PEOPLES GAS SYSTEM

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 080318-GU

In Re: Petition for rate increase by Peoples Gas System

Submitted for Filing: August 11, 2008

DIRECT TESTIMONY AND EXHIBITS OF:

J. PAUL HIGGINS
On Behalf of Peoples Gas System

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is J. Paul Higgins and my business address is 702 North Franklin Street, Tampa, Florida 33602.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Peoples Gas System ("Peoples" or the "Company") as Assistant Controller, a position I have held since August 1, 2006.

Q. PLEASE PROVIDE A BRIEF OUTLINE OF YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I received a B.B.A. (with high honors) in Accounting from the University of Notre Dame in May 1985, and became a Certified Public Accountant in November of that year. I worked in public accounting for seven years at two of the "Big Four" CPA firms, and I became employed by Peoples in July 1993 as a budget analyst. I was appointed Manager, Finance & Budget, in 1998, and in September 2000 was promoted to Director, Finance & Budget, a position I held until being appointed to my present position.

Q. WHAT ARE YOUR CURRENT RESPONSIBILITIES?

A. As Assistant Controller, I am responsible for the determination and implementation of accounting policies and practices for Peoples. I am responsible for maintaining the financial books and records of the Company. Included in my areas of responsibility are General Accounting, Plant (Property) Accounting, Gas Accounting, Sarbanes-Oxley compliance, Accounts Payable, Payroll, and certain cash and treasury functions. I am responsible for all external financial reporting aspects for the Company including periodic surveillance reports filed with the

Commission.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will present a general overview of Peoples' case, present the O&M benchmark calculations, explain the Company's historic base year and projected test year rate base and operating and maintenance ("O&M") expenses, and describe the budgeting process used to assist in developing those projections. I will also explain how we arrived at the Company's cost of capital for the projected test year, as well as factors and assumptions used in projecting rate base, O&M expenses and cost of capital in the 2009 projected test year. My testimony will also address the calculation of, and foundation for, the revenue requirements of the Company. These and other matters are covered – at least in part – by schedules included in the minimum filing requirements ("MFRs") (Composite Exhibit __(PGS-1)) required by Rule 25-7.039, *Florida Administrative Code* that I sponsor.

Q. ARE THERE ANY OTHER SUBJECTS ON WHICH YOU WILL TESTIFY?

A. Yes. I will also testify in support and explanation of the storm damage reserve for which Peoples seeks Commission approval, as well as our proposal to change the method of recovering the fuel portion of bad debt expense. Finally, I will present the Company's proposed position regarding the treatment of off-system sales for purposes of this proceeding.

Q. HAVE YOU PREPARED OR CAUSED TO BE PREPARED ANY EXHIBITS TO BE INTRODUCED IN THIS PROCEEDING?

A. Yes. The schedules of the MFRs listed in Exhibit ___(JPH-1) were prepared by me or under my supervision. Each schedule contains a general explanation of what is called for and shown on the schedule. In addition, I prepared or caused to be prepared Exhibits ___(JPH-2) through ___(JPH-6). All of these exhibits are attached to my testimony.

Q. WHAT IS THE HISTORIC BASE YEAR PEOPLES IS USING IN THIS PROCEEDING?

A. The historic base year is the 12 months ended December 31, 2007. All data related to this base year is historical data taken from the books and records of the Company, which are kept in the regular course of the Company's business in accordance with Generally Accepted Accounting Principles ("GAAP") and provisions of the Uniform System of Accounts prescribed by the Commission. The Company's books and records are audited annually by Pricewaterhouse Coopers, TECO Energy's independent auditors, and other audits are made regularly by the Commission and the Internal Revenue Service.

Q. WHAT IS THE PROJECTED TEST YEAR FOR PURPOSES OF THIS PROCEEDING?

A. Peoples has selected the 2009 calendar year as the projected test year in this proceeding. Calendar year 2009 is appropriate for use as the test year since it is representative of Peoples' projected revenues and projected cost of service, capital structure and rate base required to provide reliable, cost-effective service to customers during the period when the Company's new rates will be in effect.

Q. WHAT IS THE AMOUNT OF THE RATE BASE FOR THE 2007

HISTORIC BASE YEAR?

A. The calculation of the 13-month average rate base for the historic base year is contained on MFR Schedule B-2. As adjusted, Peoples' average rate base as of December 31, 2007 was $513,778,483. This compares to the average rate base for the 2001 historic base year in Peoples' last rate case of $461,554,070, an increase of 11.3%.

Q. WHAT ARE SOME OF THE FACTORS THAT HAVE CONTRIBUTED TO THE GROWTH IN RATE BASE OVER THIS SIX YEAR PERIOD?

A. There are several factors that have contributed to growth in rate base over this six-year period. Notably, the Company has continued to add a significant number of new customers to its system, adding about 100,000 new residential and commercial customers during this period. To support this growth, the Company has added over 1,500 miles of main to its distribution system. The Company has also faced continuing and increasing requirements for maintenance capital expenditures, including significant amounts for relocation of facilities due to rapid expansion of highways and roads throughout the State of Florida.

Q. WHAT ADJUSTMENTS HAVE BEEN MADE TO THE RATE BASE FOR THE HISTORIC BASE YEAR?

A. Adjustments were made to remove non-utility and non-jurisdictional items from the average per-books rate base. We have also removed items that are recovered through cost recovery mechanisms, such as the purchased gas adjustment ("PGA") and conservation cost recovery clauses. The adjustments made are contained on MFR Schedules B-3 and B-13.

Q. WHAT IS THE AMOUNT OF THE COMPANY'S NET OPERATING INCOME ("NOI") FOR THE HISTORIC BASE YEAR?

A. The calculation of NOI for the historic base year is found in MFR Schedule C-1. The adjusted NOI was $41,045,483.

Q. WHAT ADJUSTMENTS WERE MADE TO THE HISTORIC BASE YEAR NOI?

A. Items recovered through cost recovery mechanisms such as the PGA and energy conservation cost recovery clauses were removed from the calculation of net operating income. Depreciation and amortization expenses were also adjusted for the effect of the rate base adjustments I have described previously. In addition, certain adjustments to NOI were made to be reflective of previous Commission directives and policies as well as to be consistent with those determined in prior rate proceedings.

Q. YOU REFERRED EARLIER TO THE "O&M BENCHMARK." PLEASE EXPLAIN THAT REFERENCE.

A. The O&M benchmark is one high level approach that the Commission uses to analyze the growth of certain costs. The Commission has a long-standing process of comparing O&M expenses from one rate case to the next. The idea is that controllable O&M expenses should in general grow at a rate similar to that of customer growth and inflation. There are often valid reasons why certain expenses or categories of expense could be expected to increase or decrease at a different rate than this benchmark, and therefore it would be necessary to explain the circumstances.

Q. HAVE YOU MADE A COMPARISON OF O&M EXPENSES FOR

THE 2007 HISTORIC BASE YEAR VERSUS THE BENCHMARK OF THE O&M EXPENSES IN THE 2001 HISTORIC BASE YEAR IN PEOPLES' LAST RATE CASE?

A. Yes. The O&M expense for the historic base year is $65,728,617 compared to a calculated benchmark of $76,766,623 using the Commission methodology of increasing controllable O&M expenses by the rate of inflation plus customer growth. The historic base year O&M expense is less than the benchmark by $11,038,006, or 14.4%. These amounts are detailed on MFR Schedule C-34. The fact that the 2007 historic base year O&M expense is 14.4% less than the O&M expense benchmark using 2001 historic base year costs adjusted for customer growth and inflation suggests strongly that the increase during that six-year period has been reasonable.

Q. **WHAT ARE THE VARIOUS FUNCTIONS COMPRISING O&M EXPENSE?**

A. The functions are Distribution, Customer Accounts, General and Administrative ("G&A"), and Sales.

Q. **ARE ALL THE FUNCTIONAL AREAS OF THE O&M BENCHMARK CALCULATED USING THE SAME COMPOUND MULTIPLIERS?**

A. Yes, all the functional areas of the O&M benchmark were calculated using the same compound multiplier as developed on MFR Schedule C-37.

