BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

PETITION FOR INCREASE IN RATES BY FLORIDA POWER & LIGHT COMPANY. DOCKET NO. 080677-EI

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2009 DEPRECIATION AND DISMANTLEMENT STUDY BY FLORIDA POWER & LIGHT COMPANY. DOCKET NO. 090130-EI

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VOLUME 20
Pages 2541 through 2666

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PROCEEDINGS: HEARING

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

DATE: Wednesday, September 2, 2009

TIME: Commenced at 11:30 a.m.
Concluded at 1:00 p.m.

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

REPORTED BY: CLARA C. ROTRUCK
Court Reporter
(850) 222-5491

PARTICIPATING: (As heretofore noted.)

I N D E X

WITNESSES

EXHIBITS

NUMBER:		ID.	ADMTD.
223 through 248			2570
443			2571
444			2571
445	Comparison of Proxy Groups	2658	
446	Consensus Proxy Group ROE Estimate	2661	

From Staff's Comprehensive Exhibit List:

	ID.	ADMTD.
Exhibit No. 37, Item Nos. 21 through 31	2552	2552

P R O C E E D I N G S

(Transcript follows in sequence from Volume 19.)

CHAIRMAN CARTER: We are back on the record and we had stopped for a break and I'm sure that everybody appreciated it. Mr. Butler?

MR. BUTLER: Thank you, Mr. Chairman. And I will let you know that I'm almost finished, so that's good.

CONTINUED CROSS EXAMINATION

BY MR. BUTLER:

Q Ms. Brown, I'm going to ask you questions that require you to look at your SLB-25 and Dr. Woolridge's Exhibit JRW-5 and then FPL's 2010 projected test year Schedule D-1A, and I believe you have a copy of all of those in front of you now, is that right?

A No, I still don't have Dr. Woolridge's exhibit.

Q Hold on, I will bring it to you right now.

Now you have all three pieces?

A Yes.

Q Okay. You have created on your SLB-25 a revised capital structure based on Dr. Woolridge's recommendations, correct?

A That is correct.

Q And you have taken the components from Dr. Woolridge's -- from page 2 of Dr. Woolridge's Exhibit JRW-5 and then reflect those in this adjusted jurisdiction column on your SLB-25, is that correct?

A Yes, I took the information provided to me by Dr. Woolridge.

Q And the total of those components is $20.67 billion, is that right?

A 20.767.

Q Thank you. I would like you to compare your capital structure to that shown on MFR D-1A. Do you have a copy of that available to you?

A Yes.

Q Would you agree that your total adjusted jurisdictional figure of 20.767 billion is very close to FPL's total company per books figure of 20.484 billion that's shown in column 2 on MFR D-1A?

A Yes, as I understand it, Dr. Woolridge was using the total company cost of capital, and that's what he provided to me. Any question further on that would have to go to Dr. Woolridge.

Q Let me be sure I'm understanding correctly. On your Exhibit SLB-25, the column heading is "Adjusted Jurisdiction," correct?

A Yes.

Q But are you saying that that's intended to reflect a per books -- total company per books capital structure?

A My understanding per Dr. Woolridge was that he was using the same amount for jurisdiction as he was for total company, so it is the same.

Q So he considers the two as interchangeable?

A As I said, I just took the information that Dr. Woolridge provided me that he was using for the cost of capital in this proceeding.

Q Well, you would agree that the figure that you present, the 20.767 billion, is about $3.4 billion greater than FPL's jurisdictional adjusted capital structure that's shown on D-1A, correct?

A Yes, I would agree with that.

Q Okay. Did you make any of the adjustments that are referred to in columns 3 and 4 of D-1A to the capital structure?

A No. Again, I was just taking what Dr. Woolridge recommended.

Q Do you know whether those are Commission-specified adjustments?

A Some of them are Commission-specified adjustments.

Q Did you make any of those Commission-specified adjustments?

A No. Again, I just took the information from Dr. Woolridge as he was recommending.

Q Well, do you know, or is this then a question for Dr. Woolridge, whether what you have entitled "Adjusted Jurisdiction" here is a set of figures that are properly comparable to company per books figures, which are shown in column 2 on D-1A, instead of jurisdictional adjusted figures, which is shown in column 7?

A Yes, I do know that Dr. Woolridge was using -- the total company and the jurisdictional were the same from what Dr. Woolridge asked me to do, yes.

Q So the same figure, and therefore if they are the same, they would not reflect any of the adjustments that are shown on columns 3 or 4 on D-1A, correct?

A They do not reflect those adjustments, correct.

Q Thank you, Ms. Brown.

MR. BUTLER: Madam Chair, would you allow me just one moment to confer with my colleagues? I'm very close to finishing.

ACTING CHAIRMAN EDGAR: Take a moment.

(Brief pause.)

/ / / / /

BY MR. BUTLER:

Q One more what I think is going to be a brief line of questions for you, Ms. Brown.

I would like you to assume that there is a company whose executive compensation compares favorably to industry benchmarks for executive compensation, that is, at or slightly below the average for the industry. Then I would also like you to assume in this hypothetical that the company has demonstrated strong performance on what I will call customer-favoring metrics, such as high reliability, low cost per kilowatt hour for electricity.

Now, if that utility had as part of its compensation structure metrics that would be influenced by favorable shareholder performance, would you see any reason why that utility's compensation would not properly be recoverable, given the performance relative to the compensation metrics and the performance metrics?

A It's kind of a compound question. I have not seen any analyses showing what the actual benefits are to ratepayers and whether the cost associated with any increased executive compensation is commensurate with the benefits that they get. However, I believe that what has been shown is that there are numerous benefits, both to shareholders and to ratepayers, but I do believe that the evidence shows that there is a significant portion of the executive compensation and the executive functions that benefit shareholders, and that's why I suggested the 50-50 sharing.

Q Let's just be sure we're talking to my hypothetical. In the hypothetical, the utility is -- the total compensation for executives is at or below the industry average, and the performance of the utility is above industry average on benchmarks that are customer benefiting, such as reliability, cost of electricity.

If the utility were in that position, wouldn't you agree that the compensation to those executives would be reasonable and properly recoverable even if there were particular metrics within the measures for the compensation that might benefit shareholders?

A Not necessarily. I would have to see, again, the cost-benefit analysis to see if what the additional pay was going to be was commensurate with the benefits that were received.

Q But if the total compensation is at or below the industry average, wouldn't that be a strong measure that the compensation was reasonable and competitive with market events using market requirements?

A If the total compensation is, as I understand your question, is equal to, for example, the benchmark in the market, then I understand that yes, that -- I'm not saying that the compensation levels -- I have not challenged the compensation levels, except to say that there is a portion of these executives' functions and performance objectives that benefit shareholders, and that shareholders should share in the cost of that.

Q But if the -- shareholders sharing in the compensation of those individuals would mean, another way of putting it, that the company would be unable to recover those costs from its customers, correct?

A That's correct, except to the extent that it's self-funded. When customers have paid, for example, a certain level of O&M or a certain return on equity, and then it's exceeded as a result of successful performance by your executives, then that's somewhat self-funded by the ratepayers.

Q But your proposal in your testimony is not based on whether or not FPL exceeds its authorized rate of return, is it?

A No.

Q That's all the questions that I have. Thank you, Ms. Brown.

MR. BUTLER: Thank you, Commissioners.

ACTING CHAIRMAN EDGAR: Are there questions from staff for this witness?

MS. BENNETT: We have some exhibits that we would like entered into the record. I provided them to the parties yesterday. I think they may be in agreement that they could go in without cross-examining the witness.

ACTING CHAIRMAN EDGAR: Let's look to all of the parties. Is that --

MR. McGLOTHLIN: OPC has no objection to those exhibits.

ACTING CHAIRMAN EDGAR: Thank you. No objection from the Attorney General, I'm seeing?

MS. BRADLEY: No objection.

ACTING CHAIRMAN EDGAR: Thank you.

MS. PERDUE: No objection.

ACTING CHAIRMAN EDGAR: No objection. No objection, okay. And no objection. Okay. No objection?

MR. BUTLER: No objection from FPL.

ACTING CHAIRMAN EDGAR: No objection. No objection. All right, thank you very much.

Why don't you go ahead and give us the list, if you would?

MS. BENNETT: All right. It's on staff's Composite Exhibit 37. They are items 21, which is interrogatory number 16 of OPC's Responses to Staff's

First Set of Interrogatories, through item 31, which is number 26 of OPC's Responses to Staff's First Set of Interrogatories. So we are entering 16 through 26, which are items 21 through 31, on Exhibit 37.

ACTING CHAIRMAN EDGAR: Is that all at this time?

MS. BENNETT: Yes, ma'am.

ACTING CHAIRMAN EDGAR: Okay. Any questions about the items that Ms. Bennett has described or listed for us?

Seeing none, we will go ahead and have those items from the composite exhibit entered into the record at this time.

(Composite Exhibit No. 37 on Comprehensive Exhibit List, Item Nos. 21 through 31, marked for identification and admitted into the record.)

ACTING CHAIRMAN EDGAR: Commissioners, are there any questions for this witness at this time?

Seeing none, Mr. McGlothlin, I believe that brings us back to you for redirect.

MR. McGLOTHLIN: Thank you.

REDIRECT EXAMINATION

BY MR. McGLOTHLIN:

Q Ms. Brown, let's begin with the last series of questions from Mr. Butler, but let's move from his hypothetical to the example of Florida Power & Light Company.

There were some references in his question to metrics that are influenced by shareholder performance. Do you remember that description in his hypothetical?

A Yes.

Q Now, turning to the example of Florida Power & Light Company, within FPL's incentive compensation program, are there metrics that are influenced by shareholder performance?

A There are metrics that are influenced by performance of the company that benefits shareholders, for example, return on equity, net income, O&M expenses, things like that.

Q Yes, if you can, give the Commissioners some examples of the type of criteria or financial objectives within the compensation form that benefits shareholders as opposed to customers.

A Well, for example, there are net income -- net income goals, return on equity goals. While they have not weighted those for the non -- for the executives that are not named, these go into their overall determination of the type of executive incentive compensation that they're going to get.

So, for example, if a return on equity goal is met or exceeded, that means that the company was able to either increase revenues or decrease expenses to the point that the return on equity has risen to a higher level. Since the rates are then funded by the ratepayers, and these expenses have been paid, then obviously any reduction in those expenses has been funded by the ratepayer.

So that's what I mean by self-funding, that some of the financial benefits that accrue to shareholders are basically self-funded, because we set the net income and the overall revenue requirements based on a certain result, and then when they improve upon that result, if you were in fact to make changes to what the ratepayers are paying, they would actually have a refund. Instead, it goes towards providing executive compensation.

MR. BUTLER: Madam Chairman?

ACTING CHAIRMAN EDGAR: Mr. Butler.

MR. BUTLER: I'm going to object to that question and move to strike the last answer. I don't believe that it's fairly responsive in redirect to what I had asked. I had asked about a hypothetical that was not structured to bring FPL's specifics into the -- into my question. The question --

ACTING CHAIRMAN EDGAR: I'm sorry, I'm not sure I understand. Are you objecting to the question or to the answer?

MR. BUTLER: I'm objecting to the question and moving to strike the answer as being well beyond the scope of my cross-examination in redirect.

ACTING CHAIRMAN EDGAR: Mr. McGlothlin?

MR. McGLOTHLIN: The witness has proposed adjustments not to a hypothetical utility, but to Florida Power & Light Company's compensation program. The thrust of Mr. Butler's questions, including the hypothetical, was to challenge the basis on which she made those disallowances. I'm going to give the witness an opportunity to explain to the Commissioners the basis for her disallowances and the rationale for them.

ACTING CHAIRMAN EDGAR: I'm going to allow, and I would ask for any party at any time, if there is an objection to the question, to raise that objection prior to the answer.

Mr. McGlothlin, you may continue.

BY MR. McGLOTHLIN:

Q Ms. Brown, you mentioned, I believe, that share price was one of the criteria or objectives that's within FPL's incentive compensation program, is that correct?

A Share price is one of the objectives that can be used. Now, whether or not it's used in a particular year is something that's decided by the compensation committee. There are a number of factors that they do use, including earnings, ROE, earnings per share growth, so there are a number of financial factors, but whether they use any particular one in a particular year is up to the compensation committee.

Q Using that one as an example of the type of things that can be taken into account and sometimes are taken into account, what is the relationship within the compensation program between the share price on the one hand and the amount of compensation received by certain employees on the other?

A They have not shown a weighting for 2009, so it's their overall goals, and you just have to look at the fact that they are -- either they are assigning weights on a year-by-year basis, or in the case of I believe 2008, they looked at it and they didn't really assign weights, they just looked at the overall achievement of the objectives.

Q Looking to the basic relationship, as share price increases, would the compensation received by a particular individual increase or decrease?

A Increase.

Q Now, Mr. Butler's hypothetical included the assumption that the hypothetical corporation was about at the benchmark for peer companies with respect to overall compensation. Do you remember that question and answer?

A Yes.

Q Would the fact -- let me start again.

Assuming that there are certain criteria, as earnings, return on equity and share price, within the compensation formula, would the fact that a particular company is at or near the benchmark necessarily indicate that 100 percent of the compensation cost should be borne by customers?

A No, because, again, there is a mix of factors, and many of them are financial in nature and benefit shareholders.

Q If you will, turn to your Exhibit SLB-12, which was the subject of some of the questions from Mr. Butler. That is a one-page schedule that has the caption, "Actual Versus Targeted Full-Time Equivalent Employees." Do you see that?

A Yes.

Q And tell the Commissioners precisely what was the nature of the error that you identified as a result of one of the questions posed to you, and what corrections should be made there.

A The only error is that the word "target" above the first three columns, what we showed was the actual number of employees by business unit and then compared it to the target employees by business unit and showed that they were typically -- actual was typically below target. The only thing that was wrong on this exhibit was just that the "actual" and "target" were -- the titles were reversed, just the titles.

Q So over 2006, '07 and '08 where it says "target," it should say "actual"?

A Correct.

Q And where it says "actual," it should say "target"?

A Correct.

Q Now, at the outset -- let me ask this first: What is the source of this information on SLB-12?

A The source is OPC's First Request for Production of Documents, Request No. 3.

Q Request directed to whom, Ms. Brown?

A To Florida Power & Light.

Q So this is FPL information?

A Yes, it is.

Q At the outset of his questions, Mr. Butler asked you whether your exhibit indicated that the actual figures exceeded the target levels. Do you recall that question and answer?

A Yes.

Q Given that this is FPL's information, would FPL have a reason to know that the actual figures were below the target figures before he asked the question?

A Yes.

Q Mr. Butler asked you another hypothetical which assumed a company employing three employees. Do you remember that?

A Yes.

Q And a part of the assumption was that one of the three employees was poached. Do you remember that?

A Yes.

Q Did the hypothetical ask you to assume that the third person would not have been replaced during that year?

A No.

Q Do you think that the hypothetical of a company having three employees and then working with only two for the following year is a real-world hypothetical?

A No, especially not if they've got to pick up an extra 2,000 hours.

Q How many employees does Florida Power & Light Company have, approximately?

A About -- over 10,000.

Q Mr. Butler referred you to what has been marked as Exhibit 444, which is the NRC decommissioning fund requirements. Do you have that available to you?

A Yes.

Q And directing you again to what is marked page 2 at the top right within CFR 50.82, subsection (8)(i). Do you have that?

