COMPANY'S ADJUSTMENT TO INFORMATION TECHNOLOGY 2006 PROGRAM VANCANCIES?

A. In the over/above schedule the Company added a new position in the expense for information technology to fill the 2006 program vacancies. The reason for this incremental expense was this position was needed to meet SOX404 internal control requirements. The Company included a total of $90,110 for the salary and benefits adjustment for 2007 and $95,066 for 2008. The 2007 adjustment was escalated by 5.5% to get the 2008 incremental expense. The adjustment for electric for 2008 allocated at 40% was an increase of $38,026.

Q. DO YOU BELIEVE THAT THIS POSITION WAS NEEDED FOR INTERNAL CONTROL PURPOSES?

A. No I do not. The Company has provided very little support for this adjustment. Basically I believe that because the Company mislabeled it as being required by internal control purposes that it mistakenly got side-tracked in documenting the need for this expense. Upon reviewing documents submitted to us on December 13, 2007, the supporting workpapers for this adjustment were provided. Based on this documentation, I do not believe that this adjustment relates to internal control requirements at all. It is simply an adjustment to normalize the 2 vacancies in the information technology department that have not been filled since 2006. Because the Company listed

this expense as an increase related to internal control requirements, it mistakenly failed to support the basis for this increase. Without support showing that these two positions have been hired in 2007 at a full time level, I believe that the adjustment is improper and should be disallowed. Accordingly, I recommend that the full allocated share to the electric division of $38,026 for 2008 should be removed.

Expenses for Executive Salaries and the Salary Survey Adjustments

Q. WHAT ADJUSTMENTS DID THE COMPANY MAKE FOR EXECUTIVE SALARIES AND THE SALARY SURVEY?

A. In its Over/Above Expense Schedule, the Company included increases in executive salary expense for 2007 and 2008 of $48,845 and $51,531, respectively. In addition, the Company made several over/above adjustments for what it labeled "to bring salaries up to market based on a salary survey." The total adjustments related to the salary survey were increases of $16,660 for 2007 and $49,980 for 2008.

Executive Salaries

Q. PLEASE EXPLAIN THE COMPANY'S ADJUSTMENT TO EXECUTIVE SALARIES?

A. In response to OPC Production of Document Request No. 82, the Company explained that the executive salary adjustment was based on the last 3 years to bring the executives' pay more in line with the current market. The Company attached Exhibit 82 to support the calculation used for the 2007 and 2008 adjustments.

This exhibit consists of several pages that reflect the calculations of pay increases for the 3 executives for 2004 through 2006. Looking collectively at the pay raises given to the executives for these years resulted in an average pay raise of 11% for 2005 and 2006. The actual pay increases per person range from 7.36% to 14.93% in 2005, and 8.83% to 12.75% in 2006.

Q. DID THE COMPANY SUBMIT ANY ANALYSIS TO SUPPORT THAT THE SALARIES WERE NOT REFLECTIVE OF THE CURRENT MARKET?

A. No, it did not. All the Company submitted was a calculation that applied the 11% average pay increase for all 3 executives across the board and add a 37% payroll overhead factor to this amount. The Company then calculated the difference between the 11% increase and a 5.5% pay increase. To this amount, the Company added the 37% overhead to reach the 2007 expense increase of $48,845.

Q. DO YOU AGREE WITH THE ADJUSTMENT THAT THE COMPANY MADE TO EXECUTIVE SALARIES?

A. No, I do not. First of all, the Company has not provided any documentation to demonstrate that its executive salaries are below market for an organization of this size. Second, the executives are taking the position that its salaries are more important than those of those employees in lower ranks. As a comparison, the Company requested an over/above 2008 salary increase of $51,530 for the executives but requested an over/above increase of $49,980 to bring its corporate and divisional non-union employees up to market. In

response to Interrogatory No. 106, the Company indicated its total payroll dollars increased by 4% in 2005 and 2% in 2006. In response to Interrogatory No. 108, the Company stated that the normal merit increases in 2004 and 2005 were 5% and 5.25%, respectively, with increases of 5.5% in 2006 and 2007. The Company also projected merit increases of 5.5% for 2008, plus the adjustments for the salary survey.

This reflects quite a stark difference in what the overall population of employees received compared to the executives. I believe that the executive pay raises should be more in line with those allowed for other employees.

