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Public Counsel

July 28, 2014

Ms. Carlotta Stauffer, Commission Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Docket No. 140025-EI

Dear Ms. Stauffer:

Please find enclosed for filing in the above referenced docket the Direct Testimony of J. Randall Woolridge.

If you have any questions or concerns; please do not hesitate to contact me. Thank you for your assistance in this matter.

Sincerely,

Patricia A. Christensen
Associate Public Counsel

cc: Parties of Record

EFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application for Rate Increase by Florida Public Utilities Company
_____/

Docket No. 140025-EI

FILED: July 28, 2014

DIRECT TESTIMONY

OF

J. RANDALL WOOLRIDGE, PHD

ON BEHALF OF THE CITIZENS OF THE STATE OF FLORIDA

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TABLE OF CONTENTS

LIST OF EXHIBITS

DIRECT TESTIMONY

OF

J. RANDALL WOOLRIDGE

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 140025-EI

Q. PLEASE STATE YOUR FULL NAME, ADDRESS, AND OCCUPATION.

A. My name is J. Randall Woolridge, and my business address is 120 Haymaker Circle, State College, PA 16801. I am a Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at the University Park Campus of the Pennsylvania State University. I am also the Director of the Smeal College Trading Room and President of the Nittany Lion Fund, LLC. A summary of my educational background, research, and related business experience is provided in Exhibit JRW-16, Appendix A.

I. SUBJECT OF TESTIMONY AND SUMMARY OF RECOMMENDATIONS

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I have been asked by the Florida Office of Public Counsel ("OPC") to provide an opinion as to the overall fair rate of return or cost of capital for the Florida Public Utilities Company ("FPUC" or "Utility") and to evaluate FPUC's rate of return

testimony in this proceeding.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. First, I will review my cost of capital recommendation for FPUC, and review the primary areas of contention between FPUC's rate of return position and OPC's. Second, I provide an assessment of capital costs in today's capital markets. Third, I discuss my proxy group of electric utility companies for estimating the cost of capital for FPUC. Fourth, I present my recommendations for the Utility's capital structure and debt cost rate. Fifth, I discuss the concept of the cost of equity capital, and then estimate the equity cost rate for FPUC. Finally, I critique the Utility's rate of return analysis and testimony. I have a table of contents just after the title page for a more detailed outline.

Q. PLEASE REVIEW YOUR RECOMMENDATIONS REGARDING THE APPROPRIATE RATE OF RETURN FOR FPUC.

A. I have reviewed the Utility's proposed senior capital cost rates, capital structure and common equity cost rate. I conclude that the recommended short-term debt cost rate is well in excess of current market rates and the recommended capital structure includes a common equity ratio that is much higher than the average common equity ratios of electric utility companies. Therefore, I have made adjustments to these two elements of the Utility's recommendation.

I have applied the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM") to a proxy group of publicly-held electric utility companies ("Electric Proxy Group"). I have also employed the group developed by

the Utility's rate of return witness, Mr. Paul R. Moul ("Moul Proxy Group"). My analysis indicates that an equity cost rate in the range of 8.75% to 9.00% is appropriate for the Utility. My recommended return on equity ("ROE") depends on the capital structure that is adopted by the Commission. If the Commission adopts OPC's recommended capital structure with a 50% common equity ratio, I recommend an equity cost rate of 9.0% for FPUC. If the Commission adopts the Company's recommended capital structure with a 58.20% common equity ratio, I recommend an equity cost rate of 8.75%. My cost of capital recommendations are summarized in Exhibit JRW-1.

Q. PLEASE SUMMARIZE THE PRIMARY ISSUES REGARDING RATE OF RETURN IN THIS PROCEEDING.

A. As noted above, I have made adjustments to Mr. Moul's recommended short-term debt cost rate and capital structure. FPUC employs the capital structure of its parent company, Chesapeake Utilities (CUC or Chesapeake), which is made of regulated (several natural gas companies and one electric company) and non-regulated businesses. This capital structure has a common equity ratio that is much higher and is out of line with other electric utilities. I note that an equity-heavy capital structure may be required to support Chesapeake's high level of unregulated businesses. My proposed capital structure, with a common equity ratio of 50%, is similar to the capital structure used by the Commission in the Utility's last rate case prior to FPUC's acquisition by Chesapeake.

FPUC has proposed an equity cost rate of 11.25%. My analysis indicates an equity cost rate in the range of 8.75% to 9.00% is appropriate for FPUC. Both Mr. Moul and I have applied the DCF and the CAPM approaches to groups of publicly-held electric utility companies. Mr. Moul has also used Risk Premium ("RP") and Comparable Earnings ("CE") approaches to estimate an equity cost rate for FPUC. In addition, Mr. Moul has included a flotation cost adjustment in his rate of return recommendation.

As I discuss in my testimony, my equity cost rate recommendation is consistent with the current economic environment. Despite the increase in interest rates over the past two years, long-term interest rates are still at low levels not seen since the 1950s. There are two primary errors in Mr. Moul's DCF analysis. First, his DCF dividend yield adjustment is excessive. Second, Mr. Moul's recommended DCF growth rate of 5.25% is higher than the growth rate indicated by his growth rate measures. In developing my DCF growth rate, I have used 13 growth rate measures, including historic and projected growth rate measures, and have evaluated growth in dividends, book value, and earnings per share. In developing my DCF growth rate, I have recognized that the long-term earnings growth rates of Wall Street analysts are overly optimistic and upwardly-biased.

The CAPM approach requires an estimate of the risk-free interest rate, beta, and the equity risk premium. Mr. Moul uses a risk-free interest rate that is more than 100 basis points above current market rates. However, the major area of disagreement involves the measurement and magnitude of the market or equity risk premium. In short, Mr. Moul's market risk premium is excessive and does not reflect current

market fundamentals. As I highlight in my testimony, there are three procedures for estimating a market or equity risk premium – historic returns, surveys, and expected return models. Mr. Moul uses a market risk premium of 6.86% in his CAPM. In developing his market risk premium, Mr. Moul has used an inflated measure of the historical risk premium and a projected market risk premium that include unrealistic assumptions regarding future economic and earnings growth and stock returns. I have used a market risk premium of 5.0%which: (1) factors in all three approaches to estimating an equity premium; and (2) employs the results of many studies of the equity risk premium. As I note, my market risk premium reflects the market risk premiums: (1) discovered in academic studies by leading finance scholars; (2) employed by leading investment banks and management consulting firms; and (3) that result from surveys of companies, financial forecasters, financial analysts, and corporate CFOs.