A Yes.

Q Would you read for the Commissioners the sentence following the capital A in parentheses?

A "The withdrawals are for expenses for legitimate decommissioning activities consistent with the definition of decommissioning in Section 50.2."

Q Drawing your attention to the phrase, "consistent with the definition of decommissioning in 50.2," do you believe that the definition necessarily delineates every potential use of the funds?

A No.

Q In response to one of Mr. Butler's questions, you referred to CFR 50.75, did you not?

A Yes, I did.

Q Please tell the Commissioners what 50.75 provides and why you cited it to Mr. Butler.

A 50.75 establishes the requirements for how the licensee is going to provide reasonable assurance that the funds will be available, and it has some discussion of the fact that there are other regulatory commissions that are involved and may have other requirements as well.

Q Was 50.75 among the provisions that Mr. Butler provided to you and the Commissioners for purposes of his questions?

A No.

MR. McGLOTHLIN: I ask the Commission to take official recognition of 50.75 CFR.

BY MR. McGLOTHLIN:

Q The -- Mr. Butler also referred to a petition that was denied by the NRC. Do you remember that question and answer?

A Yes.

Q Have we seen any indication as to whether the scope of that request is similar to or different from the proposed use that you have described in your testimony?

A I have not seen anything regarding that particular case; however, as I said, this is a -- if this was a generic rulemaking, I can understand that. What we are asking for here is a specific decision based on the excess funding that we believe that FPL has.

Q Ms. Perdue asked you some questions about your recommendations in the area of the denial of a generation base rate adjustment. Do you recall those questions and answers?

A Yes.

Q And I believe one line of questioning had to do with the uncertainty associated with near-term economic environment. Do you recall that question and answer?

A Yes.

Q As you understand it, is Florida Power & Light Company's proposed GBRA limited to 2011 or the near term?

A No, they're asking for it to be continuous.

Q And if we were to assume that FPL contemplates a GBRA that lasts not only through 2011, but for decades, can we gauge now the type of economic circumstances that would prevail at the time of future power plants at the time when FPL would want to implement the GBRA?

A No.

Q Ms. Perdue asked you to agree that in the event FPL experiences overearnings, the Commission can initiate an action to deal with that circumstance. Do you recall that question and answer?

A Yes.

Q In your view, is it appropriate for the utility to be in a position of implementing generation base rate adjustment that would have the effect of putting it in the overearnings posture, such that it would be incumbent on customers or parties or the Commission to initiate a base rate proceeding at that point?

A No. I think that shifts the burden and it's much more difficult for a ratepayer group or Intervenor to be able to develop the type of case needed to show the detail behind the financial assumptions used.

Q Ms. Perdue suggested through her questions that your positions with respect to the subsequent test year and the generation base rate adjustment are inconsistent. Do you agree that they're inconsistent?

A No, they're not inconsistent at all; in fact, they're parallel, because my concerns on both of them is that economic recovery could occur, making the assumptions that were developed inaccurate and cause the rates to be overstated, in which case we would also have excess earnings, which would then be used to offset the additional cost of any unit that would be put through the GBRA.

Q If the Commission were to approve a subsequent test year based upon speculative and uncertain projections, on whom would the risk of those projections fall in this situation?

A If we had economic recovery and the earnings became excessive, again, that would fall on the Intervenor or the Commission.

Q And if the Commission were to approve a generation base rate adjustment that had the effect of requiring customers to pay 100 percent of revenue requirements of a new power plant when existing rates were sufficient to absorb a portion of that, on whom falls the risk of subsequent action?

A Again, that would fall on the Commission or the Intervenors.

Q Ms. Perdue asked you if you were taking exception to or criticizing what she referred to as the rigorous process that Florida Power & Light applies to its projections for ratemaking purposes. Do you recall that question and answer?

A Yes.

Q Are you taking exception to the rigorous nature of the review, or are you taking exception to the use of projections in times of uncertainty for that purpose?

A I'm not taking exception to their rigorous review. I'm taking exception to the fact that in making any type of review or projection you have to use a number of factors that you are basing on current economic expectations that in this environment can change drastically.

Q If we were to begin with some assumptions and projections that everyone understands to be inherently unreliable and we were to look at those inherently unreliable projections and assumptions rigorously, at the end of that rigorous review, are they still unreliable?

A Yes.

Q You were asked some questions about the adjustment you made to reflect the fact that FPL has projected that all of its positions will be filled during the time rates were in effect. Do you recall that question and answer?

A Yes.

Q And, in response, you referred to what you called a history of the positions. Would you explain to the Commissioners what you meant by the history of positions and why that becomes the basis for your adjustment?

A Well, going back again to Exhibit SLB-12, it shows that historically FPL has targeted more positions than it's been able to have filled, and so I went back and looked at what was the average level of unfilled positions and I based my adjustment on that, with an offset for some additional overtime that I believed, from reviewing their overtime records, would be incurred as a result of not being able to fill all the positions.

Q During that series of questions and answers, I believe you said that FPL has budgeted 1.4 times the target level of compensation. Do you remember that question and answer?

A That was for the executive incentive compensation, yes.

Q Okay. With respect to that subject, what is wrong with budgeting 1.4 times the targeted level?

A Well, first, the targeted level tells you what is reasonable in the market. That's what they did their benchmarking for.

The second concern I have is that the criteria on which the targets or the actual payout factor is used is based on an assumption that these targets will be met, and when you have an economic environment where the company is claiming that without this rate increase they're only going to have a 4.25 percent rate of return, it's hard to understand how they could think that they're going to meet those objectives and be able to offer the same type of incentive or have to offer the same type of incentive.

Q If the utility were to budget its incentive compensation at 1.4 times the target level, and the target level was reached but not exceeded, what happens to the money that's billed in rates at the rate of 1.4 times target?

A It basically goes to shareholders in the form of additional return.

Q You were asked whether Florida Power & Light Company has a fiduciary duty to its investors. Do you remember that question and answer?

A Yes.

Q And you were also asked whether FPL has a duty to maintain investor support and protect against poor performance. Do you recall that series of questions and answers?

A Yes.

Q Does Florida Power & Light Company have any type of obligation of a financial nature towards its customers?

A I believe that it does. I believe that as a regulated utility, it has an obligation to provide the service at reasonable cost and rates.

Q With respect to those areas of expenses and proposals that you addressed in your testimony, in your opinion, has FPL proposed to go forward with a reasonable cost to customers?

A No. I believe that based on the adjustments that we have identified, that a large portion of their revenue requirements should be reduced.

Q With respect to the subject of late payments, I believe in response to one of the questions you indicated that you disagreed with the claim of a 30 percent behavior modification, do I --

A That is correct.

Q Would you explain to the Commissioners why you disagreed with that assertion?

A In the initial filing, the company was using a 30 percent behavior modification and there was no evidence whatsoever as to how that was derived. In Ms. Santos's rebuttal testimony, she used -- she showed an elasticity. Applying the electricity demand elasticity, she used a minus .2, but she applied that to the change in the late payment that would apply if you went from the old methodology, which was a 1.5 percent late payment fee, up to the new minimum charge of $10. And so she said that basically the change in price was a 324 percent change in price, and then applying the elasticity factor said that that would result in a 65 percent change in behavior.

In fact, if you go back and look at the detail behind their late payment data, what you find is that the average customer that would be in that category would be having a bill of about $135, and so if you look at the difference, what you are really looking at is a change in price of 5.6 percent, which would be a change in behavior of only 1.12 percent when you look at the total bill. So I believe that a customer would be more likely to look at what is the incremental cost on their total bill by paying late as opposed to what is the incremental late payment portion of that bill.

Q You also referred during the same series of questions and answers to a trend that, in your words, was happening anyway. Would you describe more specifically the trend that you had in mind?

A Yes. As noted by Ms. Santos, they were increasing -- late payments were increasing by about 150,000 per month, and the company used the 2008 late payment percentages, which was 22.3 percent late payments, and applied the 30 percent behavior modification to that.

But if you look at the history, in -- I show this on Exhibit SLB-7 -- in 2005, late payments were only 11.1 percent. It rose by 2007 to 17.75, and then rose again in 2008 to 22.31 percent. And if you just looked even at just that last year trend, instead of taking it all the way from the 11 percent, you would be looking at about a 35 percent late payment factor by 2010 based upon that trend, and I would expect that trend to continue upwards, given all the additional economic downturn information that FPL has used in other areas of its projections.

MR. McGLOTHLIN: Could I have a second to review my notes?

CHAIRMAN CARTER: Absolutely, Mr. McGlothlin.

(Brief pause.)

MR. McGLOTHLIN: No further questions.

CHAIRMAN CARTER: Exhibits? Is it 223 through 248 on Staff's composite?

MR. McGLOTHLIN: I move them.

CHAIRMAN CARTER: Are there any objections? Without objections, show it done. Let me mark this and I'll come back to you in a minute, Mr. Butler.

MR. McGLOTHLIN: My notes say 223 to 248, was that --

CHAIRMAN CARTER: To 248, okay. That's what I meant.

(Exhibit Nos. 223 through 248 admitted into the record.)

CHAIRMAN CARTER: Let's go to the back pages. Exhibit No. 443. Mr. Butler?

MR. BUTLER: FPL would move the admission of Exhibit 443.

CHAIRMAN CARTER: Mr. McGlothlin?

MR. McGLOTHLIN: No objection.

CHAIRMAN CARTER: Show it done.

(Exhibit No. 443 admitted into the record.)

CHAIRMAN CARTER: Exhibit 444, Mr. Butler?

MR. BUTLER: I would move the admission of Exhibit 444 as well.

MR. McGLOTHLIN: No objection.

CHAIRMAN CARTER: Show it done.

(Exhibit No. 444 admitted into the record.)

CHAIRMAN CARTER: Are we -- nothing further for this witness?

Thank you, Ms. Brown, you may be excused.

Call your next witness.

MR. MENDIOLA: Mr. Chairman and Commissioners, the South Florida Health and Hospital Association calls its next witness. It's Mr. Richard Baudino. He has been sworn.

Whereupon,

RICHARD BAUDINO

was called as a witness on behalf of South Florida

Hospital and Health Care Association and, having been duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. MENDIOLA:

Q Mr. Baudino, would you please state your name and business address for the record?

A Yes. My name is Richard Baudino. My business address is J. Kennedy and Associates, Incorporated, 570 Colonial Park Drive, Suite 305, Roswell, Georgia.

Q Please identify by whom you are employed and in what capacity.

A I'm employed by J. Kennedy and Associates as a consultant to the company.

Q And are you the same Richard Baudino who has previously submitted pre-filed written direct testimony identified as the direct testimony and exhibits of Richard A. Baudino on July 16, 2009?

A Yes.

Q Do you have a copy of that testimony before you?

A I do.

Q Do you have any corrections to that testimony?

A I do have a couple of corrections.

Q Let's give everyone a chance to get on the same page, and then if you could walk us through those corrections, please?

A Sure. First of all --

CHAIRMAN CARTER: Hang on one second.

Okay, you may proceed.

THE WITNESS: First of all, on page 18, on line 22, it says "ratings of A plus from S&P." That should be "A," so strike the "plus."

And then on page 52, if you go down to line 22, this is in the nature of a clarification. It says "I weighted earnings growth 75 percent." That should be "50 to 75 percent." And dividend growth, it says, "25 percent," I would like to add "25 to 50 percent." And that's to acknowledge the results of the midpoint numbers that I calculated.

COMMISSIONER EDGAR: Clarification, if I may?

CHAIRMAN CARTER: Commissioner Edgar.

COMMISSIONER EDGAR: The first number there on line 22, page 52, did you say 15 or 50?

THE WITNESS: Fifty, five-zero.

COMMISSIONER EDGAR: Thank you.

BY MR. MENDIOLA:

Q So the record is clear, Mr. Baudino, you submitted both redacted and confidential testimony in this case, is that correct?

A Yes, I did.

Q And the confidential testimony has been reviewed by FPL and determined that there is no confidential information, so now what had been previously submitted as confidential is no longer confidential, is that your understanding?

A I did not know that, but I will accept that. So I -- just for my clarification, then I can use the redacted?

CHAIRMAN CARTER: Mr. Butler, is that correct? Or Mr. Anderson?

MR. ANDERSON: It is, Mr. Chairman.

CHAIRMAN CARTER: Okay, you may proceed.

BY MR. MENDIOLA:

Q Mr. Baudino, with those corrections, if I were to ask you the same questions, would your answers be the same as you have before you?

A Yes.

MR. MENDIOLA: Mr. Chairman, then I would request that Mr. Baudino's testimony be inserted into the record as though read.

CHAIRMAN CARTER: The pre-filed testimony of the witness will be inserted into the record as though read.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

IN RE: PETITION FOR RATE INCREASE BY FLORIDA POWER AND LIGHT COMPANY	) DOCKET NO. 080677-EI

DIRECT TESTIMONY OF RICHARD A. BAUDINO

I. QUALIFICATIONS AND SUMMARY

Q. Please state your name and business address.

A. My name is Richard A. Baudino. My business address is J. Kennedy and Associates, Inc. ("Kennedy and Associates"), 570 Colonial Park Drive, Suite 305, Roswell, Georgia 30075.

Q. What is your occupation and by whom are you employed?

A. I am a consultant with Kennedy and Associates.

Q. Please describe your education and professional experience.

A. I received my Master of Arts degree with a major in Economics and a minor in Statistics from New Mexico State University in 1982. I also received my Bachelor of Arts Degree with majors in Economics and English from New Mexico State in 1979.

I began my professional career with the New Mexico Public Service Commission Staff in October 1982 and was employed there as a Utility Economist. During my employment with the Staff, my responsibilities included the analysis of a broad range of issues in the ratemaking field. Areas in which I testified included cost of service, rate of return, rate design, revenue requirements, analysis of sale/leasebacks of generating plants, utility finance issues, and generating plant phase-ins.

In October 1989, I joined the utility consulting firm of Kennedy and Associates as a Senior Consultant where my duties and responsibilities covered substantially the same areas as those during my tenure with the New Mexico Public Service Commission Staff. I became Manager in July 1992 and was named Director of Consulting in January 1995. Currently, I am a consultant with Kennedy and Associates.

Exhibit ____(RAB-1) summarizes my expert testimony experience.

Q. **On whose behalf are you testifying?**

A. I am testifying on behalf of the South Florida Hospital and Health Care Association ("SFHHA").

Q. **What is the purpose of your Direct Testimony?**

A. The purpose of my direct testimony is to address the allowed return on equity for Florida Power and Light Company ("FPL" or "Company").

Q. **Please summarize your Direct Testimony.**

A. I recommend that the Florida Public Service Commission ("Commission") approve a rate of return on equity ("ROE") for FPL of 10.40%. This recommendation is based on the low end of the range of results from my Discounted Cash Flow ("DCF") analyses for a comparison group of electric companies. I also employed the Capital

Asset Pricing Model ("CAPM"), but did not directly incorporate the results into my recommendation. In my opinion, a return on equity of 10.40% is a reasonable estimate of the required return on equity for a low-risk utility such as FPL.

I also recommend that FPL's equity ratio be reduced from the level requested by the Company. My recommended adjusted equity ratio for bond rating agency purposes is 50%. This results in an equity ratio for ratemaking purposes of 53.5%. My recommended equity ratio strikes a proper balance between supporting the Company's bond rating and minimizing costs for ratepayers.