Q. **WHAT IS THE BENCHMARK COMPARISON FOR DISTRIBUTION EXPENSE?**

A. As shown on MFR Schedule C-34, Distribution Expense for the 2007 historic base year is $3,177,964, or 15.8%, less than the benchmark. Reasons for this better-than-benchmark performance include the reorganization of Peoples' operations from four to three regions, resulting in a reduction in workforce, as well as the leveraging of technologies in the operations area where feasible. An example of the employment of technology is the Company's implementation of its new mapping software. This implementation has allowed the Company to be more precise in its management of requests to locate facilities, resulting in a reduction in the number of locate tickets required to be physically cleared by Company personnel.

Q. WHAT IS THE BENCHMARK COMPARISON FOR CUSTOMER ACCOUNTS EXPENSE?

A. As shown on MFR Schedule C-34, Customer Accounts Expense for the 2007 historic base year is $1,925,177, or 18.0%, less than the benchmark. The primary reason for this better-than-benchmark performance is Peoples' restructuring of its call center operations from four regional units into a single virtual call center with two physical locations. In addition, the Company continues to leverage cost-effective technologies in this area including the use of interactive voice response (IVR) technology as well as the use of increasing customer self-service capabilities via the internet.

Q. WHAT IS THE BENCHMARK COMPARISON FOR G&A EXPENSE?

A. As shown on MFR Schedule C-34, General & Administrative Expense for the 2007 historic base year is $1,431,312 higher than the benchmark, representing 4.3% above the benchmark calculation. While several expense items included in this category experienced increases above inflation and customer growth, two significant drivers are pension expense (account 926) and industry dues (account 930). In the 2001 base year, the Company's recorded pension cost was a pension benefit ("income") of approximately $508,000 as actuarially determined. The same item in 2007, again actuarially determined in accordance with applicable GAAP, was a pension expense of approximately $2.1 million. Also, in the Company's last rate case, the Commission approved an additional $500,000 for industry research that had previously been recorded in Cost of Gas. This reclassification into O&M expense resulted in a one-for-one increase in O&M and corresponding decrease in Cost of Gas. As shown on MFR Schedule C-38, after adjusting for these two items alone, the Company is below the calculated adjusted benchmark comparison for G&A Expense by $1,755,654, or 4.8%, for the year ended December 31, 2007.

Q. ARE THERE OTHER G&A EXPENSE ITEMS THAT HAVE SHOWN SIGNIFICANT INCREASES SINCE THE 2001 BASE YEAR?

A. Yes. One particularly noteworthy item is the expense for the Company's medical plan. Health care cost increases have been well-publicized for many years now, and Peoples' experience in this area is no different from that of most companies. Since the 2001 base year, the Company's medical expense has more than doubled. In fact, the 2007 historic base year saw an unprecedented level of health care expense of over $4 million compared to less than $1.8 million in the 2001 base year.

Q. HAS THE COMPANY EMPLOYED INITIATIVES TO CONTROL HEALTH CARE COSTS?

A. Yes. Like all benefit plans of Peoples, the medical plan is managed by the Human Resource professionals at Tampa Electric. The Company has employed a variety of initiatives to control its health care costs, including the following:

- Price strategy to encourage cost-effective plan selections;
- Annual adjustments to employee contributions;
- Annual indexing of deductibles and out-of-pocket amounts;
- Emphasis on employee and retiree awareness and consumer responsibility;
- Comprehensive disease management program to facilitate the effective medical treatment of plan participants with specific diseases that, if not properly managed, can generate expensive claim costs;
- Aggressive vendor management; and
- Restructuring of prescription drug programs to encourage increased utilization of generic medication and Retail Refill Allowance programs.

Q. WHAT IS THE BENCHMARK COMPARISON FOR SALES EXPENSE?

A. As shown on MFR Schedule C-34, Sales Expense for the 2007 historic base year is $7,366,177, or 57.6%, less than the benchmark. The Company's marketing services are provided by its affiliate, TECO

Partners, Inc. ("TPI"), and the cost of the services received under this contract has declined significantly since the Company's last rate case.

Q. HAS AN ADJUSTMENT BEEN MADE TO ALLOCATE PEOPLES' G&A EXPENSES BETWEEN THE UTILITY AND ANY NON-UTILITY AFFILIATES?

A. Yes. All applicable Peoples corporate G&A expenses are allocated between the Company and its non-utility affiliates. The allocations are recorded on the books based on budgeted expense for the year using an operating methodology based on the Modified Massachusetts Formula and employing the drivers of net revenues, payroll, and gross plant in service in order to calculate a weighted average allocation factor for each entity. Because the allocations are included in the actual per-books expenses, no further adjustment is required. MFR Schedule C-6 shows the amount of G&A (and other) expenses that have been allocated.

Q. DOES PEOPLES' HISTORIC BASE YEAR O&M EXPENSE INCLUDE CHARGES FROM TAMPA ELECTRIC?

A. Yes. The historic base year includes charges for various goods and services provided by Tampa Electric. The goods and services received are primarily corporate shared services consisting of information technology, telecommunications, payroll processing, human resources, regulatory, facility services, mail room services, bank charges and rent. The Company also contracts with Tampa Electric for meter reading services in areas where there is overlapping service territory. Expenses are determined based on direct charges for services received or resources consumed. These items are charged to Peoples at cost.

Q. DOES PEOPLES' INTEREST EXPENSE INCLUDE INTERCOMPANY EXPENSE PAID TO TAMPA ELECTRIC?

A. Yes, when applicable. Short-term debt for both Peoples and Tampa Electric is typically obtained from either the companies' bank credit facility or their accounts-receivable-backed credit facility. However, in instances when Peoples requires short-term funding and Tampa Electric has excess cash available, short-term debt is provided to Peoples by Tampa Electric. In these cases, Peoples pays a short-term investment interest rate to Tampa Electric as interest expense to Peoples. This policy holds Tampa Electric neutral in that it receives the short-term investment rate it would have earned had it invested that cash, and it benefits Peoples somewhat in that the short-term investment rate is slightly lower than the short-term borrowing rate. In the event that the roles were reversed (e.g., Peoples had cash and Tampa Electric required short-term debt), the reverse treatment would be applied.

Q. DOES PEOPLES' HISTORIC BASE YEAR O&M EXPENSE INCLUDE CHARGES FROM TECO ENERGY?

A. Yes. The historic base year includes charges for various services received from TECO Energy. Some of the services received include corporate governance, treasury, general accounting, tax support, legal services, and risk management as well as general corporate overhead. Expenses are based on direct charges where appropriate and an allocation. Allocated items are charged using an operating methodology based on the Modified Massachusetts Formula. This allocation methodology consists of developing weighted average allocation percentages of all TECO Energy affiliates, both regulated and non-regulated, based on revenues, net income and operating assets. This method has been consistently applied since Peoples became part of TECO Energy in 1997 and is consistent with the methodology employed during the Company's last rate proceeding. The goal of this approach is to take advantage of economies of scope and scale inherent in a shared services organization.

Q. HOW DID YOU DEVELOP THE RATE BASE FOR THE PROJECTED TEST YEAR?

A. Rate base was projected using a combination of trending based on historical data as well as specific adjustments based on known or reasonably foreseeable events that are expected to occur during the projected test year.

The main item affecting the rate base calculation is the projected capital expenditures that are incorporated into Plant in Service. In order to develop Plant in Service for the projected test year, capital expenditures were estimated for both 2008 and 2009. The testimony of Peoples witness Bruce Narzissenfeld describes more fully the approach taken in preparing these estimates. In addition to capital expenditures, plant retirements and removal costs were considered. The testimony of Peoples witness Donna Hobkirk, as well as Mr. Narzissenfeld, describes the procedures used in calculating these items.

The other major component of rate base is working capital. Projecting working capital for the 2009 projected test year began with developing projected balances for the various balance sheet line items, described more fully below.