Q. WHAT ADJUSTMENT ARE YOU RECOMMENDING FOR EXECUTIVE SALARIES?

A. I am recommending that the Commission take the 2006 salary levels (including incentives), which were escalated from 2004 to 2006 by 21.5% (over a 2-year period), and assume that those increases were sufficient to bring the executives up to current market. Beyond the 2006 actual levels, I believe that the executive pay raises should be limited to the 5.5% merit pay raises that the Company felt was sufficient for its other employees. Since the Company has already increased administrative salaries by 5.5% per year, the only adjustment necessary is to remove the over/above adjustment that the Company made to 2008. Thus, I recommend that the Company's 2008 over/above adjustment for executive salaries of $51,531 be removed. The electric allocation of this expense at 40% is a reduction of $41,225.

Salary Survey

Q. PLEASE EXPLAIN THE COMPANY'S ADJUSTMENT TO THE SALARY SURVEY?

A. In its MFRs, the Company increased 2007 and 2008 salaries to reflect an adjustment based on an internal salary survey to bring non-executive salaries up to market. The 2007 adjustment reflected an increase of $16,660 and an increase of $49,980 for 2008. In response to OPC Interrogatory No. 105, the Company stated that the salary survey was not expected to be completed until December 2007. The Company also stated that some personnel will require immediate adjustments to bring them up to a reasonable range and that other deficiencies will be corrected over time. Witness Martin stated that the Company made a "high level estimate" of an increase based on the salary survey and deemed that estimate to be $102,000. (Martin/Khojasteh/Mesite panel deposition, page 106). It then allocated $51,531 of the estimate to the executives and the remaining $49,980 to other corporate and division level non-union employees.

Q. HAS THE COMPANY PROVIDED THE EMPLOYEES WITH ANY OF THESE SALARY INCREASES TO DATE?

A. No, it has not. As discussed in her deposition, witness Martin stated that even the 2007 projected salaries were overstated by $34,000. (Martin/Khojasteh/Mesite panel deposition, page 110). In late-filed deposition Exhibit 14 (Martin/Khojasteh/Mesite panel deposition), the Company revised the salary survey adjustment for 2007 and 2008. Instead of the $16,660 adjustment for 2007, this adjustment now totals $34,000. For 2008, the original amount of the 2008 salary survey adjustment was $102,000;

however, that amount was decreased to $64,135 as reflected on page 3 of this same late-filed exhibit. On page 4 of the exhibit, the 2007 electric allocated portion for 2007 remains the same as the amount included in the MFRs schedule for over/above adjustments but the 2008 electric allocated amount decreased by $11,293 (from $43,382 to $32,089). Even though the amount allocated decreased, this 2008 adjustment was based on the original 2008 total Company salary adjustment of $102,000, not the revised 2008 adjustment reflected on page 3 of $64,135. Regardless of all of these inconsistencies, neither the original nor the revised salary adjustment amounts have been given to any employees as of yet.

Q. WHAT COMMENTS DO YOU HAVE REGARDING THE REQUESTED ADJUSTMENTS FOR THE SALARY SURVEY?

A. I believe that it is very unclear what adjustments the Company will make related to its salary survey. We have been provided several documents through the discovery process that were supposed to document how the Company derived its adjustment based on the salary survey. Until late-filed exhibit 14 was provided on December 20, 2007, OPC had asked on numerous occasions for the supporting calculations behind the salary survey adjustments. By looking at this document, which appears to be created on December 17, 2007, the Company did not even know what amount the adjustment would be. I am still unclear as to which adjustment the Company is now proposing.

Q. WHAT OTHER COMMENTS DO YOU HAVE ABOUT THE SALARY

SURVEY SUBMITTED IN LATE-FILED DEPOSITION EXHIBIT 14?

A. Looking at the salary survey, it is unclear what the Company has actually done. It appears that the salary survey adjustment is mainly an adjustment for salary range only, and generally does not reflect many employees below the minimum of the current or proposed ranges. Also, the "adjustment" for the "salary survey schedule" is titled "Difference in Salary Range 2007" and that reflects the differences between the maximum of the old and the new ranges, not the actual salaries to the minimum of the new range. The schedule also has columns for additional merit liability for 2008 and immediate adjustments for 2007. Neither column match with the amounts provided elsewhere in this late-filed exhibit, nor is an explanation provided as to the reason these amounts are included.