I also adjusted the amount and cost of FPL's short-term debt contained in its capital structure. My calculations reflect the addition of $600 million of short-term debt, with the cost of this debt at 0.60%, which reflects the 3-month London Interbank Offer Rate ("LIBOR") as of June 30, 2009. Mr. Kollen adds commitment fees to this number, which he explains in detail in his testimony.

Turning to the Company's testimony, the Commission should reject the return on equity recommendation of 12.50% of Dr. William Avera, witness for FPL. As I will explain in detail in Section IV of my Direct Testimony, Dr. Avera's subjective approach greatly overstated the required return on equity for FPL. Further, the results from Dr. Avera's quantitative analyses do not support his recommendation. In particular, FPL's requested equity return simply exceeds the range of results calculated by FPL itself for its utility proxy group. Dr. Avera's recommended ROE only is supported by the ROE range from a group of non-utility companies. This non-utility group completely fails to reflect the low risk utility operations of FPL. Dr. Avera's recommended return on equity of 12.50% would harm ratepayers because it would result in excessive rate levels for the Company's ratepayers.

I also recommend that the Commission reject Dr. Avera's and Mr. Pimentel's position supporting FPL's proposed capital structure and, specifically, the Company's requested equity ratio for ratemaking purposes of 59.6%. As I will show later in my Direct Testimony, FPL's requested common equity ratio is excessive, is significantly higher than the common equity ratio of similar risk electric companies, and would impose excessive and burdensome costs on ratepayers.

II. REVIEW OF ECONOMIC AND FINANCIAL CONDITIONS

Q. Mr. Baudino, what has the trend been in long-term capital costs over the last few years?

A. Exhibit ____(RAB-2) presents a graphic depiction of the trend in interest rates from January 2000 through May 2009. The interest rates shown are for the 20-year U.S. Treasury Bond and the average public utility bond from the Mergent Bond Record. Exhibit ____(RAB-2) shows that the yields on long-term Treasury and utility bonds have declined since early 2000, although rates have been quite volatile. Yields trended downward from 2002 through 2006, with the 20-year Treasury bond yield declining from 5.69% to 4.78% at the end of December 2006. The yield on the average public utility bond also decreased significantly over that time, falling from 7.83% in March 2002 to 5.83% in December 2006, a decline of 200 basis points. Public utility bond yields fell far more than long-term Treasury yields over the last four years.

2007 saw a rise in bond yields, fueled in part by investors' concerns over turmoil and defaults associated with the sub-prime lending market. This accelerated in 2008, a year in which world financial markets experienced tumultuous changes and volatility not seen since the Great Depression. As noted in the SBBI 2009 Yearbook, both large and small company stocks declined around 37% for the year.[1] Investors, in a flight to quality and safety, also pulled their funds out of those corporate bonds that were perceived to be higher risk and invested in the safety of Treasury securities.[2] The 2009 SBBI Yearbook reported that long-term Treasury Bonds returned 25.87% during 2008, while long-term corporate bonds returned 8.78%. Thus, bonds significantly outperformed stocks in 2008.

The stocks of electric utilities did not fare well during the financial market upheaval of 2008. The Dow Jones Utility Average was down from its opening level in January 2008 of 532.50 to 370.76 at the end of December, a decline of 30.4%. This decline was smaller than the decline in the overall stock market. Utility bond yields also increased significantly during the year, rising from 6.08% in January to a high of 7.80% in November. And as investors flocked to the safety of Treasury securities, the yield spread between long-term Treasury securities and the index of public utility bonds widened from 1.73% in January to 3.69% in December, the highest spread during the entire period shown in Exhibit ___(RAB-2).

So far in 2009, utility bond yields have fallen from November 2008 levels as has the spread between public utility bond yields and long-term Treasuries. The average utility bond yield in May was 6.83%, a decline of almost 100 basis points from

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1 *2009 Ibbotson SBBI Classic Yearbook,* Morningstar, page 11.

[redacted]

November 2008. And according to Moody's Credit Trends, the average public utility bond yield closed at 6.22% on June 30, 2009. At the end of May the yield spread between utility bonds and the long-term Treasury bond declined substantially to 2.61%. The Dow Jones Utility Average has also recovered this year, rising from its opening level in January of 341.15 to a June close of 357.81, an increase of 4.88% for the year.

Q. How does the investment community regard the electric utility industry as a whole?

A. In its May 29, 2009 report on the electric utility industry, Value Line noted the following:

> Since our last review, electric utility stocks as a whole have continued to struggle, based on shareprice performance. Many utilities have been hampered by higher capital costs and weaker generation margins stemming from lower demand and a sharp decline in energy prices.
>
> * * *
>
> During challenging economic times, investors tend to migrate towards utility stocks due to their relative stability and attractive dividend yields. And, now seems like a better time than ever, as the broad market selloff early in the year has led to higher yields and increased total-return potential. All told, we believe this might be a good time for investors to increase their electric-utility exposure.

Moody's Investor Service published a report entitled *U.S. Investor-Owned Electric Utilities* and made a number of observations regarding the outlook for the industry. First Moody's characterized the outlook for the electric utility industry as stable with respect to its expectations for the next twelve to eighteen months. Moody's expects that the industry's fundamentals will remain intact, but expressed concerns over rising business and operating risks over the longer term.

On page 2 of this report, Moody's also added:

The U.S. investor-owned electric utility sector enjoys solid credit metrics and the fundamental credit outlook remains stable. In general, state regulators continue to let the utilities recover prudently incurred operating costs and capital expenditures relatively quickly, and with reasonable rates of return. Moreover, we believe state regulators would otherwise prefer to regulate financially healthy companies.

The sector is also well positioned relative to many other corporate/industrial sectors, primarily due to the fundamental business plan: providing monopolistic electric service within a designated service territory in exchange for oversight and limitations on profitability. However, we are increasingly concerned with business and operating risks, which are not new but appear to be accelerating faster than previously understood. These business and operating risks include potential environmental legislation from the Obama Administration; the continued capital investment needs for refurbishing aging infrastructure; and a potentially more contentious regulatory relationship amid a protracted or severe recession.

Although liquidity appears to be reasonable today, the sector's substantial negative free cash flow generation creates a need for unfettered access to the capital markets. This represents a fundamental weakness to the sector's business plan.

Q. Briefly describe Florida Power and Light Company.

A. FPL is a wholly owned subsidiary of FPL Group.[3] FPL Group's other principle subsidiary is NextEra Energy Resources, which engages in the competitive energy business and produces its energy primarily from clean and renewable fuels. FPL is a rate regulated electric company that provides service to approximately 4.5 million customers of the east and lower west coasts of Florida. As of December 31, 2008

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3 The following description of FPL is based on information contained in the Company's 2008 Form 10-K and 2008 Annual Report.

FPL derived 53% of its revenues from Residential sales, 40% from commercial sales, and 7% from Industrial and other customers.

FPL's resources for serving load consisted of 24,997 mWs of which 22,087 were owned by FPL. FPL's current reserve margin is 28%, which is adequate to meet its current and projected customer loads. FPL's 2008 fuel mix consisted of 53% natural gas, 22% nuclear generation, 14% purchased power, 6% coal generation, and 5% oil generation. On page 7 of its 2008 10-K report, FPL noted that its "diverse fuel options, along with purchased power, enable FPL to shift between sources of generation to achieve a more economical fuel mix." FPL collects fuel costs through a recovery mechanism approved by the FPSC that enables the company to true-up differences between actual and projected costs.

Capacity payments to other companies for purchased power are recovered from customers through a capacity clause and through base rates. FPL noted on page 6 of its 10-K report that beginning in 2009, FPL will be able to recover pre-construction costs and carrying charges on construction costs for new nuclear capacity through the capacity clause.

FPL noted that it will incur significant planned capital expenditures through 2013 that are expected to total $13.4 billion.

With respect to capitalization, FPL's regulated utility operations are far less leveraged than FPL Group's unregulated operations. At the end of 2008, FPL's utility operations were capitalized with 56% common equity compared to FPL Group's unregulated operations, which were supported by only 24.2% common equity. This data came from FPL's Schedule D-2.

Q. How do FPL and FPL Group characterize their current financial position and performance.

A. In his letter to shareholders in FPL Group's 2008 Annual Report, the Chairman and Chief Executive Officer of FPL Group stated the following:

> Our successful strategy has generated outstanding value for shareholders over the longer term as well. Since 2002, FPL Group has outperformed 84 percent of the companies in the S&P Utility Index and 85 percent of the companies in the S&P 500 Index as measured by total shareholder return. Our total shareholder return during this period was 127 percent, compared with 32 percent for the S&P Utility Index and -10 percent for the S&P 500 Index.
>
> The same trend holds across the three-year, five-year and 10-year periods. FPL Group has delivered total shareholder returns of 33 percent, 81 percent and 135 percent respectively, easily outpacing the S&P Utility Index (3 percent, 49 percent and 31 percent) and the S&P 500 (-23 percent, -10 percent and -13 percent).
>
> ***We are also particularly proud of our ability to weather the financial crisis. FPL Group's financial discipline, attractive projects and strong balance sheet meant that capital remained available at reasonable costs throughout 2008. Indeed, in the midst of a very difficult credit and economic environment, we were able to raise approximately $1.3 billion of capital on reasonable terms in the fourth quarter of 2008 alone.*** (emphasis added)
>
> There's little doubt that 2008 will go down in history as one of the most tumultuous and difficult years in the past century for economies and credit markets the world over, including the U.S. and Florida economies. ***FPL Group has not been immune to these shocks, but our ability to generate double-digit earnings growth in a highly challenging year is a powerful endorsement of our long-term strategy, our commitment to financial discipline, and our dedicated and talented employees.*** (emphasis added)

In recent presentations to the financial community and at FPL Group's 2009 shareholders' meeting, FPL Group reported very positive results for the company. For example, in its presentation entitled *2009 Credit Suisse Energy Summit*, FPL Group made the following important points:

- FPL Group is a "premier U.S. power company"
- FPL Group's returns to share holders have substantially outperformed the Dow Jones Industrial Average, the Utility Index, and the S&P 500.
- FPL Group has one of the strongest balance sheets in the industry.
- FPL Group maintains a "strong liquidity position" assisted by "one of the largest bank groups in the industry".

In a presentation entitled *Sanford C. Bernstein & Co. Strategic Decisions Conference 2009* dated May 27, 2009, FPL stated on page 5 that FPL Group had the "best utility franchise in the nation" and had "favorable long-term demographic trends." And in another presentation entitled *NextEra Energy Resources 2009 Bank Meeting* dated May 5, 2009, on page 14 the FPL Group Chairman and CEO characterized FPL Group's earnings profile as "significantly weighted toward lower risk sources", 47% of which was the FPL utility. [redacted]

I have included excerpts from these three presentations in Exhibit ___(RAB-3).

Q. How is FPL viewed by the major bond rating agencies?

A. FPL's first mortgage bonds are rated A by Standard & Poor's ("S&P") and Aa3 by

Moody's.

S&P's February 12, 2009 report on FPL stated that FPL Group's outlook is stable and "reflects the predictable cash flow from FP&L, a favorable regulatory environment, and an historically healthy service territory." S&P noted that FPL Group's outlook could be pressured if growth in the unregulated businesses increases business risk, if the forecasts become more dependent on FPL Energy, or if projected cash flow does not maintain the current financial risk profile. S&P also underscored its concern that the ratings could be imperiled if FPL Group fails to manage significant risks in its merchant energy and energy marketing and trading subsidiaries.

Moody's June 20, 2008 report on FPL noted that its ratings were supported by strong financial performance and cash flow coverage, timely cost recovery mechanisms, favorable regulatory environment, and a large mainly residential service territory that has experienced high growth rates in recent years. Offsetting these strengths are the Company's large expected capital expenditures over the next few years, a slowing economy, and risks from hurricanes.

Q. **Mr. Baudino, what is your conclusion regarding the financial health and overall risk of FPL?**

A. Overall FPL remains a low risk electric utility with solid financial health and excellent bond ratings. In its own investor presentations, the Company emphasized that it is one of three companies in the power sector with an 'A' or better credit rating. And according to FPL Group's CEO Mr. Hay, FPL has the "best utility franchise in the nation." FPL's stable and relatively low risk electric operations have provided substantial financial stability to FPL Group and its more risky wholesale market-based power marketing subsidiaries. FPL Group would be a substantially riskier company without the stable utility operations of FPL.

As FPL Group's CEO Mr. Hay pointed out, despite extreme instability and uncertainty in the credit markets last year, FPL Group had no problem accessing liquidity for its operations, including its utility operations. And FPL Group derives most of its earning from lower risk sources, the largest contributor being FPL's regulated utility operations. Now that credit markets have become more stable this year, FPL should continue to have access to the credit it needs to fund operations and invest in plant and infrastructure to serve its Florida customers and on very reasonable terms.

III. DETERMINATION OF FAIR RATE OF RETURN

Q. Please describe the methods you employed in estimating a fair rate of return for FPL.

A. I employed a Discounted Cash Flow ("DCF") analysis for a group of comparison electric companies to estimate the cost of equity for the Company's regulated electric operations. I also employed several Capital Asset Pricing Model ("CAPM") analyses using both historical and forward-looking data.

Q. What are the main guidelines to which you adhere in estimating the cost of equity for a firm?

A. Generally speaking, the estimated cost of equity should be comparable to the returns of other firms with similar risk structures and should be sufficient for the firm to attract capital. These are the basic standards set out by the United States Supreme Court in *Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)* and *Bluefield W.W. & Improv. Co. v. Public Service Comm'n, 262 U.S. 679 (1922).*

From an economist's perspective, the notion of "opportunity cost" plays a vital role in estimating the return on equity. One measures the opportunity cost of an investment equal to what one would have obtained in the next best alternative. For example, let us suppose that an investor decides to purchase the stock of a publicly traded electric utility. That investor made the decision based on the expectation of dividend payments and perhaps some appreciation in the stock's value over time;

however, that investor's opportunity cost is measured by what she or he could have invested in as the next best alternative. That alternative could have been another utility stock, a utility bond, a mutual fund, a money market fund, or any other number of investment vehicles.

The key determinant in deciding whether to invest, however, is based on comparative levels of risk. Our hypothetical investor would not invest in a particular electric company stock if it offered a return lower than other investments of similar risk. The opportunity cost simply would not justify such an investment. Thus, the task for the rate of return analyst is to estimate a return that is equal to the return being offered by other risk-comparable firms.

Q. What are the major types of risk faced by utility companies?

A. In general, risk associated with the holding of common stock can be separated into three major categories: business risk, financial risk, and liquidity risk. Business risk refers to risks inherent in the operation of the business. Volatility of the firm's sales, long-term demand for its product(s), the amount of operating leverage, and quality of management are all factors that affect business risk. The quality of regulation at the state and federal levels also plays an important role in business risk for regulated utility companies.

Financial risk refers to the impact on a firm's future cash flows from the use of debt in the capital structure. Interest payments to bondholders represent a prior call on the firm's cash flows and must be met before income is available to the common shareholders. Additional debt means additional variability in the firm's earnings, leading to additional risk.

Liquidity risk refers to the ability of an investor to quickly sell an investment without a substantial price concession. The easier it is for an investor to sell an investment for cash, the lower the liquidity risk will be. Stock markets, such as the New York and American Stock Exchanges, help ease liquidity risk substantially. Investors who own stocks that are traded in these markets know on a daily basis what the market prices of their investments are and that they can sell these investments fairly quickly. Many electric utility stocks are traded on the New York Stock Exchange and are considered liquid investments.