Q. IN FORECASTING THE 2008 "BASE YEAR + 1" BALANCE SHEET, DID YOU USE THE COMPANY'S 2008 BUDGETED BALANCE SHEET ASSUMPTIONS?

A. Yes, with a few exceptions. First, Accumulated Deferred Income Taxes ("ADIT") was changed to reflect the creation of bonus depreciation as a result of the passage of the Economic Stimulus Act of 2008. Second, the Company's 2008 budget included an estimate of interim rate relief in its revenue for 2008. For purposes of the forecasted surveillance report and preparation of the MFRs for this rate case, the Company excluded this amount from its 2008 revenue projections, and the related net income and income tax amounts were adjusted in the Company's equity and accrued income tax accounts. Also, during preparation of the detailed MFRs for the 2008 Plant in Service accounts, a budget discrepancy was discovered with respect to the treatment of a large contribution in aid of construction related to the pipeline extension to serve Tampa Electric's Bayside Power Station. This discrepancy was corrected in preparing the detailed 2008 projections in the MFRs, and as a result there were shifts between Plant in Service and construction work in progress ("CWIP") balances as well as a reduction of about $400,000 in depreciation expense for 2008 which impacted the projected balance in Accumulated Depreciation as of December 31, 2008. In addition, a long-term debt issue that was originally planned for June 2008 was actually issued in May 2008. The Company's balance sheet and related interest expense accounts were adjusted to reflect the actual event that occurred in May. Finally, during 2008 the Company has recorded Other Comprehensive Income ("OCI") as a result of Statement of Financial Accounting Standard ("FAS") No. 133 accounting for an interest rate swap related to the aforementioned long-term debt issuance. This accounting treatment was not contemplated in the original 2008 budgeted balance sheet. In order to ensure that year-end balances for 2008 appropriately reflect this treatment, the related balance sheet line items (OCI and Deferred Tax Asset accounts) were adjusted to reflect the results of the actual debt issuance.

Q. HOW DID YOU DEVELOP THE BALANCE SHEET FOR THE PROJECTED TEST YEAR?

A. In developing projections for the balance sheet accounts for the projected test year, the Company employed the same process used in developing its annual budgeted balance sheet. These methods are described on an account by account basis in MFR Schedule G-6. The ending balances as of December 31, 2008 were used as the beginning balances for the 2009 balance sheet, and activity for each line item was forecasted for the projected test year. Plant in Service balances were forecasted based on the Company's 2009 capital budget by account, estimated retirements, and expenditures for removal costs. An analysis was used to project certain balance sheet accounts, including Accounts Receivable, Accounts Payable, and Unbilled Revenues. Certain accounts were trended for known patterns of activity that occur in the normal course of business. Finally, for the regulatory clause accounts -- Unrecovered Gas Costs and Conservation Cost Recovery -- the Company forecasted 13-month average balances at or near zero reflecting the Company's intention to not be significantly over or under-recovered during the projected test year.

Q. WHAT AMOUNT OF WORKING CAPITAL HAS THE COMPANY INCLUDED IN RATE BASE FOR THE PROJECTED TEST YEAR?

A. As shown on MFR Schedule G-1, Pages 2 and 3, the Company is requesting a negative $11,494,371 in working capital for the 2009 projected test year. This means that rate base will be reduced by this amount.

Q. WHAT METHODOLOGY DID THE COMPANY USE TO CALCULATE THIS LEVEL OF WORKING CAPITAL?

A. Working capital was developed using the balance sheet method which has been accepted for many years by the Commission. The various components that make up working capital were projected using a variety of methods described in MFR Schedule G-6, pages 2 and 3.

Q. WERE ANY EQUITY INFUSIONS TO PEOPLES FROM TECO ENERGY INCLUDED IN THE BALANCE SHEET FOR THE PROJECTED TEST YEAR?

A. Yes. The equity infusions budgeted for 2009 total $25 million. This infusion is the result of the Company's planned capital structure needs based on its expenditures and business requirements. The balance between debt and equity continues to be maintained in a manner that ensures financial integrity for the Company now and into the future. As described more fully in Gordon Gillette's testimony, the Company has targeted an equity ratio of 55%.

Q. HOW DOES PEOPLES DEVELOP ITS BUDGET FOR OPERATING AND MAINTENANCE EXPENSES?

A. The Company prepares a detailed annual budget for O&M expense, revenue, and capital expenditures. The O&M expense budget is built primarily by resource type (payroll, materials and supplies, outside services, etc.) and is prepared in great detail covering all operating divisions/regions, as well as Peoples corporate departments and intercompany O&M charges from Tampa Electric and TECO Energy. For payroll, the Company's largest expense type, budgeted amounts are calculated on an individual employee basis. Operating divisions/regions budget payroll expenses by person, including an estimate for merit increases and an allocation of payroll costs to capital expenditures or clearing accounts if applicable. Similarly, corporate departments budget payroll expense for each individual, including an estimate for merit increases. Any requests for new employees would be added to these detailed budget inputs. Other resource types are budgeted at the local level by managers closest to the specific areas and functions based on historical expense levels and expected activities and cost increases for the upcoming year. The individual division/region O&M expense budgets are then rolled up for the total company and included in overall analyses of need and reasonableness for the upcoming year before the total O&M expense budget is approved. Generally, this process occurs from August through December of any particular year and is the typical O&M expense budget process for the Company on an annual basis. Variances from budget are monitored and explained on a monthly, quarterly, and annual basis.

Q. WHAT OTHER FACTORS SHOULD THE COMMISSION

CONSIDER IN RELYING ON THE COMPANY'S BUDGET PROCESS?

A. Peoples employs a budget process that incorporates the American Institute of Certified Public Accountants ("AICPA") guidelines for preparing prospective financial information. The Company's process reflects all of the guidelines, including those related to quality, consistency, documentation, the use of appropriate accounting principles and assumptions, the adequacy of review and approval, and the regular comparison of financial forecasts with actual results.

Q. HOW WAS THE O&M EXPENSE BUDGET FOR 2008, THE HISTORIC BASE YEAR + 1, DEVELOPED?

A. The Company's 2008 budget for O&M expense was prepared as described in my answer to your previous question. In the MFRs (Schedule G-2, pages 10-19), a calculation has been made of O&M expense for the base year + 1 using the trending methodology prescribed by the Commission, adjusting for certain specific items where trend factors do not represent the future expected expense level.

Q. HOW DOES THE 2008 BUDGET COMPARE WITH THE DATA INCLUDED IN THE MFRs FOR THE HISTORIC BASE YEAR + 1?

A. The amount of O&M expense shown on Schedule G-2, page 19, for 2008 is higher than the Company's O&M expense budget for 2008 by about $155,000, a difference of less than one-quarter of one percent.

Q. HOW DID YOU DEVELOP THE O&M EXPENSE PROJECTIONS FOR THE PROJECTED TEST YEAR?

A. For the 2009 projected test year, Peoples prepared O&M expense projections using two distinct methodologies and reconciled the total O&M expense calculated using the two methods. In the first methodology, the Company prepared a detailed 2009 O&M expense budget much as described above for the Company's annual budget process. Input was sought from field operation managers and corporate department heads regarding expected 2009 O&M expense levels, including any changes other than inflationary increases and planned increases or decreases to existing 2008 staffing levels. Detailed budget information was provided by Tampa Electric and TECO Energy departments for direct and allocated expenses for 2009. This data was incorporated in a detailed O&M expense budget such as the Company would have produced during its annual budget process.

In the second methodology, the Company calculated O&M expense for the projected test year using the trending methodology prescribed by the Commission, adjusting for certain specific items where trend factors do not represent the expected 2009 expense level. These calculations are shown on MFR Schedule G-2, pages 10-19.

Q. HOW DOES THE 2009 BUDGET COMPARE WITH THE DATA INCLUDED IN THE MFRs FOR THE PROJECTED TEST YEAR?

A. The amount of O&M expense as shown on Schedule G-2, page 19 for 2009 is lower than the Company's O&M expense budget for 2009 by about $72,000, a difference of 0.1%. Based on this comparison of both the 2008 and 2009 O&M expense budgets to the amounts calculated in the MFRs, the O&M expense in the MFRs appears reasonable for each of those years.