The size premium is based on historical stock returns and, as discussed in my testimony, there are a number of errors in using historical market returns to compute risk premiums. In addition, any equity cost rate adjustment based on the relative size of a public utility is inappropriate. One study noted in my testimony tested for a size premium in utilities and concluded that, unlike industrial stocks, utility stocks do not exhibit a significant size premium. The primary reason that a size premium is not required for utilities is that utilities are regulated closely by state and federal agencies and commissions, and hence their financial performance is monitored on an on-going basis by both the state and federal governments.

Mr. Moul also estimates an equity cost rate using his RP model. There are two errors in his approach. First, Mr. Moul uses a projected long-term A-rated utility bond yield of 5.50% which is about 100 basis points above current market rates. Second, Mr. Moul's risk premium is based on the historical relationship between common stocks and the yields on long-term Treasury and corporate bonds. Mr. Moul's historical market risk premium of 6.50% is overstated. I demonstrate that there are a number of empirical issues in using historical risk premiums as measures of expected market risk premiums.

Mr. Moul includes a flotation cost adjustment to his equity cost rate estimates. Such an adjustment is not needed because Mr. Moul has not identified any flotation costs for the Utility. In addition, I demonstrate that there is no dilution of shareholders' equity associated with any equity issuances.

There is another issue that I believe significant in this proceeding. This is the presumed risk profile of FPUC and the appropriate return for the Company. With respect to risk, FPUC is not directly comparable to other Florida electric utilities. Unlike Florida Power & Light, Duke Energy Florida, Tampa Electric Company, and Gulf Power Company, FPUC is a transmission/distribution-only electric utility. Hence, FPUC does not generate the power that it sells and, therefore, does not have the risk associated with generation. The lower risk is reflected in low authorized ROEs for distribution-only electric utilities. In addition, the riskiness of FPUC is directly tied to its parent company, Chesapeake. CUC operates in three segments: Regulated Energy, Unregulated Energy, and Other. The Regulated Energy segment, which distributes natural gas in Delaware, Maryland and Florida, and electricity in

Florida, accounts for only 60% of revenues. The Unregulated Energy segment wholesales and distributes propane, markets natural gas, and provides other merchandise sales for heating, ventilation, air conditioning, plumbing, and electrical services. And the Other segment provides information technology services and solutions for enterprise and e-business applications. Hence, the other unregulated business activities of CUC add risk to the overall business profile of the parent company.

In summary, the primary areas of disagreement in measuring FPUC's cost of capital are: (1) FPUC's proposed capital structure, short-term and legacy long-term debt cost rates; (2) the DCF equity cost rate estimates, and in particular, Mr. Moul's DCF growth rate which is greater than his DCF growth rate indicators; (3) the base interest rate and market or equity risk premium in the RP and CAPM approaches; (4) the use of the CE approach which is outdated and not market-oriented; and (5) whether or not equity cost rate adjustments are needed to account for size and flotation costs.

II. CAPITAL COSTS IN TODAY'S MARKETS

Q. PLEASE DISCUSS CAPITAL COSTS IN U.S. MARKETS.

A. Long-term capital cost rates for U.S. corporations are a function of the required returns on risk-free securities plus a risk premium. The risk-free rate of interest is the yield on long-term U.S Treasury bonds. The yields on 10-year U.S. Treasury bonds from 1953 to 2011 the present are provided on Panel A of Exhibit JRW-2. These

yields peaked in the early 1980s and have generally declined since that time. These yields have fallen to historically low levels in recent years due to the financial crisis. In 2008, U.S, Treasury yields declined to below 3.0% as a result of the mortgage and subprime market credit crisis, the turmoil in the financial sector, the monetary stimulus provided by the Federal Reserve, and the slowdown in the economy. From 2008 until 2011, these rates fluctuated between 2.5% and 3.5%. In 2012, the yields on 10-year U.S. Treasuries declined from 2.5% to 1.5% as the Federal Reserve continued to support a low interest rate environment and economic uncertainties persisted. These yields increased from mid-2012 to about 3.0% as of December 2013 on speculation of a tapering of the Federal Reserve's aggressive monetary policy. After the Federal Reserve's December 18, 2013 announcement that it was indeed tapering its bond buying program, these yields began to decline and were approximately 2.5% as of July 2014.

Panel B on Exhibit JRW-2 shows the differences in yields between 10-year Treasuries and Moody's Baa-rated bonds since the year 2000. This differential primarily reflects the additional risk required by bond investors for the risk associated with investing in corporate bonds as opposed to obligations of the U.S. Treasury. The difference also reflects, to some degree, yield curve changes over time. The Baa rating is the lowest of the investment grade bond ratings for corporate bonds. The yield differential hovered in the 2.0% to 3.5% range until 2005, declined to 1.5% until late 2007, and then increased significantly in response to the financial crisis. This differential peaked at 6.0% at the height of the financial crisis in early 2009 due to tightening in credit markets, which increased corporate bond yields, and the "flight to

quality" which decreased U.S. Treasury yields. The differential subsequently declined, and has been in the 2.5% to 3.5% range over the past four years.

The risk premium is the return premium required by investors to purchase riskier securities. The risk premium required by investors to buy corporate bonds is observable based on yield differentials in the markets. The market risk premium is the return premium required to purchase stocks as opposed to bonds. The market or equity risk premium is not readily observable in the markets (as are bond risk premiums) since expected stock market returns are not readily observable. As a result, equity risk premiums must be estimated using market data. There are alternative methodologies to estimate the equity risk premium, and these alternative approaches and equity risk premium results are subject to much debate. One way to estimate the equity risk premium is to compare the mean returns on bonds and stocks over long historical periods. Measured in this manner, the equity risk premium has been in the 5% to 7% range. However, studies by leading academics indicate that the forward-looking equity risk premium is actually in the 4.0% to 6.0% range. These lower equity risk premium results are in line with the findings of equity risk premium surveys of CFOs, academics, analysts, companies, and financial forecasters.

Q. PLEASE DISCUSS INTEREST RATES ON LONG-TERM UTILITY BONDS.

A. Panel A of Exhibit JRW-3 provides the yields on A-rated public utility bonds. These yields peaked in November 2008 at 7.75% and henceforth declined significantly. These yields declined to below 4.0% in mid-2013, and then increased with interest rates in general to the 4.75% range as of late 2013. They have since declined to about

4.50%. Panel B of Exhibit JRW-3 provides the yield spreads between long-term A-rated public utility bonds relative to the yields on 20-year U.S. Treasury bonds. These yield spreads increased dramatically in the third quarter of 2008 during the peak of the financial crisis and have decreased significantly since that time. For example, the yield spreads between 20-year U.S. Treasury bonds and A-rated utility bonds peaked at 3.4% in November 2008, declined to about 1.5% in the summer of 2012, and have since remained in the 1.5% range.