Q. WHAT IS YOU RECOMMENDED ADJUSTMENT FOR THE SALARY SURVEY?

A. I do not believe that the Company has supported the over/above salary adjustment that it is requesting in this case. First, it is unclear what adjustments would be necessary based on the information that we received in late-filed deposition exhibit 14 to the Martin/Khojasteh/Mesite panel deposition. Second, based on my analysis of this exhibit, at a minimum, a decrease of $23,205 to 2008 expenses is warranted to reflect the electric portion of the most recent set of salary survey numbers. Third, even if the Commission considers any adjustments that may be needed, the Company is proposing adjustments to the salary ranges, not immediate pay raises to employees. The Company has stated that the increases in the salary ranges

may not correlate into immediate salary adjustments and if granted would be given throughout the year. As such, a full year of salary increase for the salary survey is unwarranted. Lastly, the Company has stated in response to several over/above adjustments that the actual amounts expended would depend upon amounts approved in the rate case. Therefore, implementation of any salary survey adjustments may also wait until May or June 2008 after the conclusion of the rate case. Based on the above, I recommend that the Company's over/above salary adjustment for the salary survey be removed. Accordingly, a decrease of $43,382 for the electric allocated portion is appropriate.

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes, it does.

BY MS. CHRISTENSEN:

Q. Ms. Merchant, can I ask you to please summarize your testimony.

A. Thank you. Good afternoon, Commissioners. We've stipulated many of the issues in this case that relate to my testimony, so I'm only going to summarize the ones that are left outstanding.

First I would like to talk about the new positions that the company has requested as over and above increases in their MFRs and in subsequent filings in the rebuttal testimony.

In the MFRs, the company has requested five new positions. These included information technology program vacancies, a combined joint use audit and pole inspections position for storm hardening. The third one that they asked for is a corporate accounting position for special audits and internal control. They also asked for a new customer relations analyst and coordinator for internal control, and they asked for a new corporate services administrator for compliance.

In response to OPC discovery questions regarding incremental training costs, the company added in their rebuttal testimony yet another new position for a full-time training coordinator.

There are varying reasons why I have agreed or

disagreed with the new positions, which I will address. One main thing that has existed throughout this case has been the lack of supporting detail provided by the company and confusion surrounding the numerous over and above adjustments requested. Additionally, with the exception of the information technology positions, no hiring activities have occurred to date other than announcing the vacancies. We learned just last week that the IT positions were not new and had been filled in 2007. And after review of the actual salaries that the company has for those positions, we've stipulated that issue and included those in the case.

I've next recommended that the Commission allow the new position for the storm hardening activities, for monitoring pole inspections and joint use audits. However, I believe that this new position should also absorb some of the other incremental safety and training components that they've requested for the Northwest Division, and because of this, I've recommended that no additional travel allowance be given for that position because he'll be taking care of that local territory.

I also believe that the existing safety coordinator in the Northeast Division can absorb the additional reporting and training needs for that

operating territory.

Additionally, I recommend that the company recover the salary for the new corporate accounting position, but that position appears -- it appears justified, but it won't be filled until at least the middle of 2008, and thus, I've recommended that only 50 percent of that position be included for rate setting purposes.

And for the remaining two positions, for the customer relations and the clerical customer service administrator, I've recommended that these positions not be approved. The company has failed to adequately support the need for these incremental positions, and the company's responses to much of the requested discovery was not sufficient.

I next take issue with the requested increase related to the salary survey which was completed in late December 2007. First, the company admitted that the electric portion of the salary survey adjustment was overstated by approximately 23,000. Second, even if the Commission considers that any adjustments are needed, the majority of the increase that the company has proposed relates to increased salary ranges, not pay rate increases. They're not immediate raises to the employees, and if granted, may be given throughout the

year, and as such, a full year of salary increase for the salary survey is unwarranted. Accordingly, I believe that the over and above adjustment for the salary survey should be removed.

The company also included increases in executive salary expenses for the company's three executives in 2008, and the only justification they provided to me or to the Office of Public Counsel prior to rebuttal testimony was the supporting calculations, how they calculated the adjustment, and a statement that said that this adjustment was necessary to bring their salaries into compliance with the market. The 2006 executive salary levels including incentives were escalated from 2004 to 2006 by 21.5 percent, and that's prior to the test year, and then their over and above adjustment is an additional 11 percent for 2007 and a 5.5 percent for 2008.

Without further support, I do not believe the company has justified why its executives should receive these levels of pay increases, especially when its rank-and-file employees received only 5.5 percent pay increases. And those were not necessarily pay increases. They've asked for the pay grade increase, not necessarily a pay increase. And accordingly, I've removed the company's over and above adjustment for

executive salaries.

Lastly, I testify that the company's request to receive a full year of rate base recovery for a transformer is inappropriate because the project won't be placed in service until at least spring 2008. The proper ratemaking adjustment would be to reflect this plant on a 13-month average basis in rate base based on the date that the plant is put in service. The rationale provided for this exception by the company was that that a future rate case might be needed if full recovery is not allowed. The test year matching concept provides that the average rate base is matched with average cost of capital, revenues, expenses, and customer billing factors. If you mismatch one of the individual components, the risk increases that the resulting rates will be skewed and unreasonable.