Q. HAS THE COMPANY CONDUCTED ANY ANALYSES TO DETERMINE WHETHER THE PROJECTED O&M EXPENSES ARE REASONABLE?

A. Yes. We have performed several analyses that confirm the reasonableness of O&M expenses for the projected test year. First, as noted above and shown on Exhibit ___(JPH-2), it is compelling that the O&M expense amounts for 2008 and 2009, built by two separate and distinct methods, differ only immaterially from each other. Second, after excluding certain one-time or unusual changes in either 2008 or 2009 expense levels, the percentage increase for each of those years was less than 4%, which again appears reasonable. Third, the Company's performance with respect to the Commission's benchmark as shown on MFR Schedule C-34, and as I have previously more fully described, is an indication of the reasonableness of base O&M expense levels. Finally, the Company periodically compares itself to industry data available from sources such as the American Gas Association, and these comparisons show that based on various metrics Peoples' O&M expense levels are reasonable. In addition, the assumptions used in preparing our O&M forecasts were developed in a manner consistent with the aforementioned AICPA guidelines for prospective financial information. Accordingly, I believe the projected O&M expense amount included in the MFRs for the projected test year is reasonable and justified.

Q. WHAT TRENDING FACTORS WERE USED IN THE MFRS TO DEVELOP THE 2008 AND 2009 O&M EXPENSE AMOUNTS DISCUSSED ABOVE?

A. As prescribed by the Commission, Peoples considered the trending factors of payroll only, customer growth plus payroll, customer growth plus inflation, and inflation only. For inflation, the Company used the Consumer Price Index – All Urban ("CPI-U") forecasts for 2008 and 2009 provided by Moody's Economy.com service. These estimates of inflation for 2008 and 2009 were 2.9% and 2.1%, respectively. Payroll increases were based on actual merit increases for 2008 of 3.5% overall and a projected increase of 4.0% for 2009 provided by compensation professionals in the Tampa Electric Human Resources department.

Q. YOU MENTIONED THAT CERTAIN EXPENSE ITEMS WERE NOT PROJECTED USING TRENDING FACTORS. PLEASE DESCRIBE THESE.

A. That is correct. In several instances, we have specific knowledge of expense items that will not follow those trend factors for 2008 or 2009. In those cases, the Company used the "Other Not Trended" lines on MFR Schedule G-2, pages 10-19 to project these items.

Q. PLEASE DESCRIBE THESE "OTHER NOT TRENDED" EXPENSE ITEMS IN MORE DETAIL.

A. Certainly. I will take these one at a time, by the applicable account number.

<u>Account 871 – Distribution Load Dispatching</u> – In late 2007, the Company established a full-time gas control department at the Company's corporate headquarters. Peoples currently has one full-time employee engaged in this activity and plans to hire one additional gas control analyst in 2008 and three additional analysts in 2009 in order to provide a robust

gas control function on a 24-hour, 7-days a week basis. The Company's distribution system has become more complex in recent years as a result of an increase in the number of interstate pipelines supplying gas to the system and an increase in the number of power generation customers placed behind the Company's system. In order to provide "24/7" functionality, the Company needs a department of five analysts engaged in this activity. The 2009 projected test year includes expenses for this effort.

Account 878 – Meter and House Regulator Expenses – In 2008, the Company is scheduled to complete a three-year program to replace approximately 62,600 residential meters necessitated by the discovery of a manufacturing defect. In a settlement with the manufacturer, Peoples received amounts over the three-year period to fund the replacement of these meters. As a result of various efficiencies during the replacement process, the Company has been able to replace the meters at a cost substantially below the reimbursement amount, thereby generating offsets to O&M expense during these three years. In 2008, the Company is projecting an offset, net of the related expenses for replacement, to O&M expense in account 878. As this program is expected to be completed in 2008 and no further settlement funds will be received in future years, there will be no expense offsets in the 2009 projected test year.

Account 880 – Other Expenses – This account has been used to record the Company's requested amount for a storm damage reserve, as described more fully later in my testimony.

Account 887 – Maintenance of Mains – The large increase in this account represents expected expenses related to the new distribution pipeline integrity costs as well as for additional required system reliability. This item is also described more fully later in my testimony.

<u>Account 904 – Uncollectible Accounts</u> – Bad debt expense was based on the four-year average factor developed during the rate case as part of the expansion factor calculation. This approach is consistent with that used by the Commission in the Company's last rate proceeding as well as in other rate proceedings.

<u>Account 912 – Demonstrating and Selling Expenses</u> – Sales expense was based on the new contract for marketing services between Peoples and its marketing services provider TPI. In 2008 a new contract was negotiated to reflect new or expanded services which Peoples requested to be provided by TPI. Also, the Company is placing an increased focus on saturation efforts on existing mains, and this endeavor requires more labor intensive one-on-one marketing to potential customers than has been done in the past. The 2008 expense was grown at inflation for 2009 as called for in the contract. Even after this increase, the remaining sales and marketing expenses are more than $6 million below the benchmark expense described earlier.

<u>Account 920 – Administrative and General Salaries</u> – The Company has a variable incentive pay mechanism for all employees based on the achievements of individuals as well as the Company against pre-established goals. These goals include factors for safety, customer favorability, operational unit financial goals, and individually-determined goals. In addition, there is both an upside and a downside to the incentive

payout based on Peoples' net income performance. During 2007, as a result of revenues that were substantially below plan, which drove lower than planned net income, Peoples' incentive payout to all employees was significantly reduced. For the 2008 and 2009 projections for this proceeding, the incentive payout has been included at the targeted payout amounts. It is important to note that the Company's Human Resource professionals routinely evaluate salary levels for all jobs in the Company using data from outside salary experts, and this compensation review includes consideration of targeted incentives for each position's market valuation. In order to evaluate market compensation comparisons, the Company uses data from various outside expert resources including Towers Perrin, World at Work, Mercer Inc., Hewitt Associates, Watson Wyatt Worldwide, and Gartner, Inc. Compensation levels, including targeted incentive compensation, reflect a market-based level necessary to attract and retain qualified employees.

<u>Account 921 – Office Supplies and Expenses</u> – This account contains a variety of expenses including intercompany items from both Tampa Electric and TECO Energy as described more fully elsewhere in my testimony. For purposes of projecting the 2009 projected test year expense levels, both Tampa Electric and TECO Energy provided detailed budget amounts for 2009. In several cases, these items did <u>not</u> reflect trend increases over 2007 historic base year levels and therefore the items were included as "other not trended" in determining 2009 expense levels. Information Technology expense, a shared service provided to Peoples by Tampa Electric, was flat from 2007 to 2008 and was reduced by over

$90,000 from 2008 to 2009. The G&A expense allocation from TECO Energy was reduced by nearly $550,000 from 2007 to 2008, so this item was also included in "other not trended" expenses. Two other items included in "other not trended" expense for this account were credit card fee expense (eliminated during 2007 due to a change in this program) and airplane related expenses, which experienced higher than normal trends due largely to fuel expense increases above inflation and certain maintenance and pilot training costs that did not follow inflationary patterns.

<u>Account 925 – Injuries and Damages</u> – This account (sub account 925-02) includes costs for Injuries and Damages expense, a significant expense item for the Company which includes the cost of insurance premiums as well as claims incurred and legal expense in defending these claims. To project this expense for the 2008 budget and 2009 projected test year, the Company prepared an analysis of the past five years' activity in account 925-02, including increases and decreases in the related liability account on the balance sheet (Injuries and Damages Reserve). Over this period, claims incurred and the reserve account levels have fluctuated significantly, so an average over the five-year period was developed. In addition, the Company's Risk Management department (a shared service provided by TECO Energy), in conjunction with its outside actuarial firm, prepared an analysis of premiums expended and actual claims losses incurred over the past eight years. I reviewed data from both of these sources and developed an expense level for 2009 that was appropriate based on this data.

