BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of: DOCKET NO. 090006-WS

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.
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PROCEEDINGS: AGENDA CONFERENCE
ITEM NO. 6

COMMISSIONERS PARTICIPATING:
CHAIRMAN MATTHEW M. CARTER, II
COMMISSIONER LISA POLAK EDGAR
COMMISSIONER KATRINA J. McMURRIAN
COMMISSIONER NANCY ARGENZIANO
COMMISSIONER NATHAN A. SKOP

DATE: Tuesday, June 2, 2009

PLACE: Betty Easley Conference Center
Room 148
4075 Esplanade Way
Tallahassee, Florida

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P R O C E E D I N G S

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CHAIRMAN CARTER: And with that, Commissioners, we are now on Item 6.

Staff, you are recognized.

MR. SPRINGER: Good morning, Commissioners. I'm Michael Springer on behalf of technical staff, and this is Jean Hartman on behalf of staff counsel.

By statute, the Commission has used a water and wastewater leverage formula for determining a reasonable range of returns on equity for water and wastewater utilities for over 25 years. The last time the leverage formula went to hearing was last year in 2008. Using the same methodology approved by the Commission following the 2008 proceeding, staff has updated the leverage formula to reflect the most current financial information. We're here to answer any of your questions.

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

COMMISSIONER SKOP: Thank you, Mr. Chairman.

CHAIRMAN CARTER: Is it on? Chris, check the Commissioner's mike.

COMMISSIONER SKOP: Thank you, Mr. Chairman. I appreciate it. My button was on but the mike was not working.

Just a quick question, a couple of questions for Mr. Maurey with respect to the updated leverage formula. If we could turn to Page 6, Attachment 1, Page 1 of 6 of the staff recommendation. I guess I was looking at that trying to understand the changes in terms of the leverage formula that's currently in effect versus the current leverage formula calculation. And, Mr. Maurey, would it be correct that the CAPM model is driving the reduction primarily in the leverage formula?

MR. MAUREY: Yes.

COMMISSIONER SKOP: Okay. And would that be primarily due to the Federal Reserve policy as it affects the risk-free rate component of the CAPM model?

MR. MAUREY: In large measure. It also -- a decrease in the beta contributed to the decline in the CAPM result.

COMMISSIONER SKOP: Okay. And generally speaking, both the DCF and the CAPM models work best during periods of market stability and sometimes -- as opposed to market volatility. They tend to function better when the markets are stable; is that correct?

MR. MAUREY: That's correct.

COMMISSIONER SKOP: Okay. Previously I guess the leverage formula went up in 2008 and then went back -- up by 75 basis points, I believe, somewhere around there, and then down by 121 basis points for the 2009 that we're being asked to adopt today. Is that generally correct?

MR. MAUREY: In addition to the drop in the CAPM, another factor affecting it was the, a change in slope. But, yes, that, that is correct.

COMMISSIONER SKOP: Okay. But basically in terms of the fluctuation or the volatility in the year-to-year adoption of the leverage formula it previously went up 75 basis points and then now it's going down 121 basis points, subject to check. Is that generally --

MR. MAUREY: Yes.

COMMISSIONER SKOP: Okay. I guess what was somewhat surprising to me, and I guess the Commission adopted the previous leverage formula in January 2008 and we're currently adopting the new one, but it seems to me that, and there may be a good reason for this, but there seems to be some sort of lag associated with the model in conjunction with prevailing economic conditions. I would think that if, if the model would have been adopted last year, we would have seen the reduction probably sooner, I mean, or earlier rather than we did now. And the reason that I wanted to kind of go into that is that we're adopting this model for 2009 and it reflects a lot of the changing market conditions, which I have no problem with. But I also read over the weekend, I guess the most recent Treasury auction for the ten-year notes showed an increase of 150 basis points in terms of the yield. And I guess they have another auction for longer term Treasuries coming out this Thursday, which is also expected to see the yields increase due to I guess the move away from Treasury, a whole host of reasons. But I was wondering how that might impact the CAPM component of the calculation, or should that be a factor or should we -- you know, I guess we can update the leverage formula quarterly, which I don't think anyone really wants to do. But I'm just wondering if we make a decision today but suddenly the markets change, as they seem to be on the cusp of doing, what impacts that might have.