Q. PLEASE DISCUSS THE FEDERAL RESERVE'S MONETARY POLICY AND INTEREST RATES.

A. On September 13, 2012, the Federal Reserve (the "Fed") released its policy statement relating to Quantitative Easing III ("QEIII"). In the statement, the Federal Reserve announced that it intended to expand and extend its purchasing of long-term securities to about $85 billion per month.[1] The Federal Open Market Committee ("FOMC") also indicated that it intends to keep the target rate for the federal funds rate between 0 to 1/4 percent through at least mid-2015. In subsequent meetings over the next year, the Federal Reserve reiterated its continuation of its bond buying program and tied future monetary policy moves to unemployment rates and the level of interest rates. Specifically, the FOMC kept the target range for the federal funds rate at 0 to 1/4 percent and reiterated its opinion that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains

[1] Board of Governors of the Federal Reserve System, "Statement Regarding Transactions in Agency Mortgage-Backed Securities and Treasury Securities," September 13, 2012.

above 6.5%.[2] Beginning in May 2013, the speculation in the markets was that the Federal Reserve's bond buying program would be tapered or scaled back. This speculation was fueled by more positive economic data on jobs and the economy, as well as by statements from FOMC members indicating that QEIII could be reduced later this calendar year. The speculation led to an increase in interest rates, with the 10-year U.S. Treasury yield increasing to about 3.0% as of December 2013.

In response to continuing positive economic data, the Fed did decide to taper QEIII at its December 18, 2013 meeting. The Fed voted to reduce its purchases of mortgage-backed securities and Treasuries by $5 billion per month beginning in January 2014. However, this tapering did not involve monetary tightening by the Fed. Indeed, the Fed extended its commitment to keep short-term interest rates "exceptionally low" until either the unemployment rate falls to around 6.5% or the inflation rate exceeds 2.5% a year.[3] Despite the announcement of the QEIII tapering, the markets reacted positively to the news due to the clarity provided by the FOMC on the future of the monetary stimulus, interest rates, and economic activity. At the time of the December 18, 2013 FOMC announcement, the yield on the 10-year U.S. Treasury yield was 2.9%.

Q. PLEASE DISCUSS THE FEDERAL RESERVE'S ACTIONS IN 2014 AND INTEREST RATES.

A. The January 29, 2014 FOMC meeting was historic as Janet Yellen took over for Ben Bernanke as the Fed Chairman. The FOMC also tapered its bond buying program by

[2] Board of Governors of the Federal Reserve System, "FOMC Statement," December 12, 2012.

[3] Board of Governors of the Federal Reserve System, FOMC Press Release, December 18, 2013.

another $5 billion per month beginning in February.[4] The FOMC also reiterated the importance of its bond buying program and continued "highly accommodative" monetary policy and has indicated that the monetary stimulus program will continue into the foreseeable future.[5]

Q. HOW HAVE THE MARKETS REACTED TO THE FEDERAL RESERVE'S SCALE BACK OF QEIII AND UPDATED CLARITY ON MONETARY POLICY?

A. The yield on the 10-year U.S. Treasury yield was 3.0% as of January 2, 2014. This yield trended down in January and was at 2.72% after the January FOMC meeting. Since that time, the 10-year U.S. Treasury yield has traded in the 2.5% to 2.8% range, and is currently 2.5%. To provide some perspective on the level of interest rates, the last time that the 10-year Treasury yield traded as low as 2.5%, prior to the onset of the financial crises in 2008, was in 1954!

Q. BASED ON THIS DISCUSSION, WHAT IS YOUR CONCLUSION CONCERNING CAPITAL COSTS IN TODAY'S MARKETS?

A. Capital costs remain at historically low levels. The increase in interest rates which were anticipated to occur when the Fed began tapering its bond buying program have not occurred. In fact, interest rates have declined since the beginning of the tapering program in January of 2014.

[4] Board of Governors of the Federal Reserve System, FOMC Press Release, January 29, 2014.
[5] Board of Governors of the Federal Reserve System, FOMC Press Release, June 18, 2014.

III. PROXY GROUP SELECTION

Q. PLEASE DESCRIBE YOUR APPROACH TO DEVELOPING A FAIR RATE OF RETURN RECOMMENDATION FOR FPUC.

A. To develop a fair rate of return recommendation for FPUC, I have evaluated the return requirements of investors on the common stock of a proxy group of publicly-held electric utility companies.

Q. PLEASE DESCRIBE YOUR PROXY GROUP OF COMPANIES.

A. The selection criteria for my proxy group include the following:

1. At least 50% of revenues are from regulated electric operations as reported by *AUS Utilities Report*;
2. Listed as Electric Utility by *Value Line Investment Survey* and listed as an Electric Utility or Combination Electric & Gas Utility in *AUS Utilities Report*;
3. An investment grade corporate credit and bond rating;
4. Has paid a cash dividend for the past three years, with no cuts or omissions;
5. Not involved in an acquisition of another utility, and not the target of an acquisition, in the past six months; and
6. Analysts' long-term EPS growth rate forecasts available from Yahoo, Reuters, and/or Zacks.

My Electric Proxy Group includes 32 companies. Summary financial statistics for the proxy group are listed in Exhibit JRW-4.[6] The median operating revenues and net

[6] In my testimony, I present financial results using both mean and medians as measures of central tendency. However, due to outliers among means, I have used the median as a measure of central tendency.

plant among members of the Electric Proxy Group are $3,412.1 million and $9,618.4 million, respectively. The group's median receives 85% of revenues from regulated electric operations, has a BBB+ bond rating from Standard & Poor's, has a current common equity ratio of 47.4%, and has an earned return on common equity of 9.8%.

Q. PLEASE DESCRIBE THE MOUL PROXY GROUP.

A. Mr. Moul has selected a proxy group of eleven electric utilities. Mr. Moul's group is different in that he requires that the electric utilities be located in the southeastern U.S. Whereas I believe that my group provides a more comprehensive sample to estimate an equity cost rate for the Company, I will also include the Moul Proxy Group in my analysis.

Summary financial statistics for Mr. Moul's proxy group is provided in Panel B of page 1 of Exhibit JRW-4. The median operating revenues and net plant for the Moul Proxy Group are $11,990.9 million and $28,008.7 million, respectively. The group receives 77% of its revenues from regulated electric operations, has a BBB+ bond rating from S&P, a current common equity ratio of 44.5%, and a current earned return on common equity of 10.3%.

Q. HOW DOES THE INVESTMENT RISK OF FPUC COMPARE TO THAT OF YOUR ELECTRIC PROXY GROUP AND THE MOUL PROXY GROUP?

A. I believe that bond ratings provide a good assessment of the investment risk of a company. FPUC's bonds are not rated by S&P and Moody's. However, as highlighted by Mr. Moul, FPUC's bonds are rated by the National Association of

Insurance Commissioners ("NAIC"). FPUC has a NAIC designation of 1, which presumes an S&P equivalent rating ranging from A- to AAA. Conservatively, I will associate an S&P bond rating of A from the NAIC designation of 1. As shown in Exhibit JRW-4, page 1, the average S&P's and Moody's bond ratings for the Electric and Moul Proxy Groups are both BBB+. Therefore, based on bond ratings, FPUC's risk is lower than that of the two proxy groups.

