

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

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

DOCKET NO. 080006-WS
ORDER NO. PSC-08-0702-PHO-WS
ISSUED: October 21, 2008

Pursuant to Notice and in accordance with Rule 28-106.209, Florida Administrative Code (F.A.C.), a Prehearing Conference was held on October 13, 2008, in Tallahassee, Florida, before Commissioner Nancy Argenziano, as Prehearing Officer.

APPEARANCES:

MARTIN S. FRIEDMAN, ESQUIRE, c/o Rose, Sundstrom & Bentley, LLP,
2180 West State Road 434, Suite 2118, Longwood, Florida 32779
On behalf of UTILITIES INC. (Utilities, Inc.).

CHARLIE BECK, ESQUIRE, c/o The Florida Legislature, 111 West Madison
Street, Room 812, Tallahassee, Florida 32399-1400
On behalf of Office of Public Counsel(OPC).

JEAN E. HARTMAN, ESQUIRE, Florida Public Service Commission, 2540
Shumard Oak Boulevard, Tallahassee, Florida 32399-0850
On behalf of the Florida Public Service Commission (Staff).

PREHEARING ORDER

I. **CASE BACKGROUND**

Section 367.081(4)(f), Florida Statutes (F.S.), authorizes this Commission to establish, not less than once each year, a leverage formula to calculate a reasonable range of returns on equity (ROE) for water and wastewater (WAW) utilities. Since 2001, we have used the leverage formula methodology established in Order No. PSC-01-2514-FOF-WS, issued December 24, 2001, in Docket No. 010006-WS.

On May 8, 2008, Commission staff filed a recommendation, asking that we again apply the leverage formula methodology we established in 2001. At our May 20 Agenda Conference, after hearing from our staff and from counsel of the Office of Public Counsel (OPC) and Utilities, Inc., we decided that it would be appropriate and administratively efficient to set the establishment of the 2008 leverage formula for water and wastewater utilities directly for hearing.

DOCUMENT NUMBER-DATE

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FPSC-COMMISSION CLERK

II. CONDUCT OF PROCEEDINGS

Pursuant to Rule 28-106.211, F.A.C., this Prehearing Order is issued to prevent delay and to promote the just, speedy, and inexpensive determination of all aspects of this case.

III. JURISDICTION

This Commission is vested with jurisdiction over the subject matter by the provisions of Chapters 120 and 367, F.S. This hearing will be governed by said Chapters and Chapters 25-22, 25-30, and 28-106, F.A.C., as well as any other applicable provisions of law.

IV. PROCEDURE FOR HANDLING CONFIDENTIAL INFORMATION

Information for which proprietary confidential business information status is requested pursuant to Section 367.156, F.S., and Rule 25-22.006, F.A.C., shall be treated by the Commission as confidential. The information shall be exempt from Section 119.07(1), F.S., pending a formal ruling on such request by the Commission or pending return of the information to the person providing the information. If no determination of confidentiality has been made and the information has not been made a part of the evidentiary record in this proceeding, it shall be returned to the person providing the information. If a determination of confidentiality has been made and the information was not entered into the record of this proceeding, it shall be returned to the person providing the information within the time period set forth in Section , F.S. The Commission may determine that continued possession of the information is necessary for the Commission to conduct its business.

It is the policy of this Commission that all Commission hearings be open to the public at all times. The Commission also recognizes its obligation pursuant to Section 367.156, F.S., to protect proprietary confidential business information from disclosure outside the proceeding. Therefore, any party wishing to use any proprietary confidential business information, as that term is defined in Section 367.156, F.S., at the hearing shall adhere to the following:

- (1) When confidential information is used in the hearing, parties must have copies for the Commissioners, necessary staff, and the court reporter, in red envelopes clearly marked with the nature of the contents and with the confidential information highlighted. Any party wishing to examine the confidential material that is not subject to an order granting confidentiality shall be provided a copy in the same fashion as provided to the Commissioners, subject to execution of any appropriate protective agreement with the owner of the material.
- (2) Counsel and witnesses are cautioned to avoid verbalizing confidential information in such a way that would compromise confidentiality. Therefore, confidential information should be presented by written exhibit when reasonably possible.