MR. MAUREY: A couple of points I'd like to make.

With respect to the spike in ten-year Treasuries, that 150 basis point swing was since the low in December, not, not instantaneous from last week. So it has been going up, but in just the last week it's given back 20 basis points of that. So it went from 371, now it's 346.

The point I'm making there is it is a volatile rate. And for a lot of the reasons you alluded to about reasons of inflation in the future, the longer term end of the yield curve has, has gone up. The demand to hold long government paper is requiring a higher return out of inflationary fears.

Later this week the federal government is going to discuss buying back Treasuries in hopes of bringing that yield down because with fixed mortgages tied to the ten-year Treasury, a spike in ten-year Treasury is going to lead to a spike in fixed mortgage rates and that's going to, some fear, stall the recovery of housing. That's one of the main pillars of the recovery. So in an effort to, to reverse that trend, to keep rates lower, the Fed is going to buy back Treasuries. We'll, we'll see how successful that effort is. They've issued a tremendous amount of bonds in the recent to support the multi-prong economic recovery. How much they buy back and what type of impact that has on the rates we'll see.

Now to your final question about the CAPM, yes, the 30-year Treasury rate is a key component of the CAPM. And with that rate being held low, it is, the CAPM is indicating returns that are lower, certainly lower than what the DCF model is indicating right now.

COMMISSIONER SKOP: Okay. And just to that, to that final point and to the point that you just elaborated on, given the models again in times of market volatility aren't always basic and stable and that results in, in sort of like the variation we're seeing in terms of the leverage formula going up and then going down, and if I were a betting man, I would expect it to go up next year, but would it be beneficial in terms of when we have periods of market volatility -- I know that staff -- basically the leverage formula itself is driven on an average on the DCF for the Natural Gas Index and also on the CAPM. Right now the DCF seems to be, you know, a little bit more stable than the CAPM for the reasons that we just discussed. But would it be beneficial to staff to have additional discretion in terms of being rigidly bound to the leverage formula to either maybe perhaps substitute recent Commission decisions -- I know that we had two recent gas decisions.

And I'm not suggesting that this needs to be done, but just as a basis of flexibility for staff to perhaps smooth the, the curve or have a, you know, take out some of the volatility that we're seeing in the leverage formula bouncing around like a Ping-Pong ball. Would it be beneficial to staff to be able to have alternate bases for when it's in its judgment to use as inputs to the model -- for instance, in lieu, in lieu of using a DCF or CAPM model, substituting either recent decisions of the Commission or, if the CAPM is diverging from what we would normally see, to just use a DCF or a single model approach?

MR. MAUREY: It would always be helpful to have --

COMMISSIONER ARGENZIANO: Mr. Chair. Mr. Chair.

CHAIRMAN CARTER: Yes, ma'am.

COMMISSIONER ARGENZIANO: I'm really having a hard time hearing Commissioner Skop and staff, if they're not speaking into the mike, or can Chris turn up the volume a little bit?

CHAIRMAN CARTER: Chris, could you adjust the volume?

COMMISSIONER ARGENZIANO: Thank you.

CHAIRMAN CARTER: Okay. Commissioner Skop, repeat your last question, please, sir.

COMMISSIONER SKOP: Yes. Thank you, Mr. Chair.

Just to Mr. Maurey with respect to some of the issues that we've discussed in terms of the CAPM model as it's currently functioning is predicting a little bit, trending lower than it normally would due to Federal Reserve policy. Again, these models work well in times of market stability, but in market volatility, again, we've seen the leverage formula go up and then go down. And then I would expect that it would go up by virtue of the yield curves increasing or inflationary pressure in the, in the future. But during these times of market volatility, I guess the question I'm asking, because, again, having curves that move smoothly rather than, you know, bouncing around like a Ping-Pong ball, going up by, you know, a hundred and something basis points or down and then only to go back up in a real short period of time, that volatility tends to lead to somewhat inconsistent outcomes, as we may see later today.