Account 926 – Employee Pensions and Benefits – This account includes all employee benefits expenses. As noted in my earlier testimony on the benchmarking test, several of the items in this account have experienced significant increases since our last rate case, including pension, medical, and other post employment benefits expenses. For purposes of projecting expense levels for the 2009 projected test year for Pension and FAS 106 expense (Other Post-Employment Benefits), the Company employed its outside actuarial firm (Towers Perrin) to provide detailed expense projections for 2009. Medical and dental expenses were projected for 2009 to increase 9% over 2008 levels. This projected increase represents a weighted average of medical and dental expense increases expected for 2009 as estimated by outside advisors Mercer Health and Benefits LLC. It should be noted that the 2008 budget for medical expense was not trended off the record expense level the Company experienced in 2007, when several unusually large medical claims occurred. The 2008 budgeted medical expense was lower than 2007 actual by nearly $740,000, and that expense reduction has been reflected in the Company's O&M expense projections included for purposes of this rate proceeding.

Account 928 – Regulatory Commission Expenses – This account represents the Company's provision for the amortization of expenses incurred in preparing and prosecuting this rate filing with the Commission. The amount included for the 2009 projected test year was based on the estimated total rate case expenses incurred as shown on MFR Schedule C-13 amortized over a three-year period.

Q. PLEASE EXPLAIN PEOPLES' PROPOSAL TO ESTABLISH A STORM DAMAGE RESERVE IN THIS PROCEEDING.

A. As noted earlier, Peoples has included an additional $100,000 annually in its O&M expense projection for the 2009 projected test year to begin establishing an unfunded storm damage reserve (liability) on its books. This concept is well-established with the Commission for electric utilities, who admittedly bear most of the brunt of expenditures related to storm damages. In Florida, there is one gas distribution company, Florida Public Utilities Company, which has received approval to set up an unfunded storm damage reserve liability. In this case, Peoples is seeking Commission approval to establish a reserve so the Company is not forced to incur large, unusual and unpredictable costs in any particular year. Rather, these costs would be spread out more evenly over a long period, which would provide rate stability from a customer perspective and greater financial stability from the Company's standpoint.

Q. WHAT STUDIES, IF ANY, WERE CONDUCTED TO DETERMINE THE APPROPRIATE AMOUNT OF THE RESERVE YOU SEEK AUTHORITY TO ESTABLISH?

A. In order to estimate the amount of storm damage reserve required on an annual basis, Peoples examined its historical books and records for the ten-year period from 1998 to 2007. While the bulk of expenditures occurred during the well-publicized years of 2004 (when five named hurricanes impacted the Company's system) and 2005 (during which there were three named hurricanes), there were other smaller amounts expended related to hurricanes, tropical storms, and tornadoes during this ten-year period. In 2004, Peoples spent over $740,000 as a result of the five named hurricanes that affected its distribution system, over $600,000 of which was expensed in O&M that year. In 2005, the Company incurred an additional $200,000 of O&M expense related to that year's three named storms. Over the 10-year period studied, the Company incurred a total of over $1,056,000 of expenditures, of which nearly $900,000 was classified as O&M expense in the applicable year.

Q. DO THE AMOUNTS NOTED ABOVE INCLUDE ANY EXPENSES FOR "BASE PAY" (OR STRAIGHT-TIME PAYROLL)?

A. Yes, the Company accumulated all costs related to these storms, including base payroll. The total amount of base pay included over the 10-year period was approximately $200,000. This amount of "base pay" has been excluded when determining the storm damage accrual, in keeping with established Commission practices, such as those contained in Rule 25-6.0143.

Q. HOW DID YOU CALCULATE THE AMOUNT OF RESERVE REQUESTED?

A. Based on the data noted above, on a simple average basis, the Company incurred about $70,000 of O&M expense annually over these 10 years excluding base pay. However, the vast majority (97%) of these costs were incurred in the past five years. Accordingly, we also calculated a five-year average of O&M expenses related to these storms. The five-year average was approximately $133,000. Taking into consideration these two averages, Peoples determined that an accrual of $100,000 per year was a reasonable amount with which to establish the new storm damage reserve account. The results of the study we conducted, and the determination of the accrual are contained in Exhibit ___(JPH-3).

Q. **WOULD THERE BE A "CAP" ON THIS LIABILITY ACCOUNT IN THE EVENT THE COMPANY DOESN'T ACTUALLY INCUR THE REQUESTED LEVEL OF ACCRUED EXPENSES IN THE FUTURE?**

A. Yes. Peoples proposes to accrue this amount annually in its financial statements, reducing the liability account in instances when a storm or other significant weather event occurs requiring the expenditure of funds consistent with established Commission guidelines. In the event storms or other significant disasters do not occur in the future, Peoples proposes to limit the amount of the related storm damage reserve liability to $1 million. If the account balance were to reach this level, Peoples would stop accruing the annual expense amount requested in this rate proceeding.

Q. **WHAT IS THE COMPANY'S PROPOSAL WITH RESPECT TO BAD DEBT EXPENSE?**

A. In this proceeding, Peoples is proposing to recover the gas cost portion of the Company's uncollectible accounts through the PGA. This is a change in cost recovery for this expense item, moving the recovery from base rates to the PGA. This change in recovery policy would, of course, result in an offsetting increase in cost of gas expense and a reduction to O&M expense in the same amount.

Q. **WHY IS PEOPLES PROPOSING THIS CHANGE?**

A. The Company believes this request is consistent with the Commission's intent in establishing the PGA mechanism, which is designed to permit natural gas utilities to recover, on a timely basis, the total cost of natural gas purchased for delivery to its customers, and to assure that such cost is not over- or under-collected. There should be no dispute with respect to the nature of these expenses in this circumstance – the funds were spent to obtain gas that was sold to and used by customers, and the Company has been unable to collect the cost of this gas. Therefore, it is appropriate to include this in the PGA for recovery.

Q. HOW DID THE COMPANY REFLECT THIS PROPOSAL IN THE REVENUE REQUIREMENTS CALCULATION IN THIS CASE?

A. In order to reflect this appropriately in the MFRs and revenue requirements calculation for the projected test year, Peoples first calculated an estimate of the total annual uncollectible account expense for the 2009 projected test year. As noted earlier, the total expense was based on the four-year average factor developed during the rate case as part of the expansion factor calculation. Then, the Company removed a portion of the total calculated expense from O&M expense in the projected test year via a pro forma adjustment as shown on MFR Schedule G-2, page 2 – an estimate of the percentage of total uncollectible expenses that are attributable to the cost of gas.

Q. HOW DID YOU DETERMINE THE PERCENTAGE OF UNCOLLECTIBLE ACCOUNTS ATTRIBUTABLE TO THE COST OF GAS?

A. In order to calculate an estimate to apply to the projected test year total uncollectible expense, Peoples performed a detailed analysis of historical write-offs for 2005, 2006 and 2007. During these three years, the fuel portions of total bad debt expense were 40%, 49%, and 47%, respectively, and the weighted average percentage for the three-year period was 46%. The Company applied this weighted average percentage to total calculated bad debt expense for the projected test year of $1,573,000, and the resulting amount ($723,580) was reduced from O&M expense via a pro forma adjustment as previously described.

Q. WHAT DOES THE COMPANY'S TOTAL ANNUAL BAD DEBT EXPENSE REPRESENT AS A PERCENTAGE OF ITS TOTAL ANNUAL REVENUES?

A. Total bad debt expense for the projected test year represents less than one-half of one percent of projected total revenues in the projected test year.

Q. HOW AND WHEN WOULD THIS PROPOSED CHANGE BE IMPLEMENTED GOING FORWARD IF IT IS APPROVED BY THE COMMISSION?

A. While the calculation of the percentage noted above was performed using historical data, uncollectible fuel expense to be charged to the PGA on a going forward basis will be determined using actual fuel expense included in the individual customer's bills that is deemed uncollectible, calculated using a methodology similar to that used in studying the historical periods noted. Additionally, the fuel proportion of write-offs (as calculated) will be applied to recoveries and account adjustments. The change would be implemented upon Commission approval and issuance of a final order in this proceeding.