At the conclusion of that portion of the hearing that involves confidential information, all copies of confidential exhibits shall be returned to the proffering party. If a confidential exhibit

has been admitted into evidence, the copy provided to the court reporter shall be retained in the Office of Commission Clerk's confidential files. If such material is admitted into the evidentiary record at hearing and is not otherwise subject to a request for confidential classification filed with the Commission, the source of the information must file a request for confidential classification of the information within 21 days of the conclusion of the hearing, as set forth in Rule 25-22.006(8)(b), F.A.C., if continued confidentiality of the information is to be maintained.

V. PREFILED TESTIMONY AND EXHIBITS; WITNESSES

Testimony of all witnesses to be sponsored by the parties has been prefiled and will be inserted into the record as though read after the witness has taken the stand and affirmed the correctness of the testimony and associated exhibits. All testimony remains subject to timely and appropriate objections. Upon insertion of a witness' testimony, exhibits appended thereto may be marked for identification. Each witness will have the opportunity to orally summarize his or her testimony at the time he or she takes the stand. Summaries of testimony shall be limited to five minutes.

Witnesses are reminded that, on cross-examination, responses to questions calling for a simple yes or no answer shall be so answered first, after which the witness may explain his or her answer. After all parties and Staff have had the opportunity to cross-examine the witness, the exhibit may be moved into the record. All other exhibits may be similarly identified and entered into the record at the appropriate time during the hearing.

The Commission frequently administers the testimonial oath to more than one witness at a time. Therefore, when a witness takes the stand to testify, the attorney calling the witness is directed to ask the witness to affirm whether he or she has been sworn.

VI. ORDER OF WITNESSES

<u>Witness</u>	<u>Proffered By</u>	<u>Issues #</u>
<u>Direct</u>		
Pauline M. Ahern	Utilities, Inc.	1-3
James A. Rothschild	OPC	1-3
<u>Rebuttal</u>		
Pauline M. Ahern	Utilities, Inc.	1-3
<u>Surrebuttal</u>		
James A. Rothschild	OPC	1-3

VII. BASIC POSITIONS

UTILITIES

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

OPC: The leverage formula methodology adopted in 2001 produces results which do not make sense today. Long term treasury interest rates dropped by about 95 basis points since the methodology was adopted in 2001, yet the formula produces a cost of equity for a company with a common equity ratio of 40% which is 133 basis points higher than produced in 2001. With such a large drop in long term interest rates, the Commission should be highly confident that the cost of equity also dropped. The cost of equity of 12.67% which the formula calculates for such a company today is far too high.

The stand-alone DCF model used in determining the leverage formula is fundamentally sound, but the CAPM model used in determining the leverage formula produces results contrary to financial theory because it incorrectly uses a short term growth rate rather than a long term growth rate in its calculation. If the CAPM approach is revised to reflect the actual risk premium earned in excess of the inflation rate, it produces results which are consistent with the results of the DCF model.

The current leverage formula incorporates a number of “adders” to the cost of equity computed for a comparative group of companies. The adders for bond yield differential, private placement premium, small utility risk premium, and financing costs are not justified and should be removed from the determination of the leverage graph formula. An adder for the increment to growth caused by sales of new common stock above book value would be appropriate, however.

The Commission should adopt the following new leverage formula recommended by Citizens’ witness James A. Rothschild:

$$k=(OCC-D(1-ER))/ER$$

where k=cost of equity

D=cost of debt, determined as a function of the percentage of equity in the capital structure

OCC=overall cost of capital

ER=Equity ratio

STAFF: Staff’s positions are preliminary and based on materials filed by the parties and on discovery. The preliminary positions are offered to assist the parties in preparing for the hearing. Staff’s final positions will be based upon all the evidence in the record and may differ from the preliminary positions.

VIII. ISSUES AND POSITIONS

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?

