

**Ruth Nettles**

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**From:** Michele Parks [michele@RSBattorneys.com]  
**Sent:** Friday, October 03, 2008 3:19 PM  
**To:** Filings@psc.state.fl.us  
**Cc:** Jean Hartman; Charles Beck  
**Subject:** Docket No.: 080006-WS  
**Attachments:** PREHEARING STATEMENT.pdf; PREHEARING STATEMENT.doc

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- b. Docket No.: 080006-WS; Water and Wastewater Industry Annual Reestablishment of Authorized Range of Return on Common Equity of Water and Wastewater Utilities Pursuant to Section 367.081 (4) (f), F.S.
- c. Utilities, Inc.
- d. 7 pages
- e. Prehearing Statement

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DOCUMENT NUMBER-DATE

09386 OCT-3 8

10/6/2008

FPSC-COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity of water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.

DOCKET NO. 080006-WS

PREHEARING STATEMENT OF UTILITIES, INC.

Pursuant to Order No. PSC-08-0430--PCO-WS, issued July 1, 2008, Utilities, Inc. ("Utilities, Inc." or the "Company"), by and through its undersigned counsel, files its Prehearing Statement as follows:

(1) All Known Witnesses

Utilities, Inc., relies on the prefiled testimony of and intends to call the following witnesses:

<u>Witness Name</u>	<u>Title</u>	<u>Subject</u>
Pauline M. Ahern	Principal of AUS Consultants	Reestablishment of authorized rate of return on common equity for water and wastewater utilities

Utilities, Inc. reserves the right to call additional witnesses to respond to Commission inquiries not addressed in direct or rebuttal testimony and witnesses to address issues not presently designated but that may be designated by the Prehearing Officer at the prehearing conference on October 13, 2008.

(2) Exhibits

Utilities, Inc., has identified and intends to sponsor the following exhibits:

<u>Exhibit No.</u>	<u>Description</u>	<u>Person Sponsoring</u>	<u>Cross-Reference</u>
	Educational Background & Experience	Pauline M. Ahern	PMA-1

DOCUMENT NUMBER-DATE

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FPSC-COMMISSION CLERK

<u>Exhibit No.</u>	<u>Description</u>	<u>Person Sponsoring</u>	<u>Cross-Reference</u>
	Blue Chip Financial Forecasts, Aug. 1, 2001	Pauline M. Ahern	PMA-2
	Weekly U. S. Spot Price for Oil	Pauline M. Ahern	PMA-3
	Labor Force Statistics	Pauline M. Ahern	PMA-4
	Moody's A-Rate Public Utility Bonds Yields	Pauline M. Ahern	PMA-5
	Value Line, Aug. 3, 2001	Pauline M. Ahern	PMA-6
	Calculation of Mean, Standard Deviation, and Coefficient of Variation of Russell 2000	Pauline M. Ahern	PMA-7
	Comparison of Adjusted Rates	Pauline M. Ahern	PMA-8
	S&P Corporate Ratings Criteria Utilities	Pauline M. Ahern	PMA-9
	Comparison of the Impact on Revenue Cost of Capital of Holding Before Income Tax	Pauline M. Ahern	PMA-10
	Correct Deviation of Cost Rate of Common Equity	Pauline M. Ahern	PMA-11
	Indicated Common Equity Cost Rate	Pauline M. Ahern	PMA-12
	New Regulatory Finance by Roger A. Morin, Ph.D., pp. 128-129	Pauline M. Ahern	PMA-13
	Deviation of Investment Risk	Pauline M. Ahern	PMA-14
	Fundamentals of Financial Management by Eugene F. Brigham, pp. 622-623	Pauline M. Ahern	PMA-15
	Ibbotson SBBI 2008 Valuation Yearbook, p. 119	Pauline M. Ahern	PMA-16
	Principles of Corporate Finance by Brealey and Myers, pp. 622-623	Pauline M. Ahern	PMA-17
	New Regulatory Finance by Roger A. Morin, Ph. D., pp. 303-307	Pauline M. Ahern	PMA-18
	Ibbotson SBBI 2008 Valuation Yearbook, pp. 77-83	Pauline M. Ahern	PMA-19
	SBBI 1999 Yearbook, pp. 157-158	Pauline M. Ahern	PMA-20
	Essentials of Managerial Finance by Weston and Brigham, p. 272	Pauline M. Ahern	PMA-21
	New Regulatory Finance by Roger A. Morin, Ph. D., p. 133-143	Pauline M. Ahern	PMA-22

<u>Exhibit No.</u>	<u>Description</u>	<u>Person Sponsoring</u>	<u>Cross-Reference</u>
	Principles of Corporate Finance by Brealey and Myers, pp. 146-147	Pauline M. Ahern	PMA-23
	Total Returns on Large Company Stocks	Pauline M. Ahern	PMA-24
	Coefficients of Determination and Ibbotson SBBI Valuation Yearbook, pp. 111-113	Pauline M. Ahern	PMA-25
	Investments: Analysis and Management by Jack Clark Francis, pp. 273-275	Pauline M. Ahern	PMA-26
	Ibbotson SBBI 2007 Valuation Yearbook, pp. 92-97	Pauline M. Ahern	PMA-27
	Brief Summary of Common Equity Cost Rate	Pauline M. Ahern	PMA-28

Utilities, Inc., may utilize other documents as exhibits at the time of hearing, either during cross-examination or as further impeachment or rebuttal exhibits, and the precise identification of such documents cannot be determined at this time.

(3) Statement of Utilities, Inc.'s Basic Position

The leverage formula as proposed represents a reasonable methodology for establishing a return on equity for water and wastewater utilities in Florida.