Q. Are there any indices available to investors that quantify the total risk of a company?

A. Bond ratings are tools that investors use to assess the risk comparability of firms. Bond rating agencies such as Moody's and Standard and Poor's perform detailed analyses of factors that contribute to the risk of a particular investment. The end result of their analyses is a bond rating that reflects these risks.

With respect to FPL's utility operations, it is also important to note the statements made by key personnel in the Company regarding the utility's low risk operations and that it has the "best utility franchise in the nation." The combination of these statements and the foregoing data are compelling evidence of FPL's low-risk profile.

Discounted Cash Flow ("DCF") Model

Q. Please describe the basic DCF approach.

A. The basic DCF approach is rooted in valuation theory. It is based on the premise that the value of a financial asset is determined by its ability to generate future net cash flows. In the case of a common stock, those future cash flows take the form of dividends and appreciation in stock price. The value of the stock to investors is the discounted present value of future cash flows. The general equation then is:

$$V = \frac{R}{(1+r)} + \frac{R}{(1+r)^2} + \frac{R}{(1+r)^3} + \ldots \frac{R}{(1+r)^n}$$

Where: V = *asset value*
R = *yearly cash flows*
r = *discount rate*

This is no different from determining the value of any asset from an economic point of view; however, the commonly employed DCF model makes certain simplifying assumptions. One is that the stream of income from the equity share is assumed to be perpetual; that is, there is no salvage or residual value at the end of some maturity date (as is the case with a bond). Another important assumption is that financial markets are reasonably efficient; that is, they correctly evaluate the cash flows relative to the appropriate discount rate, thus rendering the stock price efficient relative to other alternatives. Finally, the model I employ also assumes a constant growth rate in dividends. The fundamental relationship employed in the DCF method is described by the formula:

$$k = \frac{D_1}{P_0} + g$$

Where: D_1 = *the next period dividend*
P_0 = *current stock price*
g = *expected growth rate*
k = *investor-required return*

Under the formula, it is apparent that "k" must reflect the investors' expected return. Use of the DCF method to determine an investor-required return is complicated by the need to express investors' expectations relative to dividends, earnings, and book value over an infinite time horizon. Financial theory suggests that stockholders purchase common stock on the assumption that there will be some change in the rate of dividend payments over time. We assume that the rate of growth in dividends is constant over the assumed time horizon, but the model could easily handle varying growth rates if we knew what they were. Finally, the relevant time frame is prospective rather than retrospective.

Q. What was your first step in conducting your DCF analysis for FPL?

A. My first step was to construct a comparison group of companies with a risk profile that is reasonably similar to FPL.

Q. Please describe your approach for selecting a comparison group of electric companies.

A. I used several criteria to select a comparison group. First, using the July 2009 issue of the AUS Utility Reports, I selected electric companies that were rated at least A by Moody's and Standard and Poor's. FPL currently carries senior secured bond ratings of A+ from S&P and Aa3 from Moody's, so using the either/or criterion for an A rating assures that the companies in the comparison group carry bond ratings that are similar to FPL.

From that group, I selected companies that had at least 50% of their revenues from electric operations and that had long-term earnings growth forecasts from Value Line and either Zacks Investment Research ("Zacks") or First Call/Thomson Financial. I will describe Zacks and First Call/Thomson Financial later in my testimony. From this group, I then eliminated companies that had recently cut or eliminated dividends, were recently or currently involved in merger activities, or had recent experience with significant earnings fluctuations.

I also eliminated Duke Energy due to a major corporate restructuring that will significantly affect future earnings. I also eliminated Exelon Corp. because most earnings and growth is expected to come from an unregulated generation subsidiary. I eliminated MGE Energy because it did not have earnings growth forecasts from either Zacks or Thomson.

The resulting group of the comparison electric companies that I used in my analysis is shown in the table below.

FLORIDA POWER AND LIGHT COMPANY
COMPARISON GROUP

	S&P Rating	Moody's Rating
1 ALLETE, Inc. (NYSE-ALE)	A-	NR
2 Alliant Energy Corporation (NYSE-LNT)	A-	A2
3 Consolidated Edison, Inc. (NYSE-ED)	A-	A1
4 DPL Inc.(NYSE-DPL)	A	A2
5 DTE Energy Company (NYSE-DTE)	A-	A3
6 Edison International (NYSE-EIX)	A	A2
7 FPL Group, Inc. (NYSE-FPL)	A	Aa3
8 IDACORP, Inc. (NYSE-IDA)	A-	A3
9 NSTAR (NYSE-NST)	AA-	A1
10 Progress Energy Inc. (NYSE-PGN)	A-	A2
11 Public Service Enterprise Group (NYSE-PEG)	A-	A3
12 Southern Company (NYSE-SO)	A	A2
13 Wisconsin Energy Corporation (NYSE-WEC)	A-	Aa3
14 Xcel Energy Inc. (NYSE-XEL)	A-	A3

Q. What was your first step in determining the DCF return on equity for the comparison group?

A. I first determined the current dividend yield, D_1/P_0, from the basic equation. My general practice is to use six months as the most reasonable period over which to estimate the dividend yield. The six-month period I used covered the months from January through June 2009. I obtained historical prices and dividends from Yahoo! Finance. The annualized dividend divided by the average monthly price represents the average dividend yield for each month in the period.

The resulting average dividend yield for the group is 5.25%. These calculations are shown in Exhibit ____(RAB-4).

Q. **Mr. Baudino, did the dividend yield for your comparison group exhibit volatility over the six-month period you used in your analysis?**

A. Yes. Page 3 of Exhibit ____(RAB-4) shows the monthly average yields for the comparison group, which ranged from 4.75% to 5.66%. Obviously, increased volatility in the stock market affected utility stock prices as well.

Q. **Having established the average dividend yield, how did you determine the investors' expected growth rate for the electric comparison group?**

A. The investors' expected growth rate, in theory, correctly forecasts the constant rate of growth in dividends. The dividend growth rate is a function of earnings growth and the payout ratio, neither of which is known precisely for the future. We refer to a perpetual growth rate since the DCF model has no arbitrary cut-off point. We must estimate the investors' expected growth rate because there is no way to know with absolute certainty what investors expect the growth rate to be in the short term, much less in perpetuity.

In this analysis, I relied on three major sources of analysts' forecasts for growth. These sources are Value Line, Zacks, and Thomson Financial.

Q. **Please briefly describe Value Line, Zacks, and Thomson Financial.**

A. Value Line is an investment survey that is published for approximately 1,700 companies, both regulated and unregulated. It is updated quarterly and probably represents the most comprehensive and widely used of all investment information services. It provides both historical and forecasted information on a number of important data elements. Value Line neither participates in financial markets as a broker nor works for the utility industry in any capacity of which I am aware.

According to Zacks' website, Zacks "was formed in 1978 to compile, analyze, and distribute investment research to both institutional and individual investors." Zacks gathers opinions from a variety of analysts on earnings growth forecasts for numerous firms including regulated electric utilities. The estimates of the analysts responding are combined to produce consensus average and median estimates of earnings growth.

Like Zacks, Thomson Financial also provides detailed investment research on numerous companies. Thomson also compiles and reports consensus analysts' forecasts of earnings growth. I obtained these forecasts from Yahoo! Finance.

Q. Why did you rely on analysts' forecasts in your analysis?

A. Return on equity analysis is a forward-looking process. Five-year or ten-year historical growth rates may not accurately represent investor expectations for dividend growth. Analysts' forecasts for earnings and dividend growth provide better proxies for the expected growth component in the DCF model than historical growth rates. Analysts' forecasts are also widely available to investors and one can reasonably assume that they influence investor expectations.

Q. How did you utilize your data sources to estimate growth rates for the comparison group?

A. Exhibit____(RAB-5) presents the Value Line, Zacks, and Thomson Financial forecasted growth estimates. These earnings and dividend growth estimates for the comparison group are summarized on Columns (1) through (5) of Exhibit ____(RAB-5).

I also utilized the sustainable growth formula in estimating the expected growth rate. The sustainable growth method, also known as the retention ratio method, recognizes that the firm retains a portion of its earnings to fuel growth in dividends. These retained earnings, which are plowed back into the firm's asset base, are expected to earn a rate of return. This, in turn, generates growth in the firm's book value, market value, and dividends.

The sustainable growth method is calculated using the following formula:

$$G = B \times R$$

Where: *G = expected retention growth rate*
B = the firm's expected retention ratio
R = the expected return

In its proper form, this calculation is forward-looking. That is, the investors' expected retention ratio and return must be used in order to measure what investors anticipate will happen in the future. Data on expected retention ratios and returns may be obtained from Value Line.

The expected sustainable growth estimates for the comparison group are presented in Column (3) on page 1 of Exhibit ____(RAB-5). The data came from the Value Line forecasts for the comparison group.

Q. How did you approach the calculation of earnings growth forecasts in this case?

A. For purposes of this case, I looked at three different methods for calculating the expected growth rates for my comparison group.

For Method 1, I calculated the average of all the growth rates for the companies in my comparison group using Value Line, Zacks, and Thomson. I excluded a negative value for ALLETE because it is not plausible for investors to expect negative future growth rates for electric utilities.

For Method 2, I calculated the median growth rates for my comparison group. The median value represents the middle value in a data range and is not influenced by excessively high or low numbers in the data set. The median growth rate for each forecast provides additional valuable information regarding expected growth rates for the group.

For Method 3, I omitted double-digit growth rates and growth rates that were near zero (less than 1%) from the calculation of the averages. This is similar to omitting the high and low values from the calculation. These calculations are shown on page 2 of Exhibit ____(RAB-5).

The expected growth rates produced by all three methods fall in a range from 3.75% to 6.25%.

Q. Why did you eliminate high and low growth rate forecasts in Method 3?

A. With respect to growth rates near zero, it is reasonable to conclude that investors expect positive long-term earnings and dividend growth over time. Including growth rates of 1% or less may understate expected growth for the comparison group. Regarding double-digit growth rates, it is highly unlikely that investors would expect such high growth rates over the long run for electric utilities. Indeed, the vast majority of growth forecasts is in the single digits and reflects the more conservative financial profile of a regulated industry.

Q. How did you proceed to determine the DCF return of equity for the electric comparison group?

A. To estimate the expected dividend yield (D_1) for the group, the current dividend yield must be moved forward in time to account for dividend increases over the next twelve months. I estimated the expected dividend yield by multiplying the current dividend yield by one plus one-half the expected growth rate. I should note that for Method 3, I excluded the dividend yields for companies whose growth rates were excluded from each respective source.

I then added the expected growth rates to the expected dividend yield. The calculations of the resulting DCF returns on equity for both methods are presented on page 2 of Exhibit ____(RAB-5).

Q. Please explain how you calculated your DCF cost of equity estimates.

A. Page 2 of Exhibit ____(RAB-5) presents the DCF results utilizing three different methods. Method 1 utilizes the average growth rates for the comparison group. I used the Value Line earnings and dividend growth forecasts and the consensus analysts' forecasts. The average DCF cost of equity result is 11.01%. The midpoint of the four growth rates is 10.68%.

Method 2 employs the median growth rates from Value Line, Zacks, and Thomson. The average DCF return on equity is 10.80% and the midpoint of the results is 10.38%.

Method 3 employs the growth rates for the group excluding double digit growth forecasts and forecasts less than or equal to 1.0%. The average of these growth rates results in a DCF estimate of 11.13%. The midpoint of the growth rates results in a DCF estimate of 10.96%.

Capital Asset Pricing Model

Q. Briefly summarize the Capital Asset Pricing Model ("CAPM") approach.

A. The theory underlying the CAPM approach is that investors, through diversified portfolios, may combine assets to minimize the total risk of the portfolio.

Diversification allows investors to diversify away all risks specific to a particular company and be left only with market risk that affects all companies. Thus, the CAPM theory identifies two types of risks for a security: company-specific risk and market risk. Company-specific risk includes such events as strikes, management errors, marketing failures, lawsuits, and other events that are unique to a particular firm. Market risk includes inflation, business cycles, war, variations in interest rates, and changes in consumer confidence. Market risk tends to affect all stocks and cannot be diversified away. The idea behind the CAPM is that diversified investors are rewarded with returns based on market risk.

Within the CAPM framework, the expected return on a security is equal to the risk-free rate of return plus a risk premium that is proportional to the security's market, or non-diversifiable, risk. Beta is the factor that reflects the inherent market risk of a security and measures the volatility of a particular security relative to the overall market for securities. For example, a stock with a beta of 1.0 indicates that if the market rises by 15%, that stock will also rise by 15%. This stock moves in tandem with movements in the overall market. Stocks with a beta of 0.5 will only rise or fall 50% as much as the overall market. So with an increase in the market of 15%, this stock will only rise 7.5%. Stocks with betas greater than 1.0 will rise and fall more than the overall market. Thus, beta is the measure of the relative risk of individual securities vis-à-vis the market.

Based on the foregoing discussion, the equation for determining the return for a security in the CAPM framework is:

$$K = Rf + \beta(MRP)$$

Where: K = *Required Return on equity*
Rf = *Risk-free rate*
MRP = *Market risk premium*
β = *Beta*

This equation tells us about the risk/return relationship posited by the CAPM. Investors are risk averse and will only accept higher risk if they receive higher returns. These returns can be determined in relation to a stock's beta and the market risk premium. The general level of risk aversion in the economy determines the market risk premium. If the risk-free rate of return is 3.0% and the required return on the total market is 15%, then the risk premium is 12%. Any stock's required return can be determined by multiplying its beta by the market risk premium. Stocks with betas greater than 1.0 are considered riskier than the overall market and will have higher required returns. Conversely, stocks with betas less than 1.0 will have required returns lower than the market as a whole.

Q. In general, are there concerns regarding the use of the CAPM in estimating the return on equity?

A. Yes. As briefly discussed earlier, there is some controversy surrounding the use of the CAPM.[4] There is evidence that beta is not the primary factor in determining the risk of a security. For example, Value Line's "Safety Rank" is a measure of total risk, not its calculated beta coefficient. Beta coefficients usually describe only a small amount of total investment risk. Finally, a considerable amount of judgment must be employed in determining the risk-free rate and market return portions of the CAPM equation. The analyst's application of judgment can significantly influence the results obtained from the CAPM. My past experience with the CAPM indicates that it is prudent to use a wide variety of data in estimating returns. Of course, the range of results may also be wide, indicating the difficulty in obtaining a reliable estimate from the CAPM.

Q. How did you estimate the market return portion of the CAPM?

A. The first source I used was the Value Line Investment Survey for Windows for June 10, 2009. Value Line provides a summary statistical report detailing, among other things, forecasted growth in dividends, earnings, and book value for the companies Value Line follows. I have presented these three growth rates and the average on page 2 of Exhibit ____(RAB-6). The average growth rate is 8.14%. Combining this growth rate with the average expected dividend yield of the Value Line companies of 2.27% results in an expected market return of 10.41%. The detailed calculations are shown on page 1 Exhibit ____(RAB-6).

4 For a more complete discussion of some of the controversy surrounding the use of the CAPM, refer to *A Random Walk Down Wall Street* by Burton Malkiel, pp. 229 – 239, 1999 edition.