POSITION

UTILITIES

INC.: 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. (Ahern)

OPC: A two-stage DCF model and a CAPM model based on the actual long-term relationship between inflation and the earned risk premium is an appropriate method to estimate a fair and reasonable return on a water and wastewater (WAW) utility's common equity capital. (Rothschild)

STAFF: No position at this time.

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

POSITION

UTILITIES

INC.: 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. (Ahern)

OPC: Yes. (Rothschild)

STAFF: No position at this time.

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?

POSITION

UTILITIES

INC.:

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. (Ahern)

OPC:

Yes. This is not only consistent with the same Modigliani & Miller principle that is the basis for the leverage formula, but the relationship between capital structure and cost of debt is confirmed by the actual data associated with the comparative group of companies. (Rothschild)

STAFF:

No position at this time.

ISSUE 1C:

Should the determination of the leverage formula be based on a before-tax or after-tax cost of capital?

POSITION

UTILITIES

INC.:

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. (Ahern)

OPC:

The determination of the leverage formula should be based on a before-tax cost of capital. This will provide the cost of equity as experienced by equity investors. (Rothschild)

STAFF:

No position at this time.

ISSUE 1D:

Is it appropriate to make a Bond Yield Differential adjustment? If so, how should this adjustment be made?

POSITION

UTILITIES

INC.:

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. (Ahern)

OPC: It is not appropriate to make a bond yield differential adjustment. The cost of debt incurs upward pressure when a company uses a higher proportion of debt in the capital structure. This higher interest expense is exactly the same factor that causes an increase in the risk experienced by the equity holders. This increase in the risk experienced by the equity holders is precisely the risk that the leverage formula is measuring. Therefore, adding a bond yield differential adjustment for the anticipated higher cost of debt is a double-count. (Rothschild)

STAFF: No position at this time.

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

POSITION

UTILITIES

INC.: 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. (Ahern)

OPC: It is not appropriate to make a private placement premium adjustment. There are a sufficient number of investors such as retirement funds and life insurance companies that plan to hold an investment to maturity that there is no reason to expect a private placement premium. (Rothschild)

STAFF: No position at this time.

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

POSITION

UTILITIES

INC.: 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. (Ahern)

OPC: It is not appropriate to make a small-utility risk premium adjustment. First, building in a small utility risk premium to the leverage formula is wrong because not all companies to which the leverage formula could be applied are small. Second, financial theory explains why there shouldn't be a small company premium and empirical review of financial data shows that financial theory is correct: there is no small company premium. (Rothschild)

STAFF: No position at this time.

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

POSITION

UTILITIES

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

OPC: No. Instead, the following leverage formula methodology should be applied using updated financial data:

$$k = (\text{OCC} - D(1 - \text{ER})) / \text{ER}$$

where k=cost of equity

D=cost of debt, determined as a function of the percentage of equity in the capital structure

OCC=overall cost of capital

ER=Equity ratio

(Rothschild)

STAFF: No position at this time.

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?

POSITION

UTILITIES

INC.: 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. (Ahern)

OPC: The appropriate range of returns on common equity for water and wastewater (WAW) utilities pursuant to Section 367.081(4)(f), Florida Statutes, should be calculated using the formula recommended by Citizens' witness James A. Rothschild. The results of the implementation of that formula are shown on JAR Schedule 4, Page 1. As shown on that schedule, the appropriate return on equity to allow to a water or wastewater company with a common equity ratio of 40.0% is 10.53%, while the appropriate return on equity to allow to a water or wastewater company with a common equity ratio of 100% is 6.52%. (Rothschild)

STAFF: No position at this time.

ISSUE 4: Should this docket be closed?

POSITION

UTILITIES

INC.: No.

OPC: No.

STAFF: No. This docket should remain open to allow staff to monitor the movement in capital costs and to readdress the reasonableness of the leverage formula as conditions warrant, until next year's docket is opened.