(4) Utilities, Inc.'s Position On The Issues, Facts And Law

ISSUE 1: What is the most appropriate model or method to estimate a fair and reasonable return on a water and wastewater (WAW) utility's common equity capital?

The Discounted Cash Flow (DCF) model and the Capital Asset Pricing Model (CAPM) as applied by the PSC Staff in current leverage formula as outlined in its May 8, 2008, Memo to the Office of Commission Clerk (Cole) are the most appropriate models or methods to estimate a fair and reasonable return on a water and wastewater (WAW) utility's common equity capital. They are the most appropriate because they result in a reasonable range of common equity cost rate applicable to a WAW utility

**ISSUE 1a:** Should the leverage formula methodology take into account an individual utility's equity ratio in the determination of return on equity?

Yes. The leverage formula methodology should take into account an individual utility's common equity ratio in the determination of the rate of return on common equity, providing that the individual utility's common equity ratio is reasonable and appropriate for ratemaking purposes.

**ISSUE 1b:** Should the leverage formula methodology take into account the change to the cost of debt in response to changes in the level of common equity in a utility's capital structure?

No. For the reasons explained in the rebuttal testimony of Utilities, Inc.'s witness Pauline M. Ahern, CRRA, it is not necessary to change the cost of debt in response to changes in the level of common equity in a utility's capital structure. The assumption that the debt cost rate remains constant over an equity ratio range of 40% to 100% assumed in the current leverage formula is therefore reasonable.

**ISSUE 1c:** Should the determination of the leverage formula be based on a before-tax or after-tax cost of capital?

No. The determination of the leverage formula should be based upon an after-income tax overall cost of capital. To do otherwise assumes that the revenue cost of capital is identical over an equity ratio range of 40% to 100% which is not at all the case as explained in the rebuttal testimony of Utilities Inc.' witness Pauline M. Ahern, CRRA.

**ISSUE 1d:** Is it appropriate to make a Bond Yield Differential adjustment? If so, how should this adjustment be made?

Yes. It is appropriate to make a Bond Yield Differential adjustment to the cost rate of common equity capital. It is appropriate because the bond yield differential reflected in the debt cost rate in the current leverage formula only compensates bondholders for the riskiness of a Baa3 rated public utility bond relative to that inherent in an A rated public utility bond. It does not compensate the common equity shareholders for the added relative risk. The adjustment should also be made to the common equity cost rate in a manner identical to that in the current leverage formula.

**ISSUE 1e:** Is it appropriate to make a Private Placement Premium adjustment? If so, how should this adjustment be made?

Yes. It is appropriate to make a Private Placement Premium adjustment because investors in such debt demand compensation for the lack of liquidity relative to large, readily saleable public traded debt. The adjustment should be made in a manner identical to that in the current leverage formula.

**ISSUE 1f:** Is it appropriate to make a Small-Utility Risk Premium adjustment? If so, how should this adjustment be made?

Yes. It is appropriate to make a Small-Utility Risk Premium adjustment because size is a factor which affects business risk and must be reflected in the common equity cost rate. Since the WAW utilities operating in Florida are all significantly smaller than the companies comprising the Natural Gas Index used to calculate the leverage formula, they are relatively more risky. Consistent with the basic financial principle of risk and return, investors require a higher return to invest in such companies.

**ISSUE 2:** Should the following leverage formula methodology be applied using updated financial data:

$$\text{Return on Common Equity} = 7.36\% + 2.123/\text{Equity Ratio}$$

Where the Equity Ratio = Common Equity / (Common Equity + Preferred Equity + Long-Term and Short-Term Debt)

Range: 9.48% @ 100% equity to 12.67% @ 40% equity

No. Based upon the independent analysis provided by Utilities, Inc.'s witness Pauline M. Ahern, CRRA in her rebuttal testimony, the current leverage formula results in a reasonable range of common equity cost rate for the WAW utilities in Florida.

**ISSUE 3:** What is the appropriate range of returns on common equity for water and wastewater (WAW) utilities pursuant to Section 367.081(4)(f), Florida Statutes?

The appropriate range of the rate of return on common equity is the range proposed by the PSC Staff as outlined in its May 8, 2008 memo to the Office of Commission Clerk (Cole)

**ISSUE 4:** Should this docket be closed?

Yes.

(5) **Stipulated Issues**

The Company knows of no stipulated issues.

(6) **Pending Motions and Other Open Matters**

The Company has pending a Motion to Strike certain portions of Mr. Rothschild's Surrebuttal Testimony and Exhibit JAR-12.

(7) Pending Requests For Confidentiality

None.

(8) Objections To Witness Qualifications As An Expert

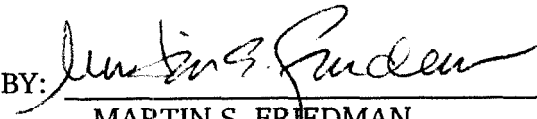
None.

(9) Reasons For Non-Compliance With Order (if any)

The Company knows of no non-compliance with the Preliminary Order.

Respectfully submitted on this 3<sup>rd</sup> day of  
October, 2008, by:

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BY:   
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MARTIN S. FRIEDMAN  
For the Firm

CERTIFICATE OF SERVICE  
DOCKET NO.: 080006-WS

I HEREBY CERTIFY that a true and correct copy of the foregoing Prehearing Statement has been furnished by electronic mail & U.S. Mail this 3<sup>rd</sup> day of October, 2008, to:

Jean Hartman, Esquire  
Office of General Counsel  
Florida Public Service Commission  
2540 Shumard Oak Boulevard  
Tallahassee, FL 32399

Charles Beck, Esquire  
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BY:   
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MARTIN S. FRIEDMAN  
For the Firm