In addition, on page 2 of Exhibit JRW-4, I have assessed the riskiness of FPUC's parent, CUC, relative to the Electric and Moul Proxy Groups using five different risk measures published by *Value Line*. These measures include Beta, Financial Strength, Safety, Earnings Predictability, and Stock Price Stability. CUC has a Safety measure of '3' versus an average of '2' for the two groups and a Financial Strength measure of 'B+" versus 'B++' for the two groups. While these two measures suggest CUC is slightly riskier than the two groups, the other risk measures indicate that CUC's risk is about the same as that of the two groups. Given these results, and relying primarily on the relative bond ratings, it is my position that the two proxy groups represent a risk-comparable group for FPUC.

IV. CAPITAL STRUCTURE RATIOS AND DEBT COST RATES

Q. WHAT IS FPUC'S CURRENT CAPITAL STRUCTURE FOR RATEMAKING PURPOSES?

A. FPUC's recommended capital structure from investor capital sources for ratemaking purposes includes 6.50% short-term debt, 35.30% long-term debt, and 58.21%

common equity. This is provided in Panel A of Exhibit JRW-5. Since FPUC does not have its own capital structure, this capital structure represents that of its parent.

Q. PLEASE DISCUSS THE CAPITAL STRUCTURES OF THE COMPANIES IN THE MOUL PROXY GROUP.

A. Panel B of Exhibit JRW-5 provides the average quarterly capitalization ratios for the companies in the Electric Proxy Group. Page 2 of Exhibit JRW-5 provides the supporting company data. The average of the quarterly capitalization data for the proxy group is 6.44% short-term debt, 50.18% long-term debt, 0.20% preferred stock, and 43.19% common equity. These are the capital structure ratios for the holding companies that trade in the markets and that are used to estimate an equity cost rate for FPUC. These ratios indicate that the Moul Proxy Group has, on average, a much lower common equity ratio and higher financial risk than FPUC. In fact, there is not one company in the proxy group that has a common equity ratio as high as 58.21%.

Q. WHY DOES FPUC HAVE A CAPITAL STRUCTURE WITH SUCH A HIGH COMMON EQUITY RATIO?

A. I do not know; however, I presume that it may be associated with the relatively high level of unregulated businesses. Prior to its acquisition by CUC, FPUC had a capital structure that included a common equity ratio of about 50%.

Q. GIVEN THE EXTREMELY HIGH COMMON EQUITY RATIO OF FPUC RELATIVE TO THE PROXY GROUP, HOW DOES MR. MOUL CONCLUDE THAT IT IS REASONABLE FOR THE COMPANY?

A. On page 20 of his testimony, Mr. Moul justifies his recommended capital structure for FPUC by referencing the market value capital structures of the companies in his proxy group. Pure and simple – this is an 'apples-to-oranges' comparison. Regulatory ratemaking uses book value rate bases and capitalizations and not market values. As such, Mr. Moul's justification is without merit.

Q. PLEASE DISCUSS THE SIGNIFICANCE OF THE AMOUNT OF EQUITY THAT IS INCLUDED IN AN ELECTRIC UTILITY'S CAPITAL STRUCTURE.

A. An electric utility's decision as to the amount of equity capital it will incorporate into its capital structure involves fundamental trade-offs relating to the amount of financial risk the firm carries, the overall revenue requirements its customers are required to bear through the rates they pay, and the return on equity that investors will require.

Q. PLEASE DISCUSS A UTILITY'S DECISION TO USE DEBT VERSUS EQUITY TO MEET ITS CAPITAL NEEDS.

A. Utilities satisfy their capital needs through a mix of equity and debt. Because equity capital is more expensive than debt, the issuance of debt enables a utility to raise more capital with a given commitment of dollars than it could raise with just equity. Debt is, therefore, a means of "leveraging" capital dollars. However, as the amount of debt in the capital structure increases, its financial risk increases and the risk of the utility perceived by equity investors also increases. Significantly for this case, the

converse is also true. As the amount of debt in the capital structure decreases, the financial risk decreases. The required return on equity capital is a function of the amount of overall risk that investors perceive, including financial risk in the form of debt.

Q. WHY IS THIS RELATIONSHIP IMPORTANT TO THE UTILITY'S CUSTOMERS?

A. Just as there is a direct correlation between the utility's authorized return on equity and the utility's revenue requirements (the higher the return, the greater the revenue requirement), there is a direct correlation between the amount of equity in the capital structure and the revenue requirements the customers are called on to bear. Again, equity capital is more expensive than debt. Not only does equity command a higher cost rate, it also adds more to the income tax burden that ratepayers are required to pay through rates. As the equity ratio increases, the utility's revenue requirements increase and the rates paid by customers increase. If the proportion of equity is too high, rates will be higher than they need to be. For this reason, the utility's management must pursue a capital acquisition strategy that results in the proper balance in the capital structure.

Q. HOW HAVE ELECTRIC UTILITIES TYPICALLY STRUCK THIS BALANCE?

A. Due to regulation and the essential nature of its output, an electric utility is exposed to less business risk than other companies that are not regulated. This means that an

electric utility can reasonably carry relatively more debt in its capital structure than can most unregulated companies. The utility should take appropriate advantage of its lower business risk to employ cheaper debt capital at a level that will benefit its customers through lower revenue requirements. Typically, one may see equity ratios for electric utilities range from the 40% to 50% range. As I stated earlier, the average amount of common equity in the average capital structure of the utilities in the Moul Proxy Group is 43%. In my experience, this value is typical for large electric utilities.

Q. GIVEN YOUR VIEW THAT FPUC'S EQUITY RATIO IS MUCH HIGHER THAN THAT OF THE PROXY GROUP, WHAT SHOULD THE COMMISSION DO IN THIS RATEMAKING PROCEEDING?

A. When a regulated electric utility's actual capital structure contains too high an equity ratio, the options are: (1) to impute a more reasonable capital structure and to reflect the imputed capital structure in revenue requirements; or (2) to recognize the downward impact that an unusually high equity ratio will have on the financial risk of a utility and authorize a lower common equity cost rate.

Q. PLEASE ELABORATE ON THIS "DOWNWARD IMPACT."

A. As I stated earlier, there is a direct correlation between the amount of debt in a utility's capital structure and the financial risk that an equity investor will associate with that utility. A relatively lower proportion of debt translates into a lower required return on equity, all other things being equal. Stated differently, a utility cannot expect to "have it both ways." Specifically, a utility cannot maintain an unusually

high equity ratio and not expect to have the resulting lower risk reflected in its authorized return on equity. The fundamental relationship between the lower risk and the appropriate authorized return should not be ignored.