I also considered a supplemental check to this market estimate. Morningstar publishes a study of historical returns on the stock market in its *Ibbotson SBBI 2009 Valuation Yearbook*. Some analysts employ this historical data to estimate the market risk premium of stocks over the risk-free rate. The assumption is that a risk premium calculated over a long period of time is reflective of investor expectations going forward. Exhibit ____(RAB-7) presents the calculation of the market return using the historical data.

Q. Please address the use of historical earned returns to estimate the market risk premium.

A. The use of historic earned returns on the S&P 500 to estimate the current market risk premium is rather suspect because it naively assumes that investors currently expect historic risk premiums to continue unchanged into the future regardless of present or forecasted economic conditions. Brigham, Shome, and Vinson noted the following with respect to the use of historic risk premiums calculated using the returns as reported by Ibbotson and Sinquefield (referred to in the quote as "I&S"):

> There are both conceptual and measurement problems with using I&S data for purposes of estimating the cost of capital. Conceptually, there is no compelling reason to think that investors expect the same relative returns that were earned in the past. Indeed, evidence presented in the following sections indicates that relative expected returns should, and do, vary

> significantly over time. Empirically, the measured historic premium is sensitive both to the choice of estimation horizon and to the end points. These choices are essentially arbitrary, yet can result in significant differences in the final outcome.[5]

In summary, the use of historic earned returns should be viewed with a great deal of caution. There is no real support for the proposition that an unchanging, mechanically applied historical risk premium is representative of current investor expectations and return requirements.

Q. How did you determine the risk free rate?

A. I used the average yields on the 20-year Treasury bond and five-year Treasury note over the six-month period from January through June 2009. The 20-year Treasury bond is often used by rate of return analysts as the risk-free rate, but it contains a significant amount of interest rate risk. The five-year Treasury note carries less interest rate risk than the 20-year bond and is more stable than three-month Treasury bills. Therefore, I have employed both of these securities as proxies for the risk-free rate of return. This approach provides a reasonable range over which the CAPM may be estimated.

Q. What is your estimate of the market risk premium?

5 Brigham, E.F., Shome, D.K. and Vinson, S.R., "The Risk Premium Approach to Measuring a Utility's Cost of Equity," *Financial Management*, Spring 1985, pp. 33-45.

A. Exhibit ____(RAB-6), line 9 of page 1, presents my estimates of the market risk premium based on a DCF analysis applied to current market data. The market risk premium is 6.47% using the 20-year Treasury bond and 8.41% using the five-year Treasury bond.

Utilizing the historical Ibbotson data on market returns, the market risk premium ranges from 4.40% to 5.97%. This is shown on Exhibit ____(RAB-7).

Q. How did you determine the value for beta?

A. I obtained the betas for the companies in the electric company comparison group from most recent Value Line reports. The average of the Value Line betas for the electric group is .69.

Q. Please summarize the CAPM results.

A. The CAPM results using the 20-year and five-year Treasury bond yields and Value Line market return data range from 7.77% to 8.38%.

The CAPM results using the historical Ibbotson data range from 6.96% to 8.03%. These results are shown on Exhibit ____(RAB-7).

<u>Conclusions and Recommendations</u>

Q. Please summarize the cost of equity you recommend the Commission adopt for FPL.

A. I recommend that the Commission adopt the DCF model I developed and the cost of equity estimates for the comparison group of electric utility companies that I compiled. The results for the electric company comparison group using the constant-growth DCF model and the expected growth rate forecasts ranged from 10.38% to 11.13%. Based on this range of results, I recommend that the Commission adopt a 10.40% return on equity for FPL in this proceeding. This recommendation is based on the low end of the range of results from my DCF analyses.

I offer this recommendation to the FPSC as a just and reasonable estimate of investor return on equity requirements for a lower risk electric utility such as FPL. First, FPL's bond ratings are higher than those of the companies in my comparison group. There is only one other utility in the group that has an Aa3 bond rating from Moody's. All the other companies have lower ratings that FPL. With respect to the S&P ratings, nine of the 14 companies have an A- rating, compared to FPL's A rating. FPL's higher bond rating suggests a lower required ROE than the average company in my comparison group. And as I stated earlier, FPL's own CEO has stated without qualification that the Company has the "best utility franchise in the nation." This supports my position that FPL is a lower risk electric utility compared to the average electric utility company.

Also, as I shall show subsequently in my testimony, I am recommending a much higher common equity ratio for FPL than the average equity ratio for the comparison group. This suggests that FPL has less financial risk than the comparison group, making it less risky overall. This further justifies a return on equity for FPL that is near the low end of the range of results from the DCF model.

Finally, it should be noted that the CAPM results are much lower than the DCF results in this proceeding. This is the case with both the forward-looking and the historical versions of the CAPM. I do not rely on the CAPM for my ROE recommendation, but these results suggest that using the lower end of the DCF range of results is reasonable in this case.

Q. **Both Dr. Avera and Mr. Pimentel recommend that the Commission recognize and encourage "exemplary management" in setting the return on equity for FPL. Do you agree?**

A. No. I recommend that the Commission base its allowed return on equity on market-based data and analysis that I have provided in my testimony and in particular the results of the DCF analyses. Using appropriate cost of equity models to estimate the investor required return for FPL will, if applied properly, fairly compensate investors for their equity investment. Increasing the investor required return to recognize factors such as "exemplary management" would over compensate investors and result in excessive rates to ratepayers. The regulatory balance would be tipped in favor of shareholders and against customers. Moreover, providing an inflated return on equity to recognize exemplary management performance undercuts the benefits of such performance, which should be lower costs and greater efficiency. Ratepayers should expect exemplary management from the Company without having to support an inflated return to shareholders. I recommend that the Commission reject this path.

<u>**Capital Structure and Weighted Cost of Capital**</u>

Q. Did you review FPL's requested capital structure?

A. Yes. The Company's requested capital structure and weighted cost of capital is presented in Schedule D-1A and in Exhibit AP-7 attached to the Direct Testimony of FPL witness Armando Pimentel. Dr. Avera also discussed the Company's capital structure beginning on page 74 of his testimony. Both witnesses supported an "adjusted" equity ratio of 55.8%, which includes the imputation of $950 million of off-balance sheet purchased power agreements ("PPAs"). It is important to note that this is not the capital structure the Company is using for ratemaking purposes, but is instead one that is designed to reflect how FPL off-balance sheet PPAs are treated for purposes of bond rating agency reporting.

Q. Have you calculated the weighting of common stock, preferred stock, and short and long-term debt the Company is requesting for ratemaking purposes?

A. Yes. Table 2 below presents the percentages of equity and debt excluding the imputed PPAs. These amounts come from MFR Schedule D-1a. These amounts are investor-supplied capital amounts used by the Company to develop its overall weighted return, exclusive of accumulated deferred income taxes, customer deposits, and investment tax credits.

TABLE 2			
FPL REQUESTED DEBT AND EQUITY			
		Amount	Pct.
Long-term Debt	$	5,377,787	39.2%
Short-term Debt	$	161,857	1.2%
Common Equity	$	8,178,980	59.6%
Total	$	13,718,624	100.0%

Although both Dr. Avera and Mr. Pimentel presented FPL's "adjusted" capital structure as containing 55.8% equity, for ratemaking purposes FPL proposes to include almost 60% common equity in its capital structure. The 59.6% common equity ratio is the actual equity percentage that the Company seeks to include in its rates in this proceeding, not the lower 55.8% cited in the Company's testimony. Dr. Avera and Mr. Pimentel did identify this number as "adjusted" equity, but the difference between 55.8% and the actual ratemaking equity percentage of 59.6% needs to be clarified.

Q. Mr. Baudino, is FPL's proposed level of equity reasonable?

A. No. FPL's proposed level of equity is excessive, unreasonable, and would result in unjust and unreasonable rates to ratepayers. As I will demonstrate, FPL does not require this burdensome level of equity investment to support its current credit rating. I recommend that the Commission reject FPL's proposed level of common equity and reduce it to a reasonable level that supports its credit rating and that does not burden its customers with excessive costs.

Further, FPL understated the amount of short-term debt that should be included in the capital structure. Based on the last few years of data, substantially more short-term debt should be included in the Company's capital structure for ratemaking purposes.

Q. How do you recommend that the Commission proceed with adjusting FPL's capital structure?

A. First, I recommend that FPL's equity level be reduced to conform to the high end of S&P's debt-to-total capital range consistent with an A credit profile. Second, I recommend that the Commission include $600 million of short-term debt, an amount consistent with the Company's short-term debt levels over the last few years.

The effect of these adjustments is a reduction in the Company's weighted cost of capital.

Q. Please summarize FPL's presentation of its capital structure and common equity ratio.

A. Both Dr. Avera and Mr. Pimentel support an "actual adjusted equity ratio" of 55.8%. This equity percentage was derived by including $0.949 billion of long-term PPAs into the long-term debt amount shown in Table 2 of my testimony. Mr. Pimentel and

Dr. Avera supported this presentation as being reasonable based on the premise that the rating agencies take PPAs into account when evaluating financial strength and bond ratings. On page 34 of this testimony, Mr. Pimentel testified that "FPL needs to maintain a higher unadjusted equity ratio to attain the same level of financial security with PPAs than without."

Q. **Does FPL need to maintain an unadjusted equity ratio of 60% to maintain its credit rating?**

A. In my opinion, the answer is no.

In a recent article on utilities ratings analysis[6], S&P described how it assigns three key financial ratios in developing and assigning bond ratings. These ratios are as follows:

- Funds from Operations ("FFO") Interest Coverage
- Funds from Operations / Total Debt
- Total Debt / Total Capital

This article explained how these key ratios are used by S&P in developing a "Business Risk Profile" and "Financial Risk Profile". The Financial Risk Profile is assessed based on the three key ratios cited above. The Business Risk Profile encompasses S&P's qualitative assessment of factors such as the quality of

6 "U.S. Utilities Ratings Analysis Now Portrayed In The S&P corporate Ratings Matrix"; Standard and Poor's Ratings Direct, November 30, 2007.

regulation, the markets in which the company operates, operations, competitiveness, and management. Business Risk Profiles are characterized by S&P as Excellent, Strong, Satisfactory, Weak, or Vulnerable. Financial Risk Profiles are characterized as Minimal, Modest, Intermediate, Aggressive, or Highly Leveraged.

Currently S&P assigns an "excellent" business risk profile and an "intermediate" financial risk profile to FPL Group. According to S&P, the adjusted debt/total capital ratios to support these ratings would fall into a range of 35% - 50%. This may also be viewed as an adjusted equity ratio range of 50% - 65%.

Finally, S&P noted that its ratio analysis matrix serves as a guide and that it does not arrive at ratings by rote. Other factors may lead its rating committee to a different conclusion than what would otherwise be indicated by the matrix.

Q. **What is your recommendation for an adjusted equity ratio for bond rating agency reporting purposes?**

A. I recommend that the Commission approve an adjusted equity ratio of 50%, which is at the low end of the adjusted equity range of 50% - 65%. A 50% equity ratio (and a 50% adjusted debt ratio) conforms to the S&P ratio guidelines for an electric utility such as FPL, which has an excellent business risk profile and an intermediate financial risk profile.

An adjusted equity ratio of 50% is also much less expensive for ratepayers than the Company's proposed 55.8% adjusted equity ratio. This is very important because ratepayers should not have to support a needlessly expensive capital structure that is overly rich with equity capitalization. Common equity is the most expensive form of financing for FPL, and should be prudently minimized while still supporting an A credit rating. My recommendation of an adjusted equity ratio of 50% for financial reporting purposes accomplishes an appropriate balance between the interest of shareholders and ratepayers. The Company's proposal does not.

Q. Please describe how you adjusted the Company's capital structure to reflect the 50% adjusted equity ratio.

A. Please refer to Exhibit ____(RAB-8), Adjustment No. 1. This exhibit shows two views of FPL's capital structure, one for ratemaking purposes and one for bond rating agency reporting purposes. The ratemaking capital structure starts with the actual amounts of debt and equity from the Company's filing, which total $13.718 billion. The bond rating agency reporting capital structure adds the amount of imputed debt associated with FPL's PPAs, for a total of $14.668 billion. The equity amount is reduced by $0.845 billion to get to a 50% equity ratio for financial reporting purposes. For ratemaking purposes, this results in an equity ratio of 53.5%.

Q. How does the 53.5% ratemaking equity ratio compare to historical and projected equity ratios for FPL?

A. It compares quite closely to the equity ratios contained in the Company's Schedule D-2, which includes historical and forecasted capital structures through the end of the projected test year. The common equity ratios from Schedule D-2 are as follows:

2007	54.6%
2008	56.0%
2009	55.2%
2010	53.8%
2011	54.8%

I would also note that the Company's proposed equity ratio of 59.6% greatly exceeds all of the equity ratios contained in its Schedule D-2.

Q. How does your recommended 53.5% equity ratio compare to the equity ratio of your comparison group?

A. Exhibit ___(RAB-9) shows the comparison group's capital structures for 2008 as reported by Value Line. The average equity ratio for the group, including common and preferred, is 47.6%, which is much lower than my recommended equity ratio for FPL.

Q. Please address FPL's proposed amount of short-term debt in the capital structure.

A. FPL's proposed capital structure contains only $161.9 million of short-term debt. This substantially understates the amount of short-term debt the Company has used in the recent past and if far less than contained in the forecasted capital structures in

Schedule D-2. Schedule D-2 shows the following amounts of short-term debt in FPL's historic and forecasted capital structures (in 000s):

2007	$842,300
2008	$772,934
2009	$710,087
2010	$549,207
2011	$616,316

Obviously, the Company's proposed short-term debt level of $161.9 million is not even remotely close to the levels shown in Schedule D-2. Further, as recently as October 2008 during perhaps the worst month of financial turmoil of the year, FPL issued $1.29 billion of commercial paper, according to the Company's response to SFHHA's Ninth Set of Interrogatories, Question No. 266. Without question, the Company's proposed test year level of short-term debt is totally unsupported and should be rejected by the Commission.

Q. What is your recommendation regarding the amount of short-term debt that should be included in the capital structure for ratemaking purposes?

A. I recommend that the Commission include $600 million of short-term debt in the Company's capital structure. I have included this as Adjustment No. 2 in Exhibit ___(RAB-8). This amount is rather conservative considering the amounts shown by the Company on Schedule D-2 and is quite close to the amount for 2011. In my opinion, a short-term debt level of $600 million is reasonable and tracks the Company's recent financial experience and its financial forecasts.

Q. What interest rate do you recommend for the short-term debt?

A. I recommend a short-term debt cost rate of 0.60%. Current 3-month commercial paper rates are yielding approximately 0.26% and the Company primarily issues commercial paper for short-term financing. The 3-month London Interbank Offer Rate ("LIBOR") is also often used as a reference for the cost of short-term financing. As of June 29, 2009, the LIBOR stood at 0.60%.

I also recommend that the Commission reject the Company's proposed short-term debt rate of 2.96%. This debt rate is greatly in excess of current short-term interest rates and in no way reflects current market conditions. In fact, excluding commitment fees, the interest rate proposed by the Company is 2.77%, according to MFR Schedule D-3.