Q. IF THE COMMISSION DOESN'T APPROVE THE COMPANY'S REQUESTED TREATMENT OF BAD DEBT EXPENSE, WILL AN

ADJUSTMENT TO O&M EXPENSE IN THE PROJECTED TEST YEAR BE REQUIRED?

A. Yes, it will. The Company included total projected bad debt expense in its calculation of base O&M expense for the projected test year and then removed the estimated portion of bad debt related to the PGA from projected test year O&M expense request by making a pro forma adjustment. If the Commission doesn't approve the Company's request, then the pro forma adjustment, a reduction to expense, should be eliminated. The resulting bad debt expense included for rate-making purposes would then be included as stated on MFR Schedule G-2, page 14.

Q. WHAT TREATMENT WAS ACCORDED OFF-SYSTEM SALES IN THE COMPANY'S LAST RATE PROCEEDING?

A. In Order No. PSC-03-0038-FOF-GU (Docket No. 020384-GU), the Commission ruled that "*for purposes of setting rates* in this docket, operating revenues should be increased by $500,000 in the projected test year" for off-system sales ("OSS") (emphasis added). Since the Company's original revenue projections for that filing included no amount of OSS, this level of $500,000 annually was set as a base level of OSS for purposes of setting rates. Additionally, the Commission changed the sharing mechanism whereby the Company would retain 25% of all "net revenues" from OSS from that time forward, while 75% of the net revenues were to be used to reduce the Company's cost of gas recovered through the PGA clause.

Q. WHAT AMOUNT OF OFF-SYSTEM SALES HAS BEEN

INCLUDED IN THE PROJECTED TEST YEAR REVENUES FOR RATE MAKING PURPOSES?

A. For purposes of this proceeding, the Company has included a base level of $500,000 of OSS net revenues to Peoples, consistent with the Commission's treatment of these revenues in our prior proceeding. The Company also proposes to retain the sharing mechanism in place since its last rate proceeding, with 25% of net revenues being retained by the Company and 75% going to offset expenses recovered through the PGA clause.

Q. HAS THE COMPANY BEEN SUCCESSFUL IN REALIZING A LARGER AMOUNT OF OFF-SYSTEM SALES THAN THIS REQUEST IN PRIOR YEARS? IF SO, WHY DOES THE COMPANY REQUEST THE SAME LEVEL AS IN THE PRIOR PROCEEDING?

A. Yes, Peoples has been successful in its OSS efforts, generating net revenues to the Company in excess of $500,000 annually. There are several reasons, however, why the Company is requesting the same treatment in this case.

The Commission was clear in its last order that the selected base level of sales was "for purposes of setting rates." This was not presented as the Company's expected level of future OSS revenues. This $500,000 amount, while less than the Company has been able to generate in recent years, represents a significant reduction to revenue requirements in the rate proceeding while at the same time not excessively burdening the Company with an unreasonably high "hurdle" in future years.

In contemplating this issue, it is important to remember that these sales are sporadic, opportunistic transactions that are highly dependent on market conditions. Sales agreements are short-term, spot market type transactions that are non-recurring in nature. Market conditions drive these opportunities and will dictate the Company's opportunity to make future off-system sales. In fact, the Company has already started to see a decline in this market, with 2007 sales below the 2006 level. While the future direction of market conditions is difficult to predict, the Company expects continuing decline in this market.

Q. EARLIER IN YOUR TESTIMONY ABOUT "OTHER NOT TRENDED" O&M EXPENSE, YOU MENTIONED A LARGE INCREASE FOR PIPELINE INTEGRITY AND SYSTEM RELIABILITY COSTS. PLEASE EXPLAIN THOSE IN MORE DETAIL.

A. Yes, this increased expense level is included in account number 887 (Maintenance of Mains). In the historic base year, Peoples incurred expenses of approximately $250,000 for transmission pipeline integrity activities, and its budget for 2008 anticipated a similar level. A new rule is expected to be adopted, however, which will require a significantly larger level of expenses in 2009 and beyond related to distribution pipeline integrity activities. This has been factored into the Company's 2009 O&M expense budget. In total, costs included in account 887 for pipeline integrity management and system reliability requirements represent over $750,000 in the projected test year as compared to the $250,000 expended in the historic base year.

Q. PLEASE PROVIDE SOME BACKGROUND INFORMATION ON DISTRIBUTION PIPELINE INTEGRITY ACTIVITIES.

A. The federal Pipeline Safety Act of 2002 ushered in significant new requirements for transmission pipelines. While this new legislation had an impact on local distribution companies such as Peoples, the impact was limited by the relatively small proportion of pipelines within the LDC's system that are classified as "transmission" pipelines. Since that time, however, the U.S. Department of Transportation's Pipeline and Hazardous Materials Safety Administration ("PHMSA") has been studying the issue of distribution integrity management programs ("DIMP") with the intention of promulgating new regulatory requirements in this area as well. This review process has been long and deliberate, and during the deliberations, the Pipeline Inspection, Protection, Enforcement, and Safety Act of 2006 was passed by Congress and signed into law by President Bush (Public Law 109-468, the "PIPES Act"). The PIPES Act included a mandate that PHMSA require distribution system operators such as Peoples to implement integrity management programs and install excess flow valves ("EFVs") in all new or replaced residential gas service lines where operating conditions are suitable for available valves, beginning June 1, 2008.

PHMSA issued a notice of proposed rulemaking ("NOPR") with respect to DIMP requirements which was published in the *Federal Register* for June 25, 2008 (73 FR 36015). The proposed rule is expected to be finalized in about a year.

Based on input from various stakeholders – including representatives of the natural gas industry, state regulatory agencies, and the public – PHMSA's proposed rule for distribution integrity outlines seven steps that distribution companies must take. These steps are as follows:

1. Develop and implement a written integrity management plan.
2. Know your infrastructure.
3. Identify threats, both existing and of potential future importance.
4. Assess and prioritize risks.
5. Identify and implement appropriate measures to mitigate the risks.
6. Measure performance, monitor results and evaluate effectiveness of programs while making changes where needed.
7. Periodically report a limited set of performance measures to regulators.

The rules proposed by the NOPR also address the EFV installation requirement of the PIPES Act.

Q. HOW WILL THE NEW RULE IMPACT PEOPLES' O&M EXPENSES?

A. While the full impact of costs is not known with certainty, the Company has estimated various costs related to compliance with the new rule. Peoples anticipates that the costs of developing the Company's plan, preparing required documentation, and performing required risk assessments will represent approximately $250,000 in the 2009 projected test year. This estimate was based on industry data included in a study completed by the American Gas Association. It is anticipated that most or all of this work will be accomplished by the employment of outside contractors.

Q. IS THE TOTAL AMOUNT OF "OTHER NOT TRENDED" O&M EXPENSE FOR ACCOUNT 887 SPECIFICALLY RELATED TO THE NEW DIMP RULE NOTED ABOVE?

A. No, it is not. A portion of the expenses identified in the Company's projections represent costs required for system reliability purposes, and some of the costs are related to transmission pipeline integrity activities. Such costs, while not a result of the DIMP rule itself, are related in kind to the new DIMP costs and, as such, were combined with those costs for projecting O&M expenses for the 2009 projected test year. Included for additional system reliability is $50,000 for the assessment of voltage drops in the system. As requested by the Commission, the Company is separating its distribution systems into electrically-isolated sections in order to be able to be able to test for voltage drops on an ongoing basis.

In addition, approximately $450,000 of expense will be incurred in 2009 related to ongoing transmission pipeline integrity management activities. Specifically, Peoples is completing its final phase of compliance with the transmission integrity requirements by completing an examination of encased pipelines subject to the transmission rules.