Q. PLEASE DESCRIBE YOUR RECOMMENDED CAPITAL STRUCTURE FOR FPUC.

A. The capital structure data for FPUC has a much higher common equity ratio than the Moul Proxy Group. To balance these capital structures, and to provide for a more reasonable capitalization, I use a capital structure with a common equity ratio of 50.0%. A capital structure with a 50% common equity ratio is very close to the average of the common equity ratio proposed by Mr. Moul (58.21%) and the average common equity ratio of his proxy group (43.19%).

In Panel C of Exhibit JRW-5 (page 1 of 3), I have used a common equity ratio of 50.0% and I have adjusted FPUC's short-term and long-term debt upwards on a pro rata basis such that they account, collectively, for 50.0% of total capital. The resulting capital structure includes 7.78% short-term debt, 42.22% total long-term debt, and 50.0% common equity.

Q. ARE THERE ANY OTHER REASONS WHY A CAPITAL STRUCTURE WITH A COMMON EQUITY RATIO OF 50.0% IS APPROPRIATE FOR FPUC?

A. Yes. In FPUC's last rate case, Docket No. 070304-EI, the Commission approved a capital structure which included a common equity ratio of 50.41%. FPUC was acquired by CUC in 2009. There is no justifiable basis why customers should pay higher utility

bills associated with a higher return on rate base just because one utility has purchased another utility and uses the parent company's equity-heavy capital structure in setting rates.

Q. WHAT ARE FPUC'S RECOMMENDED SENIOR CAPITAL COST RATES?

A. Mr. Moul has recommended cost rates of 3.70% for short-term debt, 12.74% for the legacy long-term debt, and 4.90% for the parent company long-term debt.

Q. WHAT SENIOR CAPITAL COST RATES ARE YOU RECOMMENDING FOR FPUC?

A. I will use Mr. Moul's recommended cost rates for the parent company long-term debt. However, the recommended short-term debt cost rate of 3.70% is excessive. Mr. Moul's recommended short-term debt cost rate is the sum of a projected London Interbank Offer Rate (LIBOR) rate of 2.60% and a 1.10% margin required on the Company's short-term credit facility. The LIBOR forecasts range from 0.90% for 2015 to 4.00% for 2018. Such long-term forecasts for LIBOR rates are simply not credible. As shown in Panel A of page 3 of Exhibit JRW-5, the current 1-month and 3-month LIBOR rates are 0.15% and 0.23%, respectively. Given the possibility that LIBOR rates will increase, I use the average of the current 1-month and 3-month LIBOR rates and the projected 2015 LIBOR rate. As shown in Panel B of page 3 of Exhibit JRW-5, in conjunction with the 1.10% margin required on the Company's short-term credit facility, this produces a short-term debt cost rate of 1.65%.

Q. WHAT ARE YOUR RECOMMENDATIONS WITH RESPECT TO THE COMPANY'S FPUC LEGACY DEBT?

A. Mr. Moul's conventional capital structure includes FPUC legacy debt of 1.09% with a 12.74% cost rate. However, in developing its regulatory capital structure for the year 2015, the Company increased the legacy debt portion of the capital structure in its pro-rata allocation of capital. The Company argues that this is done so that non-FPUC customers of CUC are not burdened with the legacy debt cost of FPUC. I do not accept this adjustment. FPUC does not have its own capital structure. The proposed capital structure is that of CUC. This capital structure finances CUC's regulated and unregulated businesses and not any of the specific businesses of CUC. Hence, this reallocation of more legacy debt to FPUC is not appropriate.

V. <u>THE COST OF COMMON EQUITY CAPITAL</u>

A. OVERVIEW

Q. WHY MUST AN OVERALL COST OF CAPITAL OR FAIR RATE OF RETURN BE ESTABLISHED FOR A PUBLIC UTILITY?

A. In a competitive industry, the return on a firm's common equity capital is determined through the competitive market for its goods and services. Due to the capital requirements needed to provide utility services and to the economic benefit to society from avoiding duplication of these services, some public utilities are monopolies. Because of the lack of competition and the essential nature of their services, it is not appropriate to permit monopoly utilities to set their own prices. Thus, regulation

seeks to establish prices that are fair to consumers and, at the same time, sufficient to meet the operating and capital costs of the utility (i.e., provide an adequate return on capital to attract investors).

Q. PLEASE PROVIDE AN OVERVIEW OF THE COST OF CAPITAL IN THE CONTEXT OF THE THEORY OF THE FIRM.

A. The total cost of operating a business includes the cost of capital. The cost of common equity capital is the expected return on a firm's common stock that the marginal investor would deem sufficient to compensate for risk and the time value of money. In equilibrium, the expected and required rates of return on a company's common stock are equal.

Normative economic models of a company or firm, developed under very restrictive assumptions, provide insight into the relationship between firm performance or profitability, capital costs, and the value of the firm. Under the economist's ideal model of perfect competition, where entry and exit are costless, products are undifferentiated, and there are increasing marginal costs of production, firms produce up to the point where price equals marginal cost. Over time, a long-run equilibrium is established where price equals average cost, including the firm's capital costs. In equilibrium, total revenues equal total costs, and because capital costs represent investors' required return on the firm's capital, actual returns equal required returns, and the market value must equal the book value of the firm's securities.

In the real world, firms can achieve competitive advantage due to product market imperfections. Most notably, companies can gain competitive advantage through product differentiation (adding real or perceived value to products) and by achieving economies of scale (decreasing marginal costs of production). Competitive advantage allows firms to price products above average cost and thereby earn accounting profits greater than those required to cover capital costs. When these profits are in excess of that required by investors, or when a firm earns a return on equity in excess of its cost of equity, investors respond by valuing the firm's equity in excess of its book value.

James M. McTaggart, founder of the international management consulting firm Marakon Associates, described this essential relationship between the return on equity, the cost of equity, and the market-to-book ratio in the following manner:[7]

> Fundamentally, the value of a company is determined by the cash flow it generates over time for its owners, and the minimum acceptable rate of return required by capital investors. This "cost of equity capital" is used to discount the expected equity cash flow, converting it to a present value. The cash flow is, in turn, produced by the interaction of a company's return on equity and the annual rate of equity growth. High return on equity (ROE) companies in low-growth markets, such as Kellogg, are prodigious generators of cash flow, while low ROE companies in high-growth markets, such as Texas Instruments, barely generate enough cash flow to finance growth.
>
> A company's ROE over time, relative to its cost of equity, also determines whether it is worth more or less than its book value. If its ROE is consistently greater than the cost of equity capital (the investor's minimum acceptable return), the business is economically profitable and its market value will exceed book value.