Q. Does the Company's requested short-term interest rate include commitment fees?

A. Yes. I recommend that the Commission not include commitment fees in the cost of short-term debt. This is because the amount of FPL's commitment fees are fixed and do not vary with the amount of short-term debt utilized by the Company. The Company is entitled to collect its commitment fees, but not in the short-term debt interest rate. Mr. Kollen included the dollar amount of FPL's commitment fees in his revenue requirement analysis and addresses this issue in further detail.

Q. **Did you review the recent Commission Order for TECO in Docket No. 080317-EI?**

A. Yes, I reviewed the Commission's Order in that Docket.

Q. **Did the Commission adjust TECO's capital structure in that Order?**

A. Yes. The Commission reduced TECO's requested equity percentage of investor-supplied capital from 56.6% to approximately 54% for ratemaking purposes. In its Order, the Commission stated the following:

> "It important to keep in mind that the level of equity recognized for purposes of setting rates should be in line with the risk associated with the provision of regulated operations. There is no mandate from S&P or any of the other rating agencies that we or any other regulatory commission allow an inflated equity ratio at the utility level to compensate for the parent company's use of higher debt leverage to fund other, non-regulated businesses."

Q. **What rate did the Commission use for short-term debt in that case?**

A. On page 34 of its Order, the Commission found that a cost rate of 2.75% was appropriate. This rate was based on the 3-month LIBOR rate plus 175 basis points to account for financing fees. Thus, the LIBOR rate approved by the Commission would have been 1.0%.

Q. **How does this compare to your recommended rate for short-term debt?**

A. This is quite close to the rate I recommend, which is 0.60%. There is no need in this case to add anything for financing costs since Mr. Kollen is including FPL's commitment fees in his revenue requirement recommendation. Also, this rate is close to the rate actually incurred by the Company since last year, which was below 0.50%.[7]

Q. Do you have any concluding comments on capital structure?

A. Yes. An excessive FPL common equity ratio could result in ratepayers subsidizing FPL Group's unregulated affiliate activities, which are grouped into the FPL Group Capital affiliate. FPL Group could not maintain a single 'A' credit rating on a corporate-wide basis without the support of an excessive FPL common equity ratio because, as I pointed out in Section II of my testimony, FPL Group Capital is extremely highly leveraged. The S&P report I cited in Section II confirmed that its single A credit rating for FPL Group was based on the consolidated credit profile of the company, which includes both FPL and FPL Group Capital. FPL Group Capital owns FPL Energy, stating that the ratings largely reflect the regulated cash flows from FPL's utility operations. The report also noted that the higher risk operations of FPL energy detract from FPL Group's credit quality.

I fully concur with the FPSC's position in the TECO Order, stating that the level of equity for ratemaking purposes should reflect regulated operations, not unregulated operations.

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7 Please refer to Exhibit ___(RAB-12), which includes excerpts from FPL Group presentations to the financial community.

Finally, I would note that my proposed capital structure strikes an appropriate balance between the interests of shareholders and ratepayers. My proposed equity ratio is consistent with an 'A' rating and supports FPL's credit quality. It also results in a fair weighted cost of capital that does not unduly burden the Company's ratepayers. I recommend that the Commission adopt my proposed equity ratio and recommended return on equity.

IV. RESPONSE TO FPL TESTIMONY

Q. Have you reviewed the Direct Testimony of Dr. William Avera?

A. Yes.

Q. Please summarize your conclusions with respect to Dr. Avera's testimony and return on equity recommendation.

A. My conclusions regarding Dr. Avera's testimony and return on equity recommendation are as follows.

First, Dr. Avera's recommended 12.50% return on equity is grossly overstated. His recommendation fails to track the results of his Utility Proxy Group analyses, which range from 10.5% to 11.7%.

Second, Dr. Avera failed to include forecasted dividend growth in his DCF analyses. Failing to include this important information overstated his DCF results.

Third, Dr. Avera overstated the Market Risk Premium in his CAPM analysis because of a faulty approach to estimating the market return portion of the CAPM. My CAPM results suggest much lower expected returns.

Fourth, Dr. Avera's expected earnings approach is inappropriate and should be rejected by the Commission.

Fifth, Dr. Avera's adjustment for flotation costs is inappropriate and should be rejected.

<u>Dr. Avera's ROE Range and Recommendation</u>

Q. Please summarize the results of Dr. Avera's ROE analyses.

A. Dr. Avera used three methods to estimate the cost of equity for FPL: the DCF model, the CAPM, and an expected earning approach. He used two groups of companies to estimate the cost of equity, one composed of regulated electric utilities ("Utility Proxy Group") and another using unregulated companies ("Non-Utility Proxy Group"), which completely excluded utility operations. The results from his various methods are as follows:

<u>Utility Proxy Group:</u>

DCF - 10.6% to 11.5%
CAPM - 10.5%
Expected earnings - 11.7%

<u>Non-Utility Proxy Group:</u>

DCF - 12.9% - 13.4%
CAPM - 11.5%

Dr. Avera also recommended a 25 basis point adjustment for flotation costs.

Based on these results, Dr. Avera recommended a range for FPL cost of equity of 12.0% - 13.0%. On page 73 of his Direct Testimony, Dr. Avera stated that his conclusion "is supported by the implications of ongoing turmoil in the capital markets and my recommended 25 basis point adjustment for flotation costs."

Q. In your opinion, do the results of Dr. Avera's various analyses support his recommended 12.5% ROE for FPL?

A. No. The bulk of Dr. Avera's results suggest a much lower ROE, more in the range of 10.5% - 11.7% if the Utility Proxy Group results are used. If one adds his flotation cost adjustment, then the range would increase to 10.75% - 11.95%, which is still below his recommended range for FPL.

Only the Non-Utility Proxy Group results support anything above 12.0%.

Q. Is it appropriate to use a group of unregulated companies that do not have monopoly service characteristics of electric utilities to estimate a fair return on equity for a low-risk regulated electric company such as FPL?

A. No. Dr. Avera's use of unregulated non-utility companies to estimate a fair rate of return for FPL is completely inappropriate and should be rejected by the Commission.

Utilities have protected markets, e.g. service territories, enjoy full recovery of prudently incurred costs, and may increase their rates to cover increases in costs.

Generally, the non-utility companies simply do not have these options and must compete with other firms for sales and for customers. Obviously, the non-utility companies have higher overall risk structures than a low-risk electric company like FPL and will have higher required returns from their shareholders. It is not at all surprising that Dr. Avera's ROE results for his Non-Utility Proxy Group were substantially higher than the results for his Utility Proxy Group. Given the higher business risk for the non-utility group of companies, this is exactly the result that would have been expected. However, these results do not form any kind of reasonable basis to estimate the investor required ROE for FPL. Quite the contrary, the returns from the non-utility proxy group are a good measure of returns that are, by definition, substantially in excess of those to be expected in the utility segment.

Moreover, FPL's bond ratings suggest a lower required return on equity than the average utility. FPL's lower risk profile was mentioned prominently by FPL Group's Mr. Hay in the presentations I cited in Section II of my testimony. Using higher required returns from a group of unregulated companies is obviously unjustified, inflates FPL's required ROE, and should be rejected by the Commission.

Q. **Do Dr. Avera's concerns regarding the "challenging capital market environment" (pg. 72) support his recommended 12.0% - 13.0% range for ROE?**

A. No, not at all. Concerns about the current capital markets are fully reflected in interest rates and stock prices. Both Dr. Avera and I used this current data in estimating our recommended ROEs to the Commission. The market data I used compel a much lower ROE range than Dr. Avera recommended.

Moreover, Dr. Avera's market data also support a much lower range than he recommends. Dr. Avera's use of judgment simply inflated his ROE recommendation. Later in my testimony, I will show how Dr. Avera's DCF and CAPM results for his Utility Proxy Group are overstated and could result in an even lower range of results.

Q. Do you have any concluding remarks for this section of your response to Dr. Avera?

A. Yes. In my response to Dr. Avera's DCF and CAPM analyses, I will confine my remarks to the results from his Utility Proxy Group analyses. I will not further address the Non-Utility Proxy Group because I have already explained why the Commission should reject the use of this group in estimating the cost of equity for FPL.

<u>**DCF Analyses**</u>

Q. Please summarize Dr. Avera's approach to the DCF model and its results.

A. Dr. Avera utilized the constant growth form of the DCF model to estimate the fair return on equity. He employed analysts' earnings growth forecasts from Value Line, First Call, IBES, and Zacks to estimate the growth component of the model.

Q. Did Dr. Avera consider dividend growth forecasts in his DCF analysis?

A. No. Dr. Avera failed to include lower dividend growth forecasts in his analysis.

On page 46 of his Direct Testimony, Dr. Avera opined that dividend growth rates "are not likely to provide a meaningful guide to investors' current growth expectations." In support of this opinion, he cited articles from the *Financial Analysts Journal* and Value Line's description of its Timeliness Rank.

Q. Should Dr. Avera have included dividend growth forecasts in his DCF analyses?

A. Yes. Dr. Avera erred in failing to include dividend growth forecasts from Value Line in his DCF analyses. With respect to regulated utility companies, dividend growth provides the primary source of cash flow to the investor. It is certainly the case that earnings growth fuels dividend growth and should be considered in estimating the ROE using the DCF model. However, Value Line's dividend growth forecasts are widely available to investors and can reasonably be assumed to influence their expectations with respect to growth. I weighted earnings growth 75% and dividend growth 25% in my growth calculations, so I agree to some extent with Dr. Avera that earnings growth is the primary factor considered by investors. But it should not be considered the only factor.

Regarding the articles from the *Financial Analysts Journal* cited by Dr. Avera on page 47 of his testimony, it is not surprising that earnings and cash flow are considered more important than book value and dividends, particularly for non-utility companies that may not pay out much in the way of dividends. However, this is not the case for utility companies. FPL Group itself stressed the importance of its historical dividend growth in a presentation by Mr. Hay dated May 22, 2009. I have included an excerpt from this presentation in Exhibit ___(RAB-10). Dividend growth estimates should be included in the forecast of dividend growth in the DCF model.

Q. What is the average dividend growth rate for Dr. Avera's Utility Proxy Group?

A. The average dividend growth rate forecast from Value Line is 4.97%. I have included these forecasts in Exhibit ____(RAB-11). As shown in Exhibit ___(RAB-11), including Value Line's dividend growth forecast results in a DCF cost of equity of 9.94% for the Utility Proxy Group. This result closely compares to my DCF ROE using dividend growth of 9.73%.

This result suggests a lower result for the lower bound of Dr. Avera's results.

<u>**Capital Asset Pricing Model**</u>

Q. Please present your conclusions regarding the results of Dr. Avera's CAPM analysis.

A. I disagree with Dr. Avera's formulation of the CAPM. Dr. Avera estimated the market return portion of the CAPM by estimating the current market return for dividend paying stocks in the S&P 500. This limited his "market" return to only 346 companies.

The market return portion of the CAPM should represent the most comprehensive estimate of the total return for all investment alternatives, not just a small subset of publicly traded stocks. In practice, of course, finding such an estimate is difficult and is one of the more thorny problems in estimating an accurate ROE when using the CAPM. If one limits the market return to stocks, then there are more comprehensive measures of the stock market available, such as the Value Line Investment Survey that I used in my CAPM analysis. Value Line's projected earnings growth used a sample of over 1500 stocks, its book value growth estimate used over 1400 stocks, and its dividend growth estimate used over 800 stocks. These are much broader samples than Dr. Avera's limited sample of dividend paying stocks from the S&P 500.

The forward-looking CAPM results I present in Exhibit ___(RAB-6) using a broader market index suggest much lower required rates of return than Dr. Avera recommends in his testimony.

Q. Dr. Avera did not present historical market returns in his CAPM analysis. Has Dr. Avera used historic return in his past ROE testimonies?

A. Yes. Dr. Avera used to present historical market returns from the SBBI Yearbook in his past testimonies. In this case, Dr. Avera did not use historic market returns for reasons that he explained on page 60 of his testimony.

As I previously testified, I too have concerns regarding the use of historical market returns to estimate the investor required return on equity for electric utilities. It should be noted, however, that the historical market return data I presented in Exhibit ___(RAB-7) suggests much lower CAPM ROEs than the 10.5% number that Dr. Avera recommended in his testimony. Furthermore, my alternative forward-looking CAPM results also underscore Dr. Avera's overstatement of the CAPM results.

<u>Expected Earning Approach</u>

Q. Please comment on Dr. Avera's expected earning approach.

A. Dr. Avera's expected earnings approach should be rejected by the Commission.

All Dr. Avera did in this analysis was report Value Line's forecasted returns on book equity for 2009 and the period 2011 - 2013. He did not use any market-based model such as the DCF or CAPM. Forecasted earned returns on book equity may have nothing whatsoever to do with investors' required returns in the marketplace. For example, if earned returns on book equity exceed the market-based DCF return on equity, then investors may expect a company to earn more on book equity than the market-based required rate of return. Instead, I recommend that the Commission utilize a range of returns generated by the DCF model in setting FPL's cost of equity in this case.

Flotation Costs

Q. **On page 63 of his Direct Testimony, Dr. Avera recommended a 25 basis point adjustment to recognize flotation costs. Should the Commission add a flotation cost adjustment to the cost of equity for FPL?**

A. No. I recommend that the Commission reject Dr. Avera's proposed flotation cost adjustment.

First, it is inappropriate to use flotation cost percentages from studies of other companies to estimate a flotation cost adjustment for the Companies. Dr. Avera failed to provide any specific information on flotation costs incurred by FPL. Thus, the 25 basis point adjustment he proposes is not tied to any actual flotation cost incurred by the Company, either now or in the past.

Second, in my opinion it is likely that flotation costs are already accounted for in current stock prices and that adding an adjustment for flotation costs amounts to double counting. A DCF model using current stock prices should already account for investor expectations regarding the collection of flotation costs. Multiplying the dividend yield by a 5% flotation cost adjustment, for example, essentially assumes that the current stock price is wrong and that it must be adjusted downward to increase the dividend yield and the resulting cost of equity. I do not believe that this is an appropriate assumption. Current stock prices most likely already account for flotation costs, to the extent that such costs are even accounted for by investors.

Current Capital Market Conditions

Q. Please summarize the FPL witnesses' position on the current state of capital markets and the relationship to FPL's allowed ROE in this case.

A. Both Dr. Avera and Mr. Pimentel expressed serious concerns with respect to current capital market conditions and the effect on FPL and its ability to access capital markets at a reasonable cost. I will cite examples below that I believe are representative of their concerns.

On page 4 of his Direct Testimony, Dr. Avera noted that FPL is planning significant new capital investments and "must be in a position of financial strength to attract private capital on reasonable terms from investors whose first instinct is to rush to the safety of U.S. Treasury securities." On page 17, Dr. Avera noted that the spread between public utility bonds and Treasury bonds has increased dramatically, reaching 338 basis points in January 2009. He also noted on page 14 that the recent sell-off in common stocks and increase in utility bond yields "are indicative of higher costs for long-term capital, reflecting the fact that the ongoing financial and economic crisis has spilled over into the utility industry."

On page 5 of his Direct Testimony, Mr. Pimentel cited a Moody's article, opining that "the current financial crisis has 'materially changed the banking environment for utilities going forward'." On page 6, he noted the impact of the reduced capacity in the banking environment to offer new credit lines and suggested that this "illustrates the need for FPL to maintain a strong financial position to benefit customers." On page 8 Mr. Pimentel noted the volatility in the short-term and long-term debt markets and stated that at times these markets lacked the necessary liquidity for an efficient market structure. However, on page 9 he also noted that FPL has been able to have continued access to financial market through the ongoing turmoil in the financial markets.