But I guess I'm wondering if it would be beneficial to staff to have some additional discretion in terms of if there are times of market volatility, to be able to look at either recent Commission decisions as a substitute for the Natural Gas Index or to use a single model approach when one of the models provides results that really would trend lower than what would be expected.

MR. MAUREY: It's always helpful to have more information than less in these matters. Our -- and that idea has been brought forth before in other workshops when we've dealt with the leverage formula over the last 25 years.

One -- and in this period of time where there are a lot of rate case activities, it's intuitively appealing to use an average decision, say for the last six months, as the starting point for the leverage formula as opposed to doing our own independent analysis here.

The concern that's often raised when that approach is suggested is sustainability. What happens in periods when there are no frequent rate case activity? And so it's, we've gone with this approach where we do an independent analysis, but it would not be wrong to do that. And if you were -- the leverage formula is a formulistic approach designed to remove subjective adjustments by staff. The Commission approves a methodology and each year staff updates it for current financial information; whereas, if you come before the Commission with an evidentiary proceeding, you have witnesses that then there's an opportunity for both objective and subjective adjustments to the models and informed decision-making, and there's a smoothing result with the ROE that's really not present in a rigid formulistic approach like the leverage formula.

The -- if the decision is made that this is such an -- that going from point to point, that's part of the reason you described it as the Ping-Pong effect. When companies come before the Commission, over time they each bring their evidence and you get, you get marked a time throughout the year so you can see how the curve smooths; whereas, this is comparing the results of one month in '08 to one month in '09, and that's where you have those, whatever it is, that snapshot in time to another snapshot in time. You don't have the smoothing effect of information throughout the year.

COMMISSIONER ARGENZIANO: Excuse me. Mr. Chair?

CHAIRMAN CARTER: Yes, Commissioner Argenziano.

COMMISSIONER ARGENZIANO: Yes. Just to clarify things, Commissioner Skop, it seems like what you're trying to do is get the utilities to stabilize the national economy. I don't know that you can do that, and I would think that you have to adjust to the reality, not to the possibility. And since CAPM and DCF are so subjective, I think all you have is reality. So to me it would be that the leverage graph needs to look at the real picture in time rather than the possibility of what's coming down the road because we can't, we can't play Carnac and understand what that is. So I'm really not sure what you're asking other than, than trying to get the, you know, to, I guess, use the utilities to stabilize the national economy, and I'm not sure that's what you do.

COMMISSIONER SKOP: I think that was anything but what I was trying to suggest respectfully. But what I am trying to do is articulate the fact that in times of market volatility the CAPM model is trending lower as a result of artificial Federal Reserve intervention into our economy, and that if that is a driving factor in what we base our leverage formula on, then that causes divergence, as we're seeing on Page 6, to the extent that the CAPM in normal economic times would track well and have good correlation with the DCF, and here it's divergent.

And what I was suggesting is not to have the utilities set economic policy, anything but that at all. What I am suggesting though is market volatility as well as volatility in terms of regulatory policy is typically not a good thing, you know. And so what I was trying to do was ascertain from our staff to the extent that they do see things that concern them with respect to a model artificially trending down lower than it would and driving results in a certain way and having a, a, for lack of a better term, a downward pressure on something which causes additional volatility and the Ping-Pong effect that was mentioned, whether it would be beneficial for staff to have some sort of discretion to use its best judgment as a result of looking at either -- recent Commission decisions. But I recognize that there are times where recent Commission decisions are not available, as Mr. Maurey has pointed out. I'm not suggesting that that would be used all the time. You know, 99.9 percent of the time the leverage formula works well. Where it does not seem to work well is in times of extreme market volatility, and these are one of those times.

So I'm merely suggesting that in the transitional times where we do have market volatility which seems to cause perturbations in the leverage formula result, again, whether staff should have the discretion to either look to recent Commission decisions as a proxy for the Natural Gas Index on the DCF or CAPM input components or alternatively whether they should just go a single model approach, in this case use the DCF and tend to not give as much weight towards a CAPM which is yielding artificially low results.