[7] James M. McTaggart, "The Ultimate Poison Pill: Closing the Value Gap," *Commentary* (Spring 1986), p.3.

> If, however, the business earns an ROE consistently less than its cost of equity, it is economically unprofitable and its market value will be less than book value.

As such, the relationship between a firm's return on equity, cost of equity, and market-to-book ratio is relatively straightforward. A firm that earns a return on equity above its cost of equity will see its common stock sell at a price above its book value. Conversely, a firm that earns a return on equity below its cost of equity will see its common stock sell at a price below its book value.

Q. PLEASE PROVIDE ADDITIONAL INSIGHTS INTO THE RELATIONSHIP BETWEEN RETURN ON EQUITY (ROE) AND MARKET-TO-BOOK RATIOS.

A. This relationship is discussed in a classic Harvard Business School case study entitled "Note on Value Drivers." On page 2 of that case study, the author describes the relationship very succinctly:[8]

> For a given industry, more profitable firms – those able to generate higher returns per dollar of equity– should have higher market-to-book ratios. Conversely, firms which are unable to generate returns in excess of their cost of equity should sell for less than book value.

Profitability	*Value*
If ROE > K	*then Market/Book > 1*
If ROE = K	*then Market/Book =1*
If ROE < K	*then Market/Book < 1*

To assess the relationship by industry, as suggested above, I performed a regression study between estimated ROE and market-to-book ratios using natural gas

[8] Benjamin Esty, "Note on Value Drivers," Harvard Business School, Case No. 9-297-082, April 7, 1997.

distribution, electric utility, and water utility companies. I used all companies in these three industries that are covered by *Value Line* and have estimated ROE and market-to-book ratio data. The results are presented in Panels A-C of Exhibit JRW-6. The average R-squares for the electric, gas, and water companies are 0.52, 0.71, and 0.77, respectively.[9] This demonstrates the strong positive relationship between ROEs and market-to-book ratios for public utilities.

Q. WHAT ECONOMIC FACTORS HAVE AFFECTED THE COST OF EQUITY CAPITAL FOR PUBLIC UTILITIES?

A. Exhibit JRW-7 provides indicators of public utility equity cost rates over the past decade. Page 1 shows the yields on long-term 'A' rated public utility bonds. These yields peaked in the early 2000s at over 8.0%, declined to about 5.5% in 2005, and rose to 6.0% in 2006 and 2007. They stayed in that 6.0% range until the third quarter of 2008 when they spiked to almost 7.5% during the financial crisis. Then, they declined to the 4.0% range in 2012, and have since increased to the 4.85% range over the past 18 months.

Page 2 of Exhibit JRW-7 provides the dividend yields for the Electric Proxy Group over the past decade. The dividend yields for the Electric Proxy Group generally declined slightly over the decade until 2007. They increased in 2008 and 2009 in response to the financial crisis, but declined in the last four years and now are about 4.2%.

[9] R-square measures the percent of variation in one variable (e.g., market-to-book ratios) explained by another variable (e.g., expected ROE). R-squares vary between zero and 1.0, with values closer to 1.0 indicating a higher relationship between two variables.

Average earned returns on common equity and market-to-book ratios for the Electric Proxy Group are on page 3 of Exhibit JRW-7. The average earned returns on common equity for the Electric Proxy Group were in the 9.0%-12.0% range over the past decade, and have hovered in the 10.0% range for the past four years. The average market-to-book ratio for the group was in the 1.10X to 1.80X during the past decade. The average declined to about 1.10X in 2009, but has since increased to 1.40X as of 2013.

Q. WHAT FACTORS DETERMINE INVESTORS' EXPECTED OR REQUIRED RATE OF RETURN ON EQUITY?

A. The expected or required rate of return on common stock is a function of market-wide as well as company-specific factors. The most important market factor is the time value of money as indicated by the level of interest rates in the economy. Common stock investor requirements generally increase and decrease with like changes in interest rates. The perceived risk of a firm is the predominant factor that influences investor return requirements on a company-specific basis. A firm's investment risk is often separated into business and financial risk. Business risk encompasses all factors that affect a firm's operating revenues and expenses. Financial risk results from incurring fixed obligations in the form of debt in financing its assets.

Q. HOW DOES THE INVESTMENT RISK OF UTILITIES COMPARE WITH THAT OF OTHER INDUSTRIES?

A. Due to the essential nature of their service as well as their regulated status, public utilities are exposed to a lesser degree of business risk than other, non-regulated businesses. The relatively low level of business risk allows public utilities to meet much of their capital requirements through borrowing in the financial markets, thereby incurring greater than average financial risk. Nonetheless, the overall investment risk of public utilities is below most other industries.

Exhibit JRW-8 provides an assessment of investment risk for 97 industries as measured by beta, which according to modern capital market theory, is the only relevant measure of investment risk. These betas come from the *Value Line Investment Survey.* The study shows that the investment risk of utilities is very low. The average betas for electric, water, and gas utility companies are 0.72, 0.71, and 0.73, respectively. As such, the cost of equity for utilities is among the lowest of all industries in the U.S.

Q. HOW CAN THE EXPECTED OR REQUIRED RATE OF RETURN ON COMMON EQUITY CAPITAL BE DETERMINED?

A. The costs of debt and preferred stock are normally based on historical or book values and can be determined with a great degree of accuracy. The cost of common equity capital, however, cannot be determined precisely and must instead be estimated from market data and informed judgment. This return to the stockholder should be

commensurate with returns on investments in other enterprises having comparable risks.

According to valuation principles, the present value of an asset equals the discounted value of its expected future cash flows. Investors discount these expected cash flows at their required rate of return that, as noted above, reflects the time value of money and the perceived riskiness of the expected future cash flows. As such, the cost of common equity is the rate at which investors discount expected cash flows associated with common stock ownership.

Models have been developed to ascertain the cost of common equity capital for a firm. Each model, however, has been developed using restrictive economic assumptions. Consequently, judgment is required in selecting appropriate financial valuation models to estimate a firm's cost of common equity capital, in determining the data inputs for these models, and in interpreting the models' results. All of these decisions must take into consideration the firm involved as well as current conditions in the economy and the financial markets.

Q. HOW DO YOU PLAN TO ESTIMATE THE COST OF EQUITY CAPITAL FOR THE COMPANY?

A. I rely primarily on the discounted cash flow ("DCF") model to estimate the cost of equity capital. Given the investment valuation process and the relative stability of the utility business, I believe that the DCF model provides the best measure of equity cost rates for public utilities. It is my experience that this Commission has traditionally relied on the DCF model. I have also performed a capital asset pricing model

("CAPM") study; however, I give these results less weight because I believe that risk premium studies, of which the CAPM is one form, provide a less reliable indication of equity cost rates for public utilities.