And this concludes my summary.

MS. CHRISTENSEN: I tender the witness for cross-examination.

CHAIRMAN CARTER: Okay. First we'll hear from the bench. Commissioner Skop, you're recognized.

COMMISSIONER SKOP: Thank you, Chairman Carter. Getting back to the thing, I guess Ms. Merchant's testimony deals somewhat with percentage increases of executive compensation, so at the

appropriate time, it would still be nice see the unredacted confidential exhibit. I don't know whether staff or what have you, but I would like to see it, and I think Commissioner Argenziano also had an interest in seeing that.

MS. BROWN: Mr. Chairman, we have them, and we can pass them out for you all right now if you would like.

CHAIRMAN CARTER: I suppose this is as good a time as any. Let's take a moment and pass those out. Thank you.

(Documents distributed.)

CHAIRMAN CARTER: Commissioners, do you want to take a moment to look those over before we go further?

Okay. Mr. Horton, or is it -- let's see. Mr. Konuch. Did I get it right this time?

MR. KONUCH: We have no questions at this time.

CHAIRMAN CARTER: No questions. Thank you.

Mr. Hatch?

MR. HATCH: No questions.

CHAIRMAN CARTER: Mr. Horton.

MR. HORTON: Yes. It's my turn again.

CHAIRMAN CARTER: You're recognized.

CROSS-EXAMINATION

BY MR. HORTON:

Q. Ms. Merchant, good afternoon.

A. Good afternoon.

Q. A couple of things you didn't -- I want to talk to you about a couple of things you didn't mention in your summary, first of all, transmission inspections.

A. Okay.

Q. Now, the company is proposing use a contractor for inspection of its transmission poles, and you agree that this is something that needs to be done; correct?

A. Yes. It's in compliance with the storm plan.

Q. And the company received an estimate and used this as the basis for their request; correct?

A. Yes. They had one estimate. It wasn't a contract or a bid or anything like that.

Q. And your issue there is that they only had one estimate. The company's proposal is to do the inspections over a six-year cycle, and they've included one-sixth of the expense in the test year, and so far we have no objection. You don't have any objection to those proposals, do you?

A. To a six-year amortization of the cost?

Q. Right, the one-sixth for the year, yes.

A. No.

Q. The objection is strictly that we only had one estimate?

A. That's correct.

Q. And I believe you also expressed concern at the fact that the estimate was for a specific period of time; correct?

A. That's correct. It was based on 2006 information.

I also expressed on page 37 of my testimony that -- and 38 that they -- no, just 37, that they were not exactly sure what the cost was going to be, so there was still some reservation on the company's part as to what the real contract would be.

Q. Well, isn't it the case here that the company did request from a vendor an estimate on the cost to do the inspections, they received that request, and based their estimate -- this wasn't for a purchase, but this was for an estimate to include the cost associated with the inspection. Isn't that where we are now? They got an estimate?

A. Right. They have one estimate, and our position on this is that they should have gotten more than one just to be able to tell us that -- you know, similar to how they did for the pole costs. They got, I think, four for the pole, the concrete pole costs, but

here they got one, and that was just what we were looking at. And all I did was reduce it by 25 percent because they didn't have but just one. So we're recognizing 75 percent of the cost, and the 25 percent that we've recommended to be disallowed is basically for not having more than one estimate.

Q. Would you expect vendors -- if you were a vendor, would you be willing to spend a lot of time and effort on the preparation of an estimate if you knew there wasn't a chance of a purchase or if it was just being used for preparation?

MS. CHRISTENSEN: Objection. Calls for speculation.

MR. HORTON: I'll rephrase it.

CHAIRMAN CARTER: Okay.

BY MR. HORTON:

Q. Have you ever had the opportunity to request estimates from vendors?

A. Yes, many times.

Q. For what purpose?

A. I just did a kitchen remodel.

Q. And how many estimates did you get?

A. Lots. For all different types of -- for the different types of contractors that I needed, I went and got probably two or three for each one.

Q. And they knew that you were in a position to award that estimate, go ahead and make a purchase at that time, did they not?

A. I don't know what they knew, but -- I mean, I was asking for their business, or I was inquiring about their business. If they're in the business to -- if they want my business, then they would probably answer my question. And that's the experience I had, is that they were willing to give me estimates.

Q. Do you think if they had not known that you were willing to give them the business that they would have been as willing to give you an estimate?