IX. EXHIBIT LIST

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
<u>Direct</u>			
Pauline M. Ahern	Utilities Inc.	PMA-1	Educational Background & Experience
James A. Rothschild	OPC	JAR-1	Resume of James A. Rothschild
James A. Rothschild	OPC	JAR-2	Discounted Cash Flow (DCF) Indicated Cost of Equity
James A. Rothschild	OPC	JAR-3	Capital Asset pricing Model
James A. Rothschild	OPC	JAR-4	Recommended Leveraged Formula
James A. Rothschild	OPC	JAR-5	Beta vs. DCF ROE for Companies used in Staff Analysis
James A. Rothschild	OPC	JAR-6	Modigliani-Miller Theorem
James A. Rothschild	OPC	JAR-7	Average Betas of 10 Groups of Companies from 1926-2007
James A. Rothschild	OPC	JAR-8	Average Equity Ratio of Comparative Gas Companies
James A. Rothschild	OPC	JAR-9	Selected Financial Data of Comparative Companies
James A. Rothschild	OPC	JAR-10	Simplified Version of the DCF Method
James A. Rothschild	OPC	JAR-11	External Financial Rate
<u>Rebuttal</u>			
Pauline M. Ahern	Utilities Inc.	Appendix A	Appendix A to the Rebuttal Testimony of Pauline M. Ahern
Pauline M. Ahern	Utilities Inc.	PMA-2	Blue Chip Financial Forecasts, Aug. 1, 2001

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
Pauline M. Ahern	Utilities Inc.	PMA-3	Weekly U. S. Spot Price for Oil
Pauline M. Ahern	Utilities Inc.	PMA-4	Labor Force Statistics
Pauline M. Ahern	Utilities Inc.	PMA-5	Moody's A-Rate Public Utility Bonds Yields
Pauline M. Ahern	Utilities Inc.	PMA-6	Value Line, Aug. 3, 2001
Pauline M. Ahern	Utilities Inc.	PMA-7	Calculation of Mean, Standard Deviation, and Coefficient of Variation of Russell 2000
Pauline M. Ahern	Utilities Inc.	PMA-8	Comparison of Adjusted Rates
Pauline M. Ahern	Utilities Inc.	PMA-9	S&P Corporate Ratings Criteria Utilities
Pauline M. Ahern	Utilities Inc.	PMA-10	Comparison of the Impact on Revenue Cost of Capital of Holding Before Income Tax
Pauline M. Ahern	Utilities Inc.	PMA-11	Correct Deviation of Cost Rate of Common Equity
Pauline M. Ahern	Utilities Inc.	PMA-12	Indicated Common Equity Cost Rate
Pauline M. Ahern	Utilities Inc.	PMA-13	New Regulatory Finance by Roger A. Morin, Ph.D., pp. 128-129
Pauline M. Ahern	Utilities Inc.	PMA-14	Deviation of Investment Risk
Pauline M. Ahern	Utilities Inc.	PMA-15	Fundamentals of Financial Management by Eugene F. Brigham, pp. 622-623
Pauline M. Ahern	Utilities Inc.	PMA-16	Ibbotson SBBI 2008 Valuation Yearbook, p. 119
Pauline M. Ahern	Utilities Inc.	PMA-17	Principles of Corporate Finance by Brealey and Myers, pp. 622-623