Q. **Please respond to these concerns regarding current market conditions and FPL's allowed cost of equity in this proceeding.**

A. Without a doubt, financial markets have undergone one of the most serious periods of volatility and uncertainty in history. And the stock market continues to be volatile in 2009. However, it should be noted that the United States government and governments around the world have moved to stabilize world financial markets and provide liquidity. Some examples of these actions in the U.S. include:

- The Emergency Economic Stabilization Act of 2008, which authorized the U.S. Treasury to spend up to $700 billion to purchase distressed assets from banks and to make capital injections into banks.

- Significant increase in loans by the Federal Reserve through is Term Auction Facility, which is designed to make loans to depository institutions (such as banks) available at its discount window.

- Creation by the Federal Reserve of the Term Asset-Backed Securities Loan Facility ("TALF"), which is designed to assist the credit needs of households and small businesses by supporting the issuance of asset-backed securities.

- Interest rate reductions by the Federal Reserve. The Fed's Discount Rate currently stands at 0.50%.

It is also important to note that, even through the height of the financial crisis last year, FPL Group did not experience problems in accessing capital markets for debt and commercial paper. As I mentioned earlier, FPL Group issued almost $1.3 billion in commercial paper in October 2008.

Further, in a presentation entitled *NextEra Energy Resources 2009 bank Meeting* dated May 5, 2009, page 7, Mr. Pimentel showed that FPL Group's corporate credit facility, which has an initial 5-year term through April 2012, was extended for an additional year through 2013. This facility is in the amount of $6.75 billion and is sufficient to meet "day-to-day" liquidity needs. This suggests that FPL's standing with the financial community is quite solid. In the same presentation dated May 6, 2009, Ms. Kathy Beilhart also noted FPL's top tier credit rating, substantial liquidity, access to commercial paper at attractive rates, and pointed out that FPL Group raised $4.3 billion since the last bank meeting. In fact, on page 5, Ms. Beilhart showed that the average rate for commercial paper for FPL Group was below 0.50%, very close to my recommended short-term debt rate of 0.60% and far less than the Company's requested short-term debt rate of 2.775, excluding commitment fees.

I have included excerpts from these two presentations in Exhibit ___(RAB-12).

Further, in statements to shareholders and the investment community, FPL Group positioned itself as a "premier energy company" with long-term positive trends, a lower-risk financial profile, outstanding shareholder returns, and adequate access to capital markets.

It is important for the Commission to allow a cost of equity for FPL that maintains its financial integrity and allows the Company continued access to capital market on reasonable terms. It is also important for FPL's customers not to be burdened by excessive rates during a severe recession, which our economy has been in since the last quarter of 2008. FPL's requested 12.50% ROE and the excessive equity in its capital structure result in a burdensome cost of capital that is too expensive for ratepayers to maintain. I recommend that the Commission adopt SFHHA's recommended capital structure and my recommended 10.40% return on equity.

Q. Does this complete your testimony?

A. Yes.

BY MR. MENDIOLA:

Q Mr. Baudino, did you prepare a summary of your testimony this morning?

A I did.

CHAIRMAN CARTER: And you're familiar with the lights?

THE WITNESS: Yes, sir.

CHAIRMAN CARTER: Good man.

BY MR. MENDIOLA:

Q And before you proceed on that, let me also ask you, you prepared exhibits to your testimony, did you not?

A I did.

Q And those are Exhibits RAB-1 through 12?

A Yes.

Q Please proceed --

CHAIRMAN CARTER: On staff's composite as -- staff, give us a hand with that on the staff composite list.

MR. MENDIOLA: Those are numbers 279 to 290.

CHAIRMAN CARTER: Thank you so much. You may proceed.

BY MR. MENDIOLA:

Q Please proceed with your summary, Mr. Baudino.

A Thank you.

Good afternoon, Commissioners. My name is Richard Baudino, and I have been retained by the South Florida Hospital and Health Care Association to estimate the investor required return for FPL.

My recommendation is the Commission approve a rate of return on equity for FPL of 10.4 percent, and this recommendation is based on the results of a discounted cash flow analysis I did for a group of comparison electric companies. In my opinion, a return on equity of 10.4 percent is a reasonable estimate of required return for a low-risk utility such as FPL.

I'm also recommending that FPL's equity ratio be reduced from the level requested by the company in this case. My recommended adjusted equity ratio for bond rating agency purposes is 50 percent, and this results in equity ratio for ratemaking purposes of 53 and a half percent. My recommended equity ratio strikes a proper balance and an appropriate balance between supporting the company's bond ratings and financial integrity and minimizing costs for Florida's ratepayers.

And I also adjusted the amount and cost of Florida Power & Light's short-term debt contained in the capital structure, and my calculations reflect the addition of 600 million of short-term debt with a cost rate for this debt of .6 percent, which reflects the three-month London Interbank Offered Rate, or LIBOR, as of June 30, 2009. This amount of short-term debt reflects FPL's recent experience with short-term debt and reduces the overall weighted cost of capital that's applied to the company's rate base. Using the small amount of short-term debt in the company's filing is inappropriate and would overstate the company's cost of capital going forward.

And turning to the company's testimony now, I recommend strongly the Commission reject the return on equity of 12 and a half percent recommended by Dr. Avera in this case, which is a witness for FPL. Dr. Avera's subjective approach greatly overstated the required return on equity for a low-risk utility such as FPL, and moreover, Dr. Avera's results are based on a proxy group -- or recommendation, I should say, is based on a proxy group of companies that are non-utility companies. He did not use the results from his electric utility group in his recommendation. The non-utility group completely fails to reflect a low-risk -- the low-risk operations of utilities such as FPL.

Dr. Avera's recommended return on equity of 12 and a half percent would be quite harmful, because it would grossly -- it would result in grossly excessive rate levels for Florida's ratepayers to support.

I also recommend the Commission reject Dr. Avera's and Mr. Pimentel's position supporting FPL's proposed capital structure, and specifically the company's requested equity ratio of 59.6 percent. FPL's requested common equity ratio is excessive, is significantly higher than the common equity ratios of similar electric companies, and would impose additional excessive and burdensome costs on ratepayers.

I would note that in statements to shareholders and the investment community, FPL has positioned itself as a premier energy company with long-term positive trends, a lower risk financial profile, outstanding shareholder returns and adequate access to capital markets. I have included presentations from -- that FPL has made to investors and banks in my exhibits, and it shows that.

In summary, it's important for the Commission to allow cost of equity for FPL that maintains its financial integrity and allows the company continued access to capital markets on reasonable terms. It's also important for FPL's customers not to be burdened by excessive rates during a severe recession, which our economy has been in. FPL has requested 12 and a half percent ROE, and the excessive equity in its capital structure results in such a burdensome cost of capital that it's too expensive to maintain.

I recommend the Commission adopt my recommended capital structure and my recommended ROE of 10.4 percent in this case. Thank you.

CHAIRMAN CARTER: Thank you very kindly.

MR. MENDIOLA: We tender the witness for cross-examination.

CHAIRMAN CARTER: Ms. Christensen, good morning.

MS. CHRISTENSEN: Good morning, and we have no questions.

CHAIRMAN CARTER: Ms. Bradley?

MS. BRADLEY: No questions.

CHAIRMAN CARTER: Ms. Kaufman?

MS. KAUFMAN: No questions, Mr. Chairman.

CHAIRMAN CARTER: Mr. LaVia?

MR. LaVIA: No questions, Mr. Chairman.

CHAIRMAN CARTER: Commissioners, I'm going to -- is it Mr. Anderson or Mr. Butler?

MR. ANDERSON: Mr. Anderson.

CHAIRMAN CARTER: Mr. Anderson, before I come to you, let me just do this: Before I went to -- Ms. Perdue, did you have any?

MS. PERDUE: No, not for this witness.

CHAIRMAN CARTER: Okay. Mr. Anderson?

MR. ANDERSON: Thank you, Chairman Carter.

CROSS EXAMINATION

BY MR. ANDERSON:

Q Mr. Baudino, can you hear me okay?

A Yes, I can.

Q Great. Good afternoon, my name is Bryan Anderson. I'm one of the attorneys for Florida Power & Light Company.

A Good afternoon, Mr. Anderson.

Q Equity is an important element of utilities' capital structure, is that right?

A Yes.

Q Equity is the money invested, not by people buying utility bonds, but by investors that are taking on the equity business risks of the company, right?

A Well, it's taken on by investors who have invested their capital in the company's common equity.

Q So equity investors are not promised any rate of return like a bondholder is promised a rate of return, right?

A That's correct.

Q Equity investor, their investments and their return, they're not secured by a mortgage and all the company's assets as the case with bondholders, right?

A That is true; however, in the regulatory environment, certainly --

CHAIRMAN CARTER: Hang on one second.

There we go. You may proceed.

THE WITNESS: It's true that there's not the coupon and it's not -- common equity is not secured by the assets of the company. However, in the regulatory arena, the company has the ability to come in and ask for a fair rate of return on its common equity, so that's a big advantage that regulated utility companies have over unregulated companies.

BY MR. ANDERSON:

Q We agree that equity investors are not guaranteed any particular dividend, they're not guaranteed any increase in stock price, right?

A They are not guaranteed contractually as they are in -- as bonds are, but they certainly are protected by the regulatory process and the company's ability to come in and ask for a reasonable return on its common equity.

Q And they're subject to the risks of Intervenor experts coming in and saying we should have a lower return on equity, right?

A I don't know if I would say that that's a risk, and I don't really understand the question. Lower than what?

Q Or an Intervenor group coming in and saying, "Don't grant a rate increase, grant no rate increase at all, decrease your rates by 300 million," that's the type of risk that matters to an equity investor, doesn't it?

A Well, not necessarily the way you phrased it, because if an Intervenor witness or Intervenor group comes in and says that the company's revenues ought to be reduced by 300 million, it could be simply excessive costs that need to be removed from the company's revenue requirement. The Commission can still approve a reasonable return on equity, which it would do in this case, I have to trust that. So no, I wouldn't agree with your question there.

Q Let's try this one. The Commission's decision on authorized return on equity will be important to investors in deciding whether to provide equity capital to FPL to sustain its existing operations and to support FPL's $16 billion in investment to serve its millions of customers over the next five years, you agree with that, right?

MR. MENDIOLA: Objection. That question calls for facts not in evidence, that is, that there is a relationship between the supposed $16 billion of capital expenditure and the required return on equity.

CHAIRMAN CARTER: Mr. Anderson, to the objection?

MR. ANDERSON: It's an entirely appropriate question. It's absolutely true, it's shown in the record in this case of many witnesses, that return on equity is an essential element to attract that $16 billion worth of capital, so this is exactly the type of question that should be posed to this type of witness.

CHAIRMAN CARTER: Ms. Helton?

MS. HELTON: If you can give me a moment?

CHAIRMAN CARTER: Okay.

Tomorrow, no lunch for you guys. This is that phenomenon.

MR. MENDIOLA: It may be helpful if the company can point to a document that outlines the $16 billion of capital expenditure as opposed to the continued assertion of that.

MR. ANDERSON: I know of no such requirement. It has been testified to by Mr. Olivera and many others, it's in many of the company's documents and it's a fact that's been shown in evidence.

And I would just like an answer to my question, whether a return on equity matters to people in deciding whether to invest their money in stock in connection with our raising the money we need to serve customers.

CHAIRMAN CARTER: I was kidding about lunch. Hang on.

Ms. Helton?

MS. HELTON: Thank you, Mr. Chairman. We believe that's an appropriate question to ask the witness.

CHAIRMAN CARTER: Okay, overruled. You may proceed.

THE WITNESS: The way I'll answer it is I'm not sure about the 16 billion, but I do know that certainly the allowed return on equity by this Commission or any other Commission will affect the price that equity investors are willing to pay for the company's stock.

Florida Power & Light is not a stand-alone company, they are part of FPL Group, so -- and they are one of the biggest parts of FPL Group. So it would affect the price in some way of FPL Group stock, but -- well, sure. But this Commission also, and other Commissions, look at all of the evidence on rate of return on equity and come up with their best recommendation on what that fair return on equity should be. That is pretty constant in all of the regulatory proceedings I'm familiar with.

BY MR. ANDERSON:

Q You don't know of any utility that has a larger expected capital expenditure in the entire United States over the next five years than Florida Power & Light Company, right?

MR. MENDIOLA: Objection. This witness doesn't speak to the level of capital expenditures of this utility compared to any other utility. He is an ROE and capital structure witness.

CHAIRMAN CARTER: I will allow. You can answer. If he doesn't know, he can say, "I don't know."

THE WITNESS: I don't know the answer to that. I have not looked at that.

BY MR. ANDERSON:

Q We'll move on to another line, then. You present some discounted cash flow and also perform a capital market pricing model analysis in your testimony, is that right?

A Yes.

Q On page 33, lines 4 to 7, you explain that your discounted cash flow -- I'll call that DCF, is that all right?

A Sure.

Q Your DCF analyses range from 10.38 percent all the way up to 11.13 percent. Do you see that?

A Yes.

Q And you've selected for your recommendation to this Commission 10.4, which is the low end of your DCF range, right?

A Right.

Q And on that same page, you point out the reasons you think that the low end of the range is right. You point to a Moody's bond rating, right?

A Yes.

Q A higher equity ratio, right?

A Yes.

Q And a statement by FPL Group's chairman, not Mr. Olivera, but Mr. Hay, that it's the best utility franchise in the nation, right?

A Right.

Q If the Florida Public Service Commission doesn't agree that FPL is low risk, as you talk about it, then your discounted cash flow analysis all by itself, exactly as you've presented it, would support an ROE up to 11.13 percent, is that right?

A If the Public Service Commission in Florida here disagrees with my analysis or feels that the 10.4 is too low for some reason, that 11.13 would be the top of the range.

Q The top of your range, right?
A Yes.
Q Okay. You are familiar with the term *beta*?
A Yes.
Q It's a measure of common stock risk, right?
A Yes.
Q On page 32, line 10, you say that the average beta of your proxy group is .69, right?
A Yes.
Q And with beta, a bigger number means more risky, right?
A It generally -- if you -- in terms of the capital asset pricing model analysis, a higher beta would suggest higher risk.
Q And turning to your RAB-6, page 2 of 2, do you have that there?
A I do.
Q You show there the beta for FPL of 0.75, is that right?
A Yes.
Q So that means FPL is more risky than the average of your proxy group, which you show down at the bottom of that column, 0.69, right?
A No. It shows that FPL Group, which is the holding company for Florida Power & Light, has a higher

beta. That is one measure of risk. So for the company as a whole, FPL Group as a whole, it tends to have a higher beta and which would, other things being equal, suggest higher risk. As we know from reviewing bond rating agency reports for FPL Group, and, in addition, FPL Group's own statements to shareholders, Florida Power & Light Company, utility, is a low risk -- lower risk operation overall than FPL Group.

Q You submit attached to your testimony Exhibit RAB-3. Do you have that?

A Yes.

Q Please look at page 9 of 10, the pie chart that shows on that page.

A I have that.

Q The caption on that page says, "FPL Group's earnings profile is significantly weighted toward lower risk sources," right?

A Yes.

Q And then we have a pie chart showing 47 percent of the earnings coming from FPL for this particular time period, correct?

A Correct.