Q. IS EVERY ITEM INCLUDED IN THIS OVER $750,000 IN O&M EXPENSE GOING TO RECUR ON AN ANNUAL BASIS?

A. No, not every item. Expenditures for certain of these items are required to be made every so many years. The Company has projected the costs related to these items on an ongoing annual basis through 2016. Using this analysis, the Company will incur an average O&M expense of nearly $720,000 every year related to these activities included in account 887. There are, of course, significant uncertainties in these cost projections for the future. Accordingly, Peoples feels that its request for approximately $750,000 for the 2009 projected test year is reasonable and warranted for rate-making purposes as this expense is expected to remain a significant issue on an ongoing basis. A summary of our analysis of these compliance expenses is attached to my testimony as Exhibit ___(JPH-4).

Q. HOW DID YOU DETERMINE PEOPLES' COST OF CAPITAL FOR THE PROJECTED TEST YEAR?

A. Schedule G-3, Page 2 shows a calculation of Peoples' cost of capital for the projected test year. Capital structure components were forecasted for 2009, and 13-month averages were developed for each item. To these amounts, certain adjustments were made in order to reconcile capital structure to rate base, and an overall cost of capital was derived. As shown on that schedule, the embedded cost of long-term debt for 2009 is 7.20%; the cost of short-term debt is 4.50%; and the costs of residential and commercial customer deposits are 6.00% and 7.00%, respectively. Deferred taxes and tax credits are shown at zero cost. Common equity is shown at a cost of 11.50% as provided for in the testimony of Dr. Donald Murry, the Company's external cost of capital witness. As shown on that schedule, when factoring in the above noted capital structure items at the appropriate proportions, the overall cost of capital for 2009 is projected to be 8.88%.

Q. HOW HAVE YOU TREATED OTHER COMPREHENSIVE INCOME ("OCI") AND THE RELATED DEFERRED TAX ASSET ("DTA") IN THE CALCULATION OF THE EMBEDDED COST OF LONG-TERM DEBT NOTED ABOVE?

A. As noted above and summarized on MFR Schedule G-3, Page 3, the Company's embedded cost of long-term debt is 7.20% for the projected test year. On this schedule, the Company has appropriately adjusted long-term debt balances for the amount of any unamortized debt issuing expenses as well as any unamortized debt discounts or premiums, which is standard practice for this Commission.

In addition, the Company has reflected unamortized OCI and related DTA as an adjustment to the long-term debt balances in calculating the embedded cost of long-term debt. These balances arose from the settlement of interest rate swaps ("hedges") placed in advance of a debt issuance that occurred in May 2008. The remaining balances in OCI and DTA related to these hedges will be amortized into interest expense over the life of the related debt. Accordingly, for purposes of calculating the embedded cost of long-term debt, the unamortized portion of OCI and DTA related to these hedges was treated as an adjustment to long-term debt in the same manner as would occur for debt issuing expenses, discounts, or premiums.

Q. HOW DID YOU RECONCILE CAPITAL STRUCTURE TO RATE BASE?

A. As required by the Commission, the Company reconciled its rate base to capital structure. In doing so, several adjustments were required in order to keep these two items in balance.

Initially, certain items are adjusted to specific capital structure items to which they are specifically related. These "specific adjustments" include unamortized debt discount and expense ("DD&E", an adjustment to long-term debt), dividends declared (an adjustment to equity), and property held for future use and non-utility adjustments to rate base (each a specific adjustment to equity). Also, there are two "reclassification" adjustments among capital structure items, including investment tax credits moving from equity to "tax credits" and OCI and the related DTA on settled hedges moving from equity to long-term debt. Since the OCI and related DTA are related to interest rate swaps on long-term debt issuances, it is appropriately reflected in long-term debt for capital structure purposes.

Two items required special treatment in the process of reconciling capital structure to rate base as they have an impact on accumulated deferred income taxes. Those items are the competitive rate adjustment receivable and unamortized rate case expense. In the case of these two adjustments, the Company first calculated an adjustment to deferred income taxes at the Company's effective tax rate, then applied the balance of the adjustment to capital structure on a pro rata basis.

Finally, the remaining items were adjusted to capital structure on a pro rata basis.

Q. WAS ANY CAPITAL STRUCTURE ADJUSTMENT TO DEFERRED TAXES NEEDED TO COMPLY WITH SPECIFIC

RULES UNDER THE INTERNAL REVENUE CODE?

A. Yes, there was a small adjustment made to deferred income taxes in the capital structure related to the fact that the Company is employing a projected test year in this rate proceeding. This adjustment was a reduction to accumulated deferred income taxes, and the offset to this amount was applied to investor sources of capital on a pro rata basis. The justification for this adjustment is described in detail in the testimony of Alan Felsenthal.

Q. **IN MAKING PRO RATA ADJUSTMENTS TO THE CAPITAL STRUCTURE, DID YOU TREAT THE VARIOUS ADJUSTMENTS IN A MANNER CONSISTENT WITH THE TREATMENT RECEIVED IN THE COMPANY'S LAST RATE CASE?**

A. Yes, except in the case of two adjustments. The two items for which different treatment was applied were acquisition adjustment and other accounts receivable.

Both of these capital structure adjustments were previously removed 100% from equity, which in our view is not appropriate. Peoples is aware that the Commission has typically removed "non-utility" items 100% from equity, and it has retained this treatment for true "non-utility" adjustments as previously noted. It is the Company's view, however, that these two items are *related to utility business* although they are not being booked "above the line" in the utility. Other accounts receivable represents primarily TECO Partners accounts receivable for things like gas appliance sales contracts. Clearly, these sales are ultimately made to increase gas usage or to assist in customer retention efforts. Similarly, the acquisition adjustment acquired in the purchase of West Florida Natural Gas that has been excluded from rate base represents an investment which is clearly related to the Company's core utility business. As such, these adjustments are more appropriately made on a pro rata basis over investor sources of capital.

In the Company's last rate order, the Commission required pro rata adjustments to be made over investor sources of capital, including common equity, preferred stock, short-term debt and long-term debt. In reconciling capital structure to rate base, Peoples has continued to apply this methodology, applying pro rata adjustments to investor sources of capital as noted (after identifying components of deferred taxes when appropriate). The reconciliation of the projected test year rate base to the projected test year capital structure is shown on Exhibit ___(JPH-5).

Q. WHAT ARE THE REVENUE REQUIREMENTS FOR THE PROJECTED TEST YEAR, AND WHAT DO THOSE REQUIREMENTS MEAN FOR PEOPLES' RATE OF RETURN ON EQUITY WITHOUT A GRANT OF THE RATE RELIEF SOUGHT IN THIS PROCEEDING?

A. The Company is seeking to adjust its rates in order to recover an overall cost of service of $196,394,217, which represents total revenue requirements. Absent the rate relief sought, projections for the 2009 projected test year show an overall rate of return of 6.02%, equating to a return on common equity ("ROE") of 5.61%. This ROE of 5.61% can be compared to the 11.25% midpoint ROE currently authorized by the Commission, and to the 11.50% midpoint ROE supported by Dr. Murry, and is not adequate to maintain the financial integrity of the Company. The calculation of the 5.61% ROE is shown on Exhibit ____(JPH-6).

Q. WHAT IS THE REVENUE DEFICIENCY PEOPLES' IS SEEKING TO RECOVER THROUGH THE ADJUSTED RATES FOR WHICH IT SEEKS THE COMMISSION'S APPROVAL?

A. As shown in MFR Schedule G-5, the Company's adjusted net operating income ("NOI") at current rates is projected to be $33,944,697 for the 2009 projected test year. When compared to the NOI requirements as filed in this proceeding for the same period, a NOI deficiency of $16,115,558 is calculated. Applying the expansion factor to this NOI deficiency amount results in a revenue deficiency of $26,488,091 for the projected test year.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. In my testimony, I presented a general overview of Peoples' case, and demonstrated that the O&M expense for the historic base year in this case is less than the applicable Commission benchmark for those expenses by $11,038,006, or 14.4%. I explained the Company's historic and projected test year rate base and O&M expenses, and described the budgeting and MFR processes used to develop those projections. I also explained the calculation of the Company's cost of capital for the projected test year, as well as factors and assumptions used in projecting rate base, O&M expenses and cost of capital in the 2009 projected test year.