A. I didn't go up front and tell them that I'm not going to choose them. And we did -- I think that's just a common thing. You're not going to give all your cards when you're asking for an estimate, but you just see what it is. You just see what the range is, you see how their quality is. You might pay more for better quality, or they might be equal quality, and one is a cheaper contract. So you've just got to look at each individual, and then when you have all these different contracts together, you can consider which one is the best option to go with.

Q. All right. But you took the estimate. You recognize that this needs to be done and there is a

cost, and you took the estimate and reduced it by 25 percent, and your only basis for reducing it by 25 percent is that we only had one estimate; is that correct?

A. Right. I reduced it by 25 percent because we would have preferred to have seen more than one estimate or contract or bid. If we had seen several of these things, it might have been that that was the more reasonable, but we didn't see any more to compare it to, so we didn't have a basis to say that was the most reasonable contract that we had, or bid or estimate.

Q. But having that estimate did give us an idea of the costs that are associated with these inspections, did it not?

A. It gave you one option for the cost.

Q. Do you know how many -- do you have any idea how many vendors there are that could provide this inspection?

A. No, I don't know how many there are. I was trying to look to see if the company had answered that in discovery, but I can't find that right now.

Q. Is there any accounting principle that would require bids or proposals, multiple bids or proposals for establishing a budget estimate?

A. I don't think that there's any accounting

principles, but I think it makes good business sense to be able to figure out whether or not the estimate that somebody is giving you is in the reasonable range.

Q. Let's turn to the distribution inspections. And again, there's a bid for the inspection of the distribution poles, is there not?

A. Yes, there was one.

Q. Is that the one attached to your testimony?

A. Yes. It was from Osmose. That's Exhibit PWM-3.

Q. Okay. We're going to come back to that in a second. Again, do you know how many potential bidders there are?

A. No, I don't. I was just relying on the company's support for this adjustment that we asked for.

Q. Okay. You've got that exhibit in front you?

A. Yes, I do.

Q. Okay. If I understand correctly, you would agree that the external -- well, tell me what on that schedule you would recognize for the cost.

A. Well, according to what the company told us in the deposition, Mr. Cutshaw, these stars -- I've added these stars to this exhibit, but this is what he told us in the deposition. The 29.88 for the external treat was one component he used. The sound and bore of $7.75 he

used. The FastGate delivery of 60 cents he used, LoadCalc for $7.26, CATV attachments, which is cable TV, 60 cents, telephone attachments of 60 cents, and GPS reading, 98 cents. And that totaled $47.67 per pole.

Q. I'm sorry, Ms. Merchant. I thought I asked what components did you use?

A. I used all but -- of the list I just read, I took out the LoadCalc of $7.26, the CATV attachments of 60 cents, and the telephone attachments of 60 cents.

Q. So you included the external treat, sound and bore, FastGate?

A. Yes, and GPS reading.

Q. And GPS reading.

A. I believe that's --

Q. Why did you eliminate LoadCalc? Isn't that something that's going to have to be done with or without an attacher?

A. It's my understanding that the LoadCalc was necessitated because the company, when they put the pole up, they know what the pole's capability is, and when they go through -- and they know that it's capable of holding their equipment, or it should be when they put it up, should meet the design criteria. And when they go along subsequently and inspect it, they're going see the full load on that pole, and the LoadCalc is

calculating the amount of the load of all the attachments on the pole. And so that's why we removed it as something that was directly caused by other attachers, because the company has already spent the money when they put the pole up to figure out what their load is for their own equipment.

Q. Do you know if the revenues from the third-party attachers -- we do receive revenues from the third-party attachers, do we not?

A. Yes, you do. And the company did not project an increase for the revenues from the third-party attachers in this rate case. And essentially what we've done is said, while we recognize that this type of cost would be incurred for an inspection, it's just that the cost is driven more by the third-party attachers, and the ratepayers shouldn't have to pay an incremental cost for an inspection that is going to recovered or should be recovered from other attachers. And that's essentially why we removed it, because there's not a revenue to go along with that. It's not that we're saying you shouldn't spend the money. It's just that the ratepayers shouldn't have to pay for that, because subsequently it should be recovered in other means.

Q. Do the revenues the company receives from these third-party attachers exceed the costs associated

with the inspections?

A. I don't know. I don't believe that the agreements have been changed in a while, so I don't think that they -- if they haven't been increased for this rate case, then these costs are not in there for the contracts to be changed. Any of the storm hardening, any of the new storm hardening costs are not in there. I would assume that.