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
Pauline M. Ahern	Utilities Inc.	PMA-18	New Regulatory Finance by Roger A. Morin, Ph. D., pp. 303-307
Pauline M. Ahern	Utilities Inc.	PMA-19	Ibbotson SBBI 2008 Valuation Yearbook, pp. 77-83
Pauline M. Ahern	Utilities Inc.	PMA-20	SBBI 1999 Yearbook, pp. 157-158
Pauline M. Ahern	Utilities Inc.	PMA-21	Essentials of Managerial Finance by Weston and Brigham, p. 272
Pauline M. Ahern	Utilities Inc.	PMA-22	New Regulatory Finance by Roger A. Morin, Ph. D., p. 133-143
Pauline M. Ahern	Utilities Inc.	PMA-23	Principles of Corporate Finance by Brealey and Myers, pp. 146-147
Pauline M. Ahern	Utilities Inc.	PMA-24	Total Returns on Large Company Stocks
Pauline M. Ahern	Utilities Inc.	PMA-25	Coefficients of Determination and Ibbotson SBBI Valuation Yearbook, pp. 111-113
Pauline M. Ahern	Utilities Inc.	PMA-26	Investments: Analysis and Management by Jack Clark Francis, pp. 273-275
Pauline M. Ahern	Utilities Inc.	PMA-27	Ibbotson SBBI 2007 Valuation Yearbook, pp. 92-97
Pauline M. Ahern	Utilities Inc.	PMA-28	Brief Summary of Common Equity Cost Rate
<u>Surrebuttal</u>			
James A. Rothschild	OPC	JAR-12	Evaluation of Dr. Morin's Testimony

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
James A. Rothschild	OPC	JAR-13	“Financial Advisers and Fuzzy Math”
James A. Rothschild	OPC	JAR-14	“The Difference in Averaging”

Parties and Staff reserve the right to identify additional exhibits for the purpose of cross-examination.

X. PROPOSED STIPULATIONS

The parties have proposed a stipulation to Issue 4. This docket should remain open to allow staff to monitor the movement in capital costs and to readdress the reasonableness of the leverage formula as conditions warrant, until next year's docket is opened.

XI. PENDING MOTIONS

There are no pending motions at this time.

XII. PENDING CONFIDENTIALITY MATTERS

There are no pending confidentiality matters at this time.

XIII. POST-HEARING PROCEDURES

If no bench decision is made, each party shall file a post-hearing statement of issues and positions. A summary of each position of no more than 50 words, set off with asterisks, shall be included in that statement. If a party's position has not changed since the issuance of this Prehearing Order, the post-hearing statement may simply restate the prehearing position; however, if the prehearing position is longer than 50 words, it must be reduced to no more than 50 words. If a party fails to file a post-hearing statement, that party shall have waived all issues and may be dismissed from the proceeding.

Pursuant to Rule 28-106.215, F.A.C., a party's proposed findings of fact and conclusions of law, if any, statement of issues and positions, and brief, shall together total no more than 40 pages and shall be filed at the same time.

XIV. RULINGS

1. The Motion for Leave to File Surrebuttal Testimony filed by the Office of Public Counsel is granted.

2. Utilities, Inc.'s Motion to Strike Portion of James A. Rothschild's Surrebuttal Testimony and Exhibits is denied.
3. The Office of Public Counsel's Motion to Strike Portions of the Rebuttal Testimony of Pauline Ahern and to Strike Exhibits PMA-13, PMA-18, and PMA-22 is denied.
4. Opening statements, if any, shall not exceed five minutes per party.

ORDERED by Commissioner Nancy Argenziano, as Prehearing Officer, that this Prehearing Order shall govern the conduct of these proceedings as set forth above unless modified by the Commission.

By ORDER of Commissioner Nancy Argenziano, as Prehearing Officer, this 21st day of October, 2008.



NANCY ARGENZIANO
Commissioner and Prehearing Officer

(SEAL)

JEH

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.569(1), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

Mediation may be available on a case-by-case basis. If mediation is conducted, it does not affect a substantially interested person's right to a hearing.

Any party adversely affected by this order, which is preliminary, procedural or intermediate in nature, may request: (1) reconsideration within 10 days pursuant to Rule 25-22.0376, Florida Administrative Code; or (2) judicial review by the Florida Supreme Court, in the case of an electric, gas or telephone utility, or the First District Court of Appeal, in the case of a water or wastewater utility. A motion for reconsideration shall be filed with the Office of Commission Clerk, in the form prescribed by Rule 25-22.060, Florida Administrative Code. Judicial review of a preliminary, procedural or intermediate ruling or order is available if review of the final action will not provide an adequate remedy. Such review may be requested from the appropriate court, as described above, pursuant to Rule 9.100, Florida Rules of Appellate Procedure.