I also offered testimony regarding the storm damage reserve for which Peoples seeks the Commission's approval, our proposal to change the accounting treatment of bad debt expense to record the fuel portion of uncollectible expense in the PGA rather than as a part of base rates, and the Company's position regarding the treatment of off-system sales for rate-making purposes.

Finally, I testified to the calculation of the revenue requirements of the Company, and the $26,488,091 revenue deficiency Peoples is seeking authority to recover through the new base rates proposed in this proceeding.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

MFR SCHEDULES SPONSORED OR CO-SPONSORED BY J. PAUL HIGGINS

MFR Schedule No. (page)	Title
A-1	Executive Summary - Magnitude of Change - Present vs. Prior Rate Case
A-2	Executive Summary - Analysis of Permanent Rate Increase Requested
A-3	Executive Summary - Analysis of Jurisdictional Rate Base
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B-13	Working Capital
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C-1	Net Operating Income
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**MFR SCHEDULES SPONSORED
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MFR Schedule No. (page)	Title
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G-2 (12-13)	Projected Test Year - Calculation of Maintenance Expenses
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Peoples Gas System
2009 Operating Budget
Operations & Maintenance Expense Summary
($ in 000's)

	2007 Actual	2008 Budget	2009 Budget
Operating Locations & Regions	$29,454	$30,599	$32,764
Corporate Departments	15,297	16,459	18,234
Shared Expenses	12,665	13,709	14,321
G&A Transferred	(472)	(478)	(488)
G&A Capitalized	(3,381)	(3,600)	(3,560)
TEC/TECO Direct Charges	7,948	8,442	8,386
TECO Energy Allocation	4,446	3,901	3,954
Total O&M expense per budget *	65,957	69,032	73,611
Total O&M expense per MFR Schedule G-2, p.19	65,957	69,187	73,539
Difference - MFR calc. $'s above (below) budget	$0	$155	($72)
Difference - MFR calc. % above (below) budget	0.0%	0.2%	-0.1%

* Excluding pass-through energy conservation expenses.

Peoples Gas System
Storm Reserve Analysis

Year	Storms	O&M	Capital	Total
1998	Georges	$27,220.13	$0.00	$27,220.13
2004	Bonnie, Charley, Ivan, Jeanne, Frances	603,353.44	138,605.00	741,958.44
2005	Dennis, Katrina, Wilma	200,229.98	19,200.00	219,429.98
2006	Ernesto	9,745.06	-	9,745.06
	Katrina	249.00	-	249.00
	Wilma	27,989.00	-	27,989.00
2007	Tornado - Ocala	29,718.49	-	29,718.49
	10-year totals	$898,505	$157,805	$1,056,310
	Less estimated straight-time payroll	(203,968)		
	10-year O&M total, less ST payroll	$694,537		
	10-year O&M average excl. ST payroll	**$69,454**		
	5-year totals	$871,285		
	Less est. straight-time payroll (10 yrs)	(203,968)		
	Adj. est. ST payroll to 5 years	6,654		
	5-year O&M total, less ST payroll	$667,317		
	5-year O&M average excl. ST payroll	**$133,463**		
	Average of 10-yr. & 5-yr. amounts	**$101,500**		

Peoples Gas System
Pipeline Integrity / System Reliability Costs
Projected O&M Expenses

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Integrity Management (Transmission)									
Balance of HCA's	$ 250,000								
Casing indirect assessment		$ 400,000							
Review Plan and HCA's	$ 50,000	$ 51,500	$ 53,045	$ 54,636	$ 56,275	$ 57,964	$ 59,703	$ 61,494	$ 63,339
Retest 2007 areas - 7 yr cycle							$ 300,000		
Retest 2008 areas - 7 yr cycle								$ 300,000	
Retest 2009 areas - 7 yr cycle									$ 500,000
Total IM - O&M	**$ 300,000**	**$ 451,500**	**$ 53,045**	**$ 54,636**	**$ 56,275**	**$ 57,964**	**$ 359,703**	**$ 361,494**	**$ 563,339**
Distribution Integrity Management									
Respond to NOPR and gather data	$ 50,000								
Develop Plan, documentation and risk assessments		$ 250,000							
Perform and document work - O&M *			$ 450,000	$ 450,000	$ 450,000	$ 450,000	$ 450,000	$ 450,000	$ 450,000
Total DIM - O&M	**$ 50,000**	**$ 250,000**	**$ 450,000**	**$ 450,000**	**$ 450,000**	**$ 450,000**	**$ 450,000**	**$ 450,000**	**$ 450,000**
Include voltage ("IR") drop in CP analysis									
Isolate sections, clear shorts, rectifiers and equipment	$ 100,000								
On-going additional work	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000
Total IR drop work - O&M	**$ 150,000**	**$ 50,000**	**$ 50,000**	**$ 50,000**	**$ 50,000**	**$ 50,000**	**$ 50,000**	**$ 50,000**	**$ 50,000**
Total O&M - Account 887	**$ 500,000**	**$ 751,500**	**$ 553,045**	**$ 554,636**	**$ 556,275**	**$ 557,964**	**$ 859,703**	**$ 861,494**	**$ 1,063,339**
Average O&M Expense (2009-2016)		**$ 719,700**							

* From AGA DIM data

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Peoples Gas System
Reconciliation of Capital Structure to Rate Base
13-Month Average December 2009
$ in 000's

Description	LT Debt	ST Debt	Deposits	Equity	Def'd Tax	Tax Credits	Pro Rata	Net
	Adjustments							
Average Capital Structure (per books)								$577,173
Reconciling Items:								
Sinking Funds	$0							-
Investment in Subsidiaries				($691)				(691)
Temporary Cash Investments							($432)	(432)
Notes Receivable				-				-
Other Accounts Receivable							(3,409)	(3,409)
Accts. Rec. - Associated Company							-	-
Merchandise Inventory				-				-
Remove Environmental WIP							-	-
Remove Unbundling Transition Charges							-	-
Remove Non-Utility Accrued Liability				-				-
Unamortized Debt Discount & Expense	(3,126)							(3,126)
Unamortized Rate Case Expense					($241)		(384)	(625)
Unrecovered Gas Costs							(11)	(11)
Competitive Rate Adjustment					(2,069)		(3,294)	(5,363)
Accts. Pay. - Associated Company							500	500
Dividends Declared				1,179				1,179
Convservation True-Up							-	-
Remove Plant for MSEA (MEP)							(200)	(200)
Property Held for Future Use				(229)				(229)
Non-Utility Adjustments to Rate Base				(202)				(202)
Remove Acquisition Adjustment							(963)	(963)
Job Development Credits				(8)		$8		-
Other Comp. Income - Unsettled hedges								-
Other Comp. Income - Settled Hedges	(3,476)			2,135	1,341			-
Deferred Tax Normalization					(205)		205	-
Total Reconciling Items	($6,602)	$0	$0	$2,184	($1,174)	$8	($7,988)	(13,572)
Average Rate Base (Adjusted)								$563,601

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PEOPLES GAS SYSTEM
CALCULATED AVERAGE RETURN ON CAPITAL
DECEMBER 31, 2009

DESCRIPTION	$(000) AMOUNT	RATIO	RATE	WEIGHTED RATE
Common Equity	$ 273,562	48.54%	**5.61%**	2.72%
Long-Term Debt	222,774	39.53%	7.20%	2.85%
Short-Term Debt	3,456	0.61%	4.50%	0.03%
Residential Customer Deposits	9,339	1.66%	6.00%	0.10%
Commercial Customer Deposits	26,310	4.67%	7.00%	0.33%
Inactive Deposits	480	0.09%		
Deferred Taxes	27,671	4.91%		
Tax Credits	8	0.00%		
TOTAL	$ 563,600	100.00%		6.02%

Note: Amounts and ratios are per MFR Schedule G-3 (page 2). Cost rates for all components except Common Equity are per MFR Schedule G-3 (page 2).