B. DCF ANALYSIS

Q. PLEASE DESCRIBE THE THEORY BEHIND THE TRADITIONAL DCF MODEL.

A. According to the DCF model, the current stock price is equal to the discounted value of all future dividends that investors expect to receive from investment in the firm. As such, stockholders' returns ultimately result from current as well as future dividends. As owners of a corporation, common stockholders are entitled to a *pro rata* share of the firm's earnings. The DCF model presumes that earnings that are not paid out in the form of dividends are reinvested in the firm so as to provide for future growth in earnings and dividends. The rate at which investors discount future dividends, which reflects the timing and riskiness of the expected cash flows, is interpreted as the market's expected or required return on the common stock. Therefore, this discount rate represents the cost of common equity. Algebraically, the DCF model can be expressed as:

$$P = \frac{D_1}{(1+k)^1} + \frac{D_2}{(1+k)^2} + \ldots \frac{D_n}{(1+k)^n}$$

where P is the current stock price, D_n is the dividend in year n, and k is the cost of common equity.

Q. IS THE DCF MODEL CONSISTENT WITH VALUATION TECHNIQUES EMPLOYED BY INVESTMENT FIRMS?

A. Yes. Virtually all investment firms use some form of the DCF model as a valuation technique. One common application for investment firms is called the three-stage DCF or dividend discount model ("DDM"). The stages in a three-stage DCF model are presented in Exhibit JRW-9, Page 1 of 2. This model presumes that a company's dividend payout progresses initially through a growth stage, then proceeds through a transition stage, and finally assumes a maturity (or steady-state) stage. The dividend-payment stage of a firm depends on the profitability of its internal investments which, in turn, is largely a function of the life cycle of the product or service.

1. Growth stage: Characterized by rapidly expanding sales, high profit margins, and an abnormally high growth in earnings per share. Because of highly profitable expected investment opportunities, the payout ratio is low. Competitors are attracted by the unusually high earnings, leading to a decline in the growth rate.

2. Transition stage: In later years, increased competition reduces profit margins and earnings growth slows. With fewer new investment opportunities, the company begins to pay out a larger percentage of earnings.

3. Maturity (steady-state) stage: Eventually, the company reaches a position where its new investment opportunities offer, on average, only slightly attractive ROEs. At that time, its earnings growth rate, payout ratio, and ROE stabilize for the remainder of its life. The constant-growth DCF model is appropriate when a firm is in the maturity stage of the life cycle.

In using this model to estimate a firm's cost of equity capital, dividends are projected into the future using the different growth rates in the alternative stages, and then the equity cost rate is the discount rate that equates the present value of the future dividends to the current stock price.

Q. HOW DO YOU ESTIMATE STOCKHOLDERS' EXPECTED OR REQUIRED RATE OF RETURN USING THE DCF MODEL?

A. Under certain assumptions, including a constant and infinite expected growth rate, and constant dividend/earnings and price/earnings ratios, the DCF model can be simplified to the following:

$$P = \frac{D_1}{k - g}$$

where D_1 represents the expected dividend over the coming year and g is the expected growth rate of dividends. This is known as the constant-growth version of the DCF model. To use the constant-growth DCF model to estimate a firm's cost of equity, one solves for k in the above expression to obtain the following:

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

Q. IN YOUR OPINION, IS THE CONSTANT-GROWTH DCF MODEL APPROPRIATE FOR PUBLIC UTILITIES?

A. Yes. The economics of the public utility business indicate that the industry is in the steady-state or constant-growth stage of a three-stage DCF. The economics include

the relative stability of the utility business, the maturity of the demand for public utility services, and the regulated status of public utilities (especially the fact that their returns on investment are effectively set through the ratemaking process). The DCF valuation procedure for companies in this stage is the constant-growth DCF. In the constant-growth version of the DCF model, the current dividend payment and stock price are directly observable. However, the primary problem and controversy in applying the DCF model to estimate equity cost rates entails estimating investors' expected dividend growth rate.

Q. WHAT FACTORS SHOULD ONE CONSIDER WHEN APPLYING THE DCF METHODOLOGY?

A. One should be sensitive to several factors when using the DCF model to estimate a firm's cost of equity capital. In general, one must recognize the assumptions under which the DCF model was developed in estimating its components (the dividend yield and the expected growth rate). The dividend yield can be measured precisely at any point in time; however, it tends to vary somewhat over time. Estimation of expected growth is considerably more difficult. One must consider recent firm performance, in conjunction with current economic developments and other information available to investors, to accurately estimate investors' expectations.

Q. WHAT DIVIDEND YIELDS HAVE YOU REVIEWED?

A. I have calculated the dividend yields for the companies in the two proxy groups using the current annual dividend and the 30-day, 90-day, and 180-day average stock

prices. These dividend yields are provided on page 2 of Exhibit JRW-10 for the Electric and Moul Proxy Groups, respectively. For the Electric Proxy Group, the mean and median dividend yields using the 30-day, 90-day, and 180-day average stock prices range from 3. 6% to 3.9%. Given this range, I use 3.8% as the dividend yield for the Electric Proxy Group. For the Moul Proxy Group, provided in Panel B of page 2 of Exhibit JRW-10, the mean and median dividend yields range from 3. 8% to 4.1% using the 30-day, 90-day, and 180-day average stock prices. Given this range, I use a dividend yield of 4.1% for the Moul Proxy Group.

Q. PLEASE DISCUSS THE APPROPRIATE ADJUSTMENT TO THE SPOT DIVIDEND YIELD.

A. According to the traditional DCF model, the dividend yield term relates to the dividend yield over the coming period. As indicated by Professor Myron Gordon, who is commonly associated with the development of the DCF model for popular use, this is obtained by: (1) multiplying the expected dividend over the coming quarter by 4, and (2) dividing this dividend by the current stock price to determine the appropriate dividend yield for a firm that pays dividends on a quarterly basis.[10]

In applying the DCF model, some analysts adjust the current dividend for growth over the coming year as opposed to the coming quarter. This can be complicated, because firms tend to announce changes in dividends at different times during the year. As such, the dividend yield computed based on presumed growth over the coming quarter as opposed to the coming year can be quite different.

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[10] *Petition for Modification of Prescribed Rate of Return*, Federal Communications Commission, Docket No. 79-05, Direct Testimony of Myron J. Gordon and Lawrence I. Gould at 62 (April 1980).

Consequently, it is common for analysts to adjust the dividend yield by some fraction of the long-term expected growth rate.