Q. I'm not sure I follow you, Ms. Merchant. I'm not sure -- the question was whether or not the revenues from the third-party attachers -- under the current arrangements, do the revenues from the third-party attachers exceed the costs associated with the inspections, the pole inspections?

A. This pole inspection, the one that you're asking to have the increase, or the ones that were existing prior to the test year?

Q. The company currently pays for pole inspections, does it not?

A. They do internal -- not to the degree that they do for this program. This is a much higher program of pole inspections than what they do currently.

Q. All right. Currently, then, do revenues received from third-party attachers exceed the expenses associated with the pole inspections?

A. I don't know exactly whether or not they cover the costs, cover a portion of the costs, but I could assume that -- and I know it's a very complicated formula, but I would assume that they would recover a portion of the costs associated with maintenance of transmission systems. And since this cost is not in the historical cost and the contracts have not been revised as of late, then I would assume that these new incremental costs would not be in the current contracts. And that's an assumption that I'm making, but the company has never incurred this detail of pole inspection costs.

Q. All right. But if the revenues are exceeding the expenses associated with the inspections, are not the customers receiving a benefit from those arrangements?

A. If the revenues from the pole -- can you say that one more time?

Q. If the revenues from the third-party attachers are exceeding the expenses associated with the inspections of the poles, are the customers not receiving a benefit from that?

MS. CHRISTENSEN: Objection. Assumes facts not in evidence. I think he can ask it as a hypothetical, but I'm not sure that there's record

evidence to support whether or not the current revenues from pole inspections actually exceed the cost of pole inspections.

MR. HORTON: I think I prefaced the question with an "if."

CHAIRMAN CARTER: Let's try it again.

BY MR. HORTON:

Q. If the revenues from the third-party attachers exceeded the expenses associated with the inspections, would not that benefit the customers?

A. Only if that was the only basis that was used to derive the cost charged to the third-party attachers, because if there's any rate of return component or any other expense other than pole inspections -- and my understanding is that there would be more costs included that would be shifted up to the third-party attachers. You can't just look at this expense and say if the revenues exceed this expense, then the customers receive a benefit. It's what is all in the formula that's used to calculate the rates that the third-party attachers collect -- or pay, excuse me.

Q. Let me ask you just a couple of questions about the new positions. The compliance accountant, I believe you agreed that that position is needed and should be approved?

A. I don't know which compliance accountant you're talking about, because the words were all shifted around.

Q. That would be in the corporate accounting department, the compliance accountant, and that would be --

A. Right. I was calling that the corporate accountant for special audits, inventory, cash, and other procedures. Compliance was another position, but, yes, I recommended that 50 percent of that position be allowed.

Q. Right. I think that's Issue 77. And your basis for the recommendation on the 50 percent was that it wasn't going to be filled until later in the year; isn't that correct?

A. That's correct.

Q. All right. Going forward, though, isn't the effect of that recommendation that the salary is cut in half for that position?

A. Well, we're looking at a test year. We're allowing 50 percent of the salary for this year, for 2008, which is what they would incur in 2008. And that's the test year concept, is that you look at what is likely to be incurred in 2008. You look at the things that go up in 2008. You're not going to give the

pay raises that occur at the end of 2008 for the full year of 2008 because they weren't in effect until the end of 2008. It's the same type of thing. It's the same concept that you would use for using a 13-month average for plant in rate base. You want to match the rate base with the expenses with the revenues that are expected to be in place during the test year.

Q. The test year is supposed to be representative of going-forward periods; correct?

A. That's correct. But also, when you go outside the test year, you have a lot of other changes that can occur. Things can go down outside the test year, and you're not looking at those things that might go down. Accumulated depreciation increases. All kinds of things change. When you go outside the test year, you start skewing the result. And that's essentially what my testimony is, is that you should just recognize exactly what's in the test year.

Q. I understand, Ms. Merchant. Let's stick to this position, though. If the person is hired in -- pick a month, I don't care -- June at $50,000, but you have only recommended recovery or inclusion of $25,000 of that expense this year, then how much of the person's $50,000 salary would the company recover in 2009?

A. Well, in 2009, they would have the full

salary. But they could also have a person that retires in 2008 that had a higher salary and they replace that person at a substantially less salary, so you would have the full salary in the test year projected because they were in 2007 and 2006. So you have all kinds of things change. But once you step outside the test year, the whole picture changes. Anything can change.

Q. Ms. Merchant, I think this is a real simple question and a real simple issue. If you only allow recovery of a half year's expense in 2008, that's all the company is going to recover in 2009. Forget retirements or anything else. If you're trying to project the expenses, isn't that what you do when you annualize, you normalize to make the test year look like future periods?