COMMISSIONER ARGENZIANO: So basically ignoring the CAPM, which then of course lowers the CAPM which is in a much, showing right now a lower ROE. I beg to differ and respectfully so. I think you have to look at the reality of what it is, whether you want to call it artificial or not, it is reality. And rather than try to predict what's coming in the future, I think, it's my opinion that you have to look at what you have in front of you now. So I think staff was correct and I would be very reluctant to want to guess as to, you know, what's, what's going to happen down the road.

COMMISSIONER SKOP: And I'm not saying that staff is incorrect. I actually support what staff has done here. What I'm trying to do is give staff additional tools to use their, exercise their, their judgment in places where staff may have some concerns with respect to a model not really kind of predicting as it would normally do.

So, again, I think we're in agreement that the leverage formula here is properly done. I'm just merely having a discussion to articulate some of the limitations of the method that we adopted and try to maybe perhaps come up with some best practices that would mitigate the volatility that has been experienced in terms of market volatility. Because I do think that this model or the leverage formula lags the prevailing economic conditions as we see. And, I mean, we're just getting around to doing a reduction and the economy is almost on the, hopefully on the cusp of recovery. So, again, if I were a betting man, I would expect the leverage formula to go up in the near-term, but we'll see.

But with that, Mr. Chair, if there's no other questions, I would move to approve staff recommendation as to Issues 1 and 2. I would also ask staff to continue to monitor prevailing economic conditions. And should an appropriate adjustment be necessary to the leverage formula consistent with staff, to also bring that back to the Commission at the later time, should staff feel it's necessary.

MR. MAUREY: We'll do that.

COMMISSIONER ARGENZIANO: Mr. Chair, may I ask a question of staff?

CHAIRMAN CARTER: Before we do a second, let's see if there are anymore questions. Commissioner Argenziano, you're recognized.

Commissioner Edgar, did you have a question?

COMMISSIONER EDGAR: No questions. I'm ready to second at the appropriate time.

CHAIRMAN CARTER: Okay. We'll come to you for the second. And, Commissioner McMurrian, did you have any?

Commissioner Argenziano, you're recognized for a question.

COMMISSIONER ARGENZIANO: Yes. Just a question to Commissioner Skop. I'm also just participating in that conversation, so it's no -- it's not an argument. It's more of a debate and discussion.

For staff, if the conditions, economic conditions change, would that, would -- I mean, would it make it -- is it -- would there be anything differently done? Wouldn't, wouldn't the utilities and also staff want to relook at that leverage graph if things were to change? Isn't that what's normally done?

MR. MAUREY: Yes, Commissioner. We do these models monthly as time permits. And with the leverage formula itself, we, we monitor the movement in cost but we typically don't bring back another formula unless there is a significant movement. And it just so happens this movement has come about the time that we would be bringing it back anyway. It's coincidental in that manner, but we would bring it back if there were a significant swing in either direction.

COMMISSIONER ARGENZIANO: Okay. Thank you.

CHAIRMAN CARTER: Thank you. Commissioners, any further questions?

Commissioner Edgar, you're recognized for a second.

COMMISSIONER EDGAR: Thank you, Mr. Chairman. I'd like to second the motion at this time.

CHAIRMAN CARTER: Commissioners, we have a motion and a second. Are there any further discussion that we basically adopt staff's recommendation on the case, any further questions? Hearing none, all in favor, let it be known by the sign of aye.

(Unanimous affirmative vote.)

All those opposed, like sign. Show it done. And I think those were the only two within the confines of that issue.

(Agenda item concluded.)

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STATE OF FLORIDA)
: CERTIFICATE OF REPORTER
COUNTY OF LEON)

I, LINDA BOLES, RPR, CRR, Official Commission Reporter, do hereby certify that the foregoing proceeding was heard at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorneys or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 15th day of June, 2009.

Linda Boles

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