Q And then the balance of that chart, 53 percent, that's attributed to the other parts of FPL Group, right?

A Yes.

Q And that chart shows 23 percent of next era energy resources long-term contracted, right?

A Right.

Q Sixteen percent, next era energy resources hedged, right?

A Right.

Q And long-term contracts and hedges, those are risk control and risk limiting features, right?

A Right.

Q And only about eight percent here is shown as spark spread, which is exposed to market price, field price, right?

A Right.

Q Now, did you review Dr. Avera's testimony in this case?

A Yes.

Q Would you accept, subject to check, that the average beta of Dr. Avera's proxy group is 0.73?

MR. MENDIOLA: Can I ask a clarification, which proxy group that is, utility or non-utility?

MR. ANDERSON: Utility proxy group.

THE WITNESS: Just a moment.

BY MR. ANDERSON:

Q I'm going to get -- do you have Bill Avera's testimony there?

A I do.

CHAIRMAN CARTER: I'm sorry, when you turn away from the microphone we don't get it.

THE WITNESS: I apologize. I'll remember to speak into the microphone.

CHAIRMAN CARTER: Not a problem. If you need to get something, just get it and then make sure that your answers are recorded.

THE WITNESS: Yes, sir. Thank you.

MR. ANDERSON: May I restate the question?

CHAIRMAN CARTER: Yes, you may proceed.

BY MR. ANDERSON:

Q Looking at Mr. Avera's testimony, Exhibit WEA-6, utility proxy group beta 0.73, right?

A Yes.

Q Did you look at Dr. Woolridge's testimony in this case?

A I did review his testimony.

Q Do you accept, subject to check, that the average beta of Dr. Woolridge's proxy group is 0.70?

A I will accept it subject to check. I do not have a copy of his testimony with me.

Q Okay, so 0.69 for you and your utility proxy group beta, 0.70 for Dr. Woolridge, 0.73 for Dr. Avera's utility proxy group, those are all pretty close, right?

A Those are all fairly close, yes.

Q And the common feature is that the FPL beta we pointed to before, the 0.75, and I accept your comment about it being FPL Group, that's higher than all three of those, isn't that right?

A Yes.

Q You performed a capital asset pricing model analysis also for this case?

A I did.

Q I would like to ask you a few questions about that.

A Sure.

Q Would you please turn to page 34, lines 4 through 8?

A Okay, I have that.

Q You state here that your CAPM results are much lower than the DCF results in this proceeding. This is the case for both the forward-looking and the historical version of the CAPM. "I do not rely on the CAPM for my ROE recommendation," you say here, right?

A Yes.

Q And looking at page 32, lines 13 to 17, are you there?

A Yes, I am.

Q This relates the results of the CAPM results, which you are not relying on, but it states that ranges 6.96 percent using historical to 8.38 percent using market returns, right?

A That's 8.03, but yes.

Q 8.03, I'm sorry, I misread.

Are you aware that Professor Woolridge's CAPM result was 7.6 percent, shown on JRW-11?

A I will accept it, subject to check. Again, I don't have his testimony here.

Q Okay. But 7.6 percent falls within the range that you considered unreasonably low, that is, it's between 6.96 percent and 8.03 percent, right?

A I would agree that it falls in that range, yes.

Q Okay. Turning back to your discounted cash flow analysis --

A Okay.

Q -- please turn to your Exhibit RAB-5, page 2 of 2. Do you have that?

A I do.

Q This is your chart, "Return on Equity Calculation, Florida Power & Light Company," right?

A Yes.

Q And in this exhibit you used both dividend and earnings growth to assess discounted cash flow method, right?

A Right.

Q The Value Line dividend growth in column 1, it's lower than the earnings growth rates in columns 2 through 4, right?

A That is correct, and that's true for all three methods that I used.

Q And let's just take an example. Let's look at the column 2 under, "Value Line Earnings Growth."

A Yes.

Q If we take the 6.23 percent growth rate shown there, right?

A Yes.

Q And we use your method one, the resulting ROE estimate for your proxy group is 11.64 percent as shown a little farther down in the column there, right? DCF return on equity under .2, right?

A Correct.

Q And then just looking at this chart as a whole for a moment, and we look at -- you've got three different methods, method one, method two, method three, right?

A Right.

Q And then you've got four different bases of computation, one of them is dividend growth, the other three use different flavors of earning growth, right?

A Yes, different sources for earnings growth.

Q Right. And it's a simple matrix, three times four, that means you've got 12 different results here, right?

A Yes.

Q Okay. Now, let's look at the results under method one for columns 2, 3 and 4, using the earnings growth method. We see a DCF return on equity of 11.64 percent under column 2, 11.43 percent under column 3, 11.23 percent under column 4, right?

A Right.

Q And then skipping down to method two, DCF return on equity under column 2, 11.66 percent, 11.05 percent, 11.39 percent, right?

A Correct.

Q And then for method three, we have 11.37 percent under column 2, 11.43 percent, and 11.23 percent under column 4, right?

A That is correct.

Q So on this page, nine of the 12 computations are all well north of 11, right?

A They are, and this is because it's all earnings growth and it doesn't -- you have not really looked at dividend growth there, which you must look at in coming up with a recommendation for an appropriate return on equity for this company.

Q Let's assume that -- you are familiar with Value Line, right, you talk about it some in your testimony?

A Yes.

Q And it's widely available to investors, right?

A Yes, it is.

Q And some investors -- many investors would use Value Line growth rates when they think about earnings, wouldn't they?

A I think it's a reasonable assumption to say that they would, yes.

Q Okay. So if investors use Value Line growth rates and they regard earnings as more indicative of long-term future growth than dividends, your discounted cash flow estimates, they would be downwardly biased, wouldn't they?

A No, because investors are going to look at both dividend growth and earnings growth, and what investors are seeing clearly is that for the next few years, dividend growth is going to be lower than earnings growth. Over time we would expect dividend growth and earnings growth to normalize and be roughly the same over time. However, with the way the discounted cash flow works, you must factor in the lower near-term growth in dividends. You must factor that in somehow. Otherwise you're going to be overstating the investor-required return over time. You must find a way to weight dividend growth.

Q And I acknowledge that reliance, comparatively speaking, on dividend growth, earnings growth, that's one of the disputes in the case, for example, between your position and that of Bill Avera, right?

A It's an area of disagreement we have, yes.

Q Okay. By the way, looking at your Exhibit RAB-4, page 1 of 3, could you turn to that?

A Yes, I have that.

Q Looking all the way down at the bottom of the June '09 column where it says "six months average 3.64 percent," that's the dividend yield you show for FPL Group, is that right?

A Correct.

Q Okay. Now, the Value Line earnings growth rate for FPL is ten percent, and that's shown on your RAB-5, do you remember that?

A Yes.

Q If the dividend yield we just talked about is used and we use your computation of dividend yield times one plus half the growth rate, that would come up with an adjusted dividend yield of 3.82 percent, is that right? I've done the math.

A That's pretty close. I would accept that, subject to check.

Q Right. So it would be 3.64 times one plus .05, the multiplication, it comes to 3.82, you add the 10, right, and that would result in a discounted cash flow on that methodology of 13.82 percent, right?

A Correct.

Q Okay. Would you agree that FPL Group, Progress Energy, Southern Company and Xcel Energy are in your proxy group, Dr. Avera's proxy group and Professor Woolridge's group? I can make it easier for you, because I prepared a table showing these. I'll just pass those out now.

A All right.

CHAIRMAN CARTER: Let's do that. Take a moment. It's only for cross-examination purposes, correct?

MR. ANDERSON: I think we will offer this.

CHAIRMAN CARTER: Do you need a number?

MR. ANDERSON: Yeah, it's Exhibit No. 445, sir, I think is what we are up to.

CHAIRMAN CARTER: No. 445, Commissioners.

And, Mr. Anderson --

MR. ANDERSON: The short title would be Comparison of Proxy Groups.

(Exhibit No. 445 marked for identification.)

BY MR. ANDERSON:

Q Do you have what has been marked as Exhibit 445?

A Yes, I do.

Q And what we did is we just took the proxy groups that Dr. Avera, utility proxy groups, Dr. Woolridge's and yours, we put them on a table here. Take a look at your column, just make sure that that's square. Look right?

A Yes.

Q And I will ask you to accept, subject to check, that we have done the same thing for Dr. Avera under FPL and the same thing for Dr. Woolridge for his utility proxy group. Is that all right?

A Yes.

Q Okay. And then if you look at the ones that are marked in bold, what we did is just culled out the ones that are in all three of your groups, and that would show FPL Group, Progress Energy, Southern Company, Xcel Energy, as being common to each of the utility proxy groups of yourself, Dr. Avera, Dr. Woolridge, right?

A Yes.

Q Okay.

A Yes, I would accept this, subject to check.

Q Okay, thank you. Let's just look for a second at your column, Mr. Baudino's column on the right-hand side, Dr. Woolridge in the middle, right?

A Okay.

Q Isn't it true that other than the four we talked about in common, there's only one other that the two of you have in common, that's Edison International, right?

A Yes.

CHAIRMAN CARTER: The two of who, I'm sorry?

MR. ANDERSON: Dr. Woolridge and Mr. Baudino.

CHAIRMAN CARTER: Thank you.

BY MR. ANDERSON:

Q And to be clear, Edison International is the other one you share in common, right?

A Yes.

Q Okay. Now I would like you to compare your column, Mr. Baudino, with the FPL Dr. Avera column, right?

A Okay.

Q And you share Elite in common with Dr. Avera, right?

A Yes.

Q Alliant Energy?

A Yes.

Q Consolidated Edison?

A Correct.

Q Then they ones we talked about, FPL, Progress, Southern, Xcel, but you share NSTAR also with FPL, right?

A Correct.

Q Wisconsin Energy?

A Correct.

Q In fact, there are five more companies in common between your group and FPL compared to just the one additional company in common with Dr. Woolridge, right?

A Yes.

MR. ANDERSON: Mr. Chairman, we are distributing another exhibit that we would like to mark as 446.

CHAIRMAN CARTER: 446. Short title, please.

MR. ANDERSON: Consensus Proxy Group ROE Estimate.

CHAIRMAN CARTER: Consensus Proxy Group ROE Estimate.

MR. ANDERSON: Yes, sir, thank you.

(Exhibit No. 446 marked for identification.)

CHAIRMAN CARTER: You may proceed.

MR. ANDERSON: Thank you.

MR. MENDIOLA: Your Honor, I would like to lodge an objection. I don't think there's anything like a consensus as to this proxy group as a group of four companies. Mr. Baudino certainly hasn't reached a consensus that an appropriate proxy group is comprised of only four companies. His proxy group is the group that's identified in his testimony.

CHAIRMAN CARTER: Mr. Anderson, to the objection?

MR. ANDERSON: I believe the definition of consensus is where people have something all in common, and all we're saying is, let's look at those four that they have in common. That is why I use the word *consensus* for the exhibit label.

MR. MENDIOLA: I think it's inappropriate unless Mr. Baudino can testify that he is in agreement that this is an appropriate proxy group. The only thing this proxy group is is a list of four companies that each of the three witnesses have in common. There is no consensus that it's an appropriate proxy group on which to calculate an ROE based on the DCF model. I object.

CHAIRMAN CARTER: Ms. Helton?

It gets close to lunch and, you know -- tomorrow I won't tell you guys what time we're having lunch. That way we can keep everybody guessing.

MS. HELTON: Mr. Chairman, I think we learned under the previous exhibit that Florida Power & Light distributed and cross-examined Mr. Baudino about that there is not consensus among Mr. Baudino -- and I apologize if I'm saying your name incorrectly -- Mr. Woolridge and FPL, so I do think it's inappropriate to call the four companies where they do use the same company as a proxy as a consensus proxy group.

CHAIRMAN CARTER: So I guess it would be more appropriate just to call it a proxy group, then, Ms. Helton, is that what you are saying?

MS. CHRISTENSEN: Commissioner, may I also be heard?

CHAIRMAN CARTER: Losing the word *consensus*.

Ms. Christensen, of course.

MS. CHRISTENSEN: I would also object to the exhibit. I think it's misleading as to what it's attempting to represent, which is what an ROE method or an estimated ROE would be for these four groups in isolation, and I think it would be misleading as to the individual witness's testimony regarding ROE.

MS. KAUFMAN: Chairman Carter, FIPUG would like to join in the objection as well as -- this doesn't really show anything other than a few overlapping companies and it doesn't have any probative value, and so we would also object.

MR. LaVIA: Retail Federation joins the objection.

MS. PERDUE: Attorney General joins as well.

MR. MENDIOLA: Your Honor, that is a consensus.

CHAIRMAN CARTER: You're still on board for the objection, is that what you're saying?

MR. MENDIOLA: Yes, sir.

CHAIRMAN CARTER: Okay.

Mr. Anderson?

MR. ANDERSON: Sure.

CHAIRMAN CARTER: And then I'll come back to you, Ms. Helton.

MR. ANDERSON: First, I want to help out, because I don't want any misunderstanding about the use of the word *consensus*. The whole point is that these are companies that the witnesses pick because they're comparable to FPL, that's all we meant. I'm happy to use the word *utilities in common*, let the methodology apply to utilities in common on that respect.

And as to the appropriateness of using this exhibit, it's entirely appropriate. This exhibit uses information, dividend yield information, from Mr. Baudino's Exhibit RAB-4, as you can see, information from his RAB-5, column 2, interrogates specifically concerning four of the companies that he has testified are comparable to utility for purposes of the proxy group. It uses his methodology that we talked about before for computing the DCF cash flow method. You can, in fact, see that 13.82 percent in the right-hand column, which we arrived at earlier for FPL, and this shows that if you use that method for these other companies, that's the math results and it's entirely appropriate to interrogate a return on equity witness about. This material comes from his testimony, his exhibits, using his methodology, sir.

MR. MENDIOLA: If I may be heard on that speech?

CHAIRMAN CARTER: Ever so briefly.

MR. MENDIOLA: Yes, sir. My objection goes beyond the use of the word --

CHAIRMAN CARTER: Let's be nice. You characterized it as a speech. That's below the belt. Let's stay focused.

MR. MENDIOLA: I'll just stick to the

objection.

My objection goes to the substance of this. This is an exhibit that simply cherry-picks certain companies off of the true proxy group of Mr. Baudino in order to elevate the calculated ROE. So my objection goes to the substance, it's a cherry-picking objection. It's -- I guess the technical objection would be that it assumes facts not in evidence. This is not a proxy group used by any of the witnesses.

CHAIRMAN CARTER: Okay. Ms. Helton?

MS. HELTON: This is one I need to confer with staff on, if you can give me just a moment.

CHAIRMAN CARTER: Okay, boys and girls. Be prepared to give us a recommendation after lunch. We're on lunch.

(Hearing adjourned at 1:00 p.m.)

(The transcript continues in sequence with Volume 21.)

CERTIFICATE OF REPORTER

STATE OF FLORIDA)

COUNTY OF LEON)

I, CLARA C. ROTRUCK, do hereby certify that I was authorized to and did stenographically report the foregoing proceedings at the time and place herein stated.

IT IS FURTHER CERTIFIED that the foregoing transcript is a true record of my stenographic notes.

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' attorney or counsel connected with the action, nor am I financially interested in the action.

DATED this 8th day of September, 2009, at Tallahassee, Leon County, Florida.

Clara C. Rotruck

CLARA C. ROTRUCK