A. I agree that sometimes you do annualize and normalize to make the test year look more normal. But the flip side of that is that the company could have increased revenues. It could be a very warm season that they might not anticipate that the revenues are going to go up as much. They could have some more growth than what they projected. There's all kinds of things that can change once you get beyond the test year.

Q. All right. You win, Ms. Merchant.

Training, let's switch to training. You

wouldn't deny and you wouldn't disagree that training of the linemen and the personnel that work on the lines is an important function of the company?

A. No. I think it's important.

Q. Okay. And you understand that FPUC is having to make different arrangements to have their linemen trained than they've had in the past? Do you agree with that?

A. Based on the information that we received from them, they are attempting to change their training method, yes. I agree with that. They tried the Tampa Electric program, and that didn't work out, and they revised their plan after that.

Q. All right. So they're going to be training themselves; correct?

A. I'm not exactly sure what they're going to do, but I can tell you that they gave me information saying they would.

Q. You said they gave you information. You're referring to the exhibit, the PowerPoint exhibit that compares the various options to the company?

A. Right. I looked at that. I looked at their response to Interrogatory 45, and I looked at the PowerPoint, the portion that was provided with 45, and then I got the subsequent one that was the complete

version of it.

Q. But that reflects that the company has considered various options for presenting this training; correct?

A. That PowerPoint presentation presented all those options, but it didn't come up with a conclusion that I recall. And --

Q. Go ahead.

A. I was just going mention, the requested increases in expenses that the company had in the response to Interrogatory 45 were just lot of numbers that they gave and just said, "Here's the new cost." You know, I've got that on page 25 of my testimony. They just said, "We're going to have a new person, we're going to have some travel expenses, we're going to have some supplies," and all these other numbers they just gave us.

And we asked for more support behind all these numbers. We just never got any more support behind all these numbers. The considerations that -- the company kept saying they're already training some of these people on the state program, which is the existing type of program, but they never came back and told us how many people and how much was included in the 2006 test year so that we could compare that to any of these

numbers or even break down any of these numbers. And that's just where we were. We just weren't given the level of support that we felt we could use to analyze all these new numbers.

Now, of course, they need training, but they just didn't give us what we asked for to support it.

MR. HORTON: I don't think I have any more questions. Thank you.

CHAIRMAN CARTER: Staff?

MS. BROWN: No questions.

CHAIRMAN CARTER: No questions from staff. Commissioners? Commissioner Argenziano, you're recognized.

COMMISSIONER ARGENZIANO: I guess -- I think you've answered most of the questions I had previously about the salary issue. Well, I guess I can't go into that because it's confidential. I have the information.

I had another question, and it escapes me. forgive me. If I remember, I'll ask you. I forgot what it was. I'm sorry. I should have wrote it down.

CHAIRMAN CARTER: That's all right. We have those moments.

Staff, no questions?

COMMISSIONER EDGAR: I'm sorry.

CHAIRMAN CARTER: Oh, Commissioner Edgar,

you're recognized.

COMMISSIONER EDGAR: Thank you. I do have a question about the exhibit, the confidential exhibit, and I think I can ask it in a way that does not compromise the confidentiality. Is it appropriate to pose -- let me pose it to Ms. Merchant, and if you can answer it, do, and if not, I'll try it again with somebody else.

THE WITNESS: Okay.

COMMISSIONER EDGAR: If would you pull out the exhibit. And let's see. The third page of the stapled items that we have, which is the first page of the chart, chart 2, right towards bottom of the columns where it says "FPUC 2007 compensation." I'm going to state no numbers. But my question is, is that all the electric portion, or is some of it electric and gas allotted?

THE WITNESS: Are you looking at a page -- I don't have numbers on my exhibit, but it's a page that has different companies on the left and Florida Public on the right and a little box down at the bottom.

COMMISSIONER EDGAR: Correct. And then just above the box --

THE WITNESS: Right, where it's bold, where the letters are A, B, C, D?

COMMISSIONER EDGAR: Correct. And it says FPUC 2007 compensation.

THE WITNESS: Yes, ma'am.

COMMISSIONER EDGAR: Those numbers right below there, CEO, COO, CFO.

THE WITNESS: That's correct.

COMMISSIONER EDGAR: Okay. And my question is, are those numbers just the electric portion, or does that include electric and gas?

THE WITNESS: That is the total company, electric, gas, LP gas, the whole company.

COMMISSIONER EDGAR: Okay. That's what I wanted to know. Thank you.

CHAIRMAN CARTER: Commissioners? Nothing further. Ms. Christensen, you're recognized.

REDIRECT EXAMINATION

BY MS. CHRISTENSEN:

Q. Just a few brief questions on redirect. Again looking at that confidential document, those bottom numbers, you have -- looking at those bottom numbers, you have recommended a salary increase that would be over and above what those bottom numbers reflect in your testimony?

A. I'll have to check that. I'm not sure if this is projected 2007 or actual 2007, but I can pull out a

document real quick.

That must have been the actual 2007. It does say 2007 compensation, because the numbers don't match the 2006 actual numbers that I have. They're higher than that.

Q. What did you recommend for the increases for the executive salaries?

A. I recommended above the 2006 actual numbers, 5-1/2 percent for 2007 and 5-1/2 percent for 2008, which is consistent with what they asked for for their other employees.

Q. Okay. And that would be -- so you would assume that the number at the bottom of the page would at least go up 5-1/2 percent?

A. Above that, yes. Now, the shaded box over here that's directly under the words "Florida Public Utilities" up at the top of the column does say -- the little fine print right under Florida Public Utilities does say that the 2007 numbers have been adjusted by inflation.

Q. Okay. And that would also be recommended in the --

A. And as with the 2008 numbers down there, just -- so I would assume the 2007 is adjusted to 2008.

Q. Okay. Thank you for that clarification. I

had, I think, just one more question. To your knowledge, what level of training did FPUC do in 2006 and before 2006?

A. They did the state lineman program, which is a home study program, which is part of what they want to continue doing.

There was confusion in our deposition. We couldn't ever tell how many people they were actually training in 2006 between the two different divisions. I think we got several different numbers, and even in the rebuttal testimony, that number is different. So I wasn't really sure exactly how many people were already trained under the state lineman program and projected already in the base year by inflation and customer growth to get to the 2008 before they made the over and above adjustment. So I'm not sure. There might be some double counting of some portion of that state lineman program and training materials in that number, but I don't know, because I didn't get the information.

Q. But you did allow for some level of training to continue and to be escalated for 2007 and 2008?

A. Correct. What was in 2006 was escalated up to 2007 and escalated forward to 2008.

MS. CHRISTENSEN: I have no further questions.

CHAIRMAN CARTER: Okay. Let's deal with our

-- well, before we -- nobody leaves the room. Why don't we collect these up first before we deal with the exhibits. I'll feel better, and I'm sure that my fellow Commissioners will feel better too that we just collect these documents in their red folders.

Okay. So we're no longer on the Hunt for Red October; right? Good.

Now let's deal with our exhibits. Ms. Christensen, you're recognized.

MS. CHRISTENSEN: I would ask that we move Exhibits 47, 48, and 49 into the record.

CHAIRMAN CARTER: Any objections? Hearing none, show it done.

(Exhibit Numbers 47, 48, and 49 were admitted into the record.)

CHAIRMAN CARTER: Ms. Christensen.

MS. CHRISTENSEN: That concludes the Office of Public Counsel's witnesses.

CHAIRMAN CARTER: Okay. Commissioners, I beg your indulgence for a moment. I want to kind of converse with staff, or maybe allow staff an opportunity to converse with the parties to see if this is a breaking point or should we go further. Staff, let's take five, and maybe you can talk with the parties and see what our next phase should be on that, because my

plans are for us to stop at 5:00. I omitted to ask the Commissioners this morning about time constraints and all like that, so my plans are to stop at 5:00 today. So staff, why don't we take 10 minutes and converse with the parties. We're in recess.

(Short recess.)

CHAIRMAN CARTER: We're back on the record. I appreciate the expediency of staff as well as the expeditious discussion with the parties, and we are sure that probably the next phase will take about an hour and a half. I mean, I'm pretty good, but I don't think I can squeeze an hour and a half into 24 minutes. So with that, we'll recess for the day and reconvene tomorrow at 9:30 a.m. We are in recess.

(Proceedings recessed at 4:35 p.m.)

CERTIFICATE OF REPORTER

STATE OF FLORIDA:

COUNTY OF LEON:

I, MARY ALLEN NEEL, Registered Professional Reporter, do hereby certify that the foregoing proceedings were taken before me at the time and place therein designated; that my shorthand notes were thereafter translated under my supervision; and the foregoing pages numbered 352 through 566 are a true and correct record of the aforesaid proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor relative or employee of such attorney or counsel, or financially interested in the foregoing action.

DATED THIS 28th day of February, 2008.

MARY ALLEN NEEL, RPR, FPR
2894-A Remington Green Lane
Tallahassee, Florida 32308
(850) 878-2221