Q. GIVEN THIS DISCUSSION, WHAT ADJUSTMENT FACTOR DO YOU USE FOR YOUR DIVIDEND YIELD?

A. I adjust the dividend yield by one-half (1/2) of the expected growth so as to reflect growth over the coming year. This is the approach employed by the Federal Energy Regulatory Commission ("FERC").[11] The DCF equity cost rate ("K") is computed as:

$$K = [(D/P) * (1 + 0.5g)] + g$$

Q. PLEASE DISCUSS THE GROWTH RATE COMPONENT OF THE DCF MODEL.

A. There is much debate as to the proper methodology to employ in estimating the growth component of the DCF model. By definition, this component is investors' expectation of the long-term dividend growth rate. Presumably, the investors' use some combination of historical and/or projected growth rates for earnings and dividends per share and for internal or book value growth to assess long-term potential.

Q. WHAT GROWTH DATA HAVE YOU REVIEWED FOR THE PROXY GROUPS?

[11] Opinion No. 414-A, *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶61,084 (1998).

A. I have analyzed a number of measures of growth for companies in the proxy groups. I reviewed *Value Line's* historical and projected growth rate estimates for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS"). In addition, I utilized the average EPS growth rate forecasts of Wall Street analysts as provided by Yahoo, Reuters and Zacks. These services solicit five-year earnings growth rate projections from securities analysts and compile and publish the means and medians of these forecasts. Finally, I also assessed prospective growth as measured by prospective earnings retention rates and earned returns on common equity.

Q. PLEASE DISCUSS HISTORICAL GROWTH IN EARNINGS AND DIVIDENDS AS WELL AS INTERNAL GROWTH.

A. Historical growth rates for EPS, DPS, and BVPS are readily available to investors and are presumably an important ingredient in forming expectations concerning future growth. However, one must use historical growth numbers as measures of investors' expectations with caution. In some cases, past growth may not reflect future growth potential. Also, employing a single growth rate number (for example, for five or ten years) is unlikely to accurately measure investors' expectations, due to the sensitivity of a single growth rate figure to fluctuations in individual firm performance as well as overall economic fluctuations (i.e., business cycles). However, one must appraise the context in which the growth rate is being employed. According to the conventional DCF model, the expected return on a security is equal to the sum of the dividend yield and the expected long-term growth in dividends.

Therefore, to best estimate the cost of common equity capital using the conventional DCF model, one must look to long-term growth rate expectations.

Internally generated growth is a function of the percentage of earnings retained within the firm (the earnings retention rate) and the rate of return earned on those earnings (the return on equity). The internal growth rate is computed as the retention rate times the return on equity. Internal growth is significant in determining long-run earnings and, therefore, dividends. Investors recognize the importance of internally generated growth and pay premiums for stocks of companies that retain earnings and earn high returns on internal investments.

Q. PLEASE DISCUSS THE SERVICES THAT PROVIDE ANALYSTS' EPS FORECASTS.

A. Analysts' EPS forecasts for companies are collected and published by a number of different investment information services, including Institutional Brokers Estimate System ("I/B/E/S"), Bloomberg, FactSet, Zacks, First Call and Reuters, among others. Thompson Reuters publishes analysts' EPS forecasts under different product names, including I/B/E/S, First Call, and Reuters. Bloomberg, FactSet, and Zacks publish their own set of analysts' EPS forecasts for companies. These services do not reveal: (1) the analysts who are solicited for forecasts; or (2) the identity of the analysts who actually provide the EPS forecasts that are used in the compilations published by the services. I/B/E/S, Bloomberg, FactSet, and First Call are fee-based services. These services usually provide detailed reports and other data in addition to analysts' EPS forecasts. Thompson Reuters and Zacks do provide limited EPS forecasts data free-of-charge on

the internet. Yahoo finance (http://finance.yahoo.com) lists Thompson Reuters as the source of its summary EPS forecasts. The Reuters website (www.reuters.com) also publishes EPS forecasts from Thompson Reuters, but with more detail. Zacks (www.zacks.com) publishes its summary forecasts on its website. Zack's estimates are also available on other websites, such as msn.money (http://money.msn.com).

Q. PLEASE PROVIDE AN EXAMPLE OF THESE EPS FORECASTS.

A. The following example provides the EPS forecasts compiled by Reuters for Alliant Energy Corp. (stock symbol "LNT"). The figures are provided on page 2 of Exhibit JRW-9. The top line shows that four analysts have provided EPS estimates for the quarter ending September 30, 2014. The mean, high, and low estimates are $1.56, $1.75, and $1.46, respectively. The second line shows the quarterly EPS estimates for the quarter ending December 31, 2014 of $0.42 (mean), $0.53 (high), and $0.18 (low). Lines three and four show the annual EPS estimates for the fiscal years ending December 2014 ($3.51 (mean), $3.55 (high), and $3.47 (low)) and December 2015 (($3.66 (mean), $3.94 (high), and $3.57 (low)). The quarterly and annual EPS forecasts in lines 1-4 are expressed in dollars and cents. As in the LNT case shown here, it is common for more analysts to provide estimates of annual EPS as opposed to quarterly EPS. The bottom line shows the projected long-term EPS growth rate, which is expressed as a percentage. For LNT, three analysts have provided long-term EPS growth rate forecasts, with mean, high, and low growth rates of 5.27%, 6.00%, and 4.80%, respectively.

Q. WHICH OF THESE EPS FORECASTS IS USED IN DEVELOPING A DCF GROWTH RATE?

A. The DCF growth rate is the long-term projected growth rate in EPS, DPS, and BVPS. Therefore, in developing an equity cost rate using the DCF model, the projected long-term growth rate is the projection used in the DCF model.

Q. WHY DO YOU NOT RELY EXCLUSIVELY ON THE EPS FORECASTS OF WALL STREET ANALYSTS IN ARRIVING AT A DCF GROWTH RATE FOR THE PROXY GROUP?

A. There are several issues with using the EPS growth rate forecasts of Wall Street analysts as DCF growth rates. First, the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate. Nonetheless, over the very long-term, dividend and earnings will have to grow at a similar growth rate. Therefore, consideration must be given to other indicators of growth, including prospective dividend growth, internal growth, as well as projected earnings growth. Second, a recent study by Lacina, Lee, and Xu (2011) has shown that analysts' long-term earnings growth rate forecasts are not more accurate at forecasting future earnings than naïve random walk forecasts of future earnings.[12] Employing data over a twenty-year period, these authors demonstrate that using the most recent year's EPS figure to forecast EPS in the next 3-5 years proved to be just as accurate as using the EPS estimates from analysts' long-term earnings growth rate forecasts. In the

[12] M. Lacina, B. Lee & Z. Xu, "An Evaluation of Financial Analysts and Naïve Methods in Forecasting Long-term Earnings', Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, *Advances in Business and Management Forecasting (Vol. 8),* pp. 77-101.

authors' opinion, these results indicate that analysts' long-term earnings growth rate forecasts should be used with caution as inputs for valuation and cost of capital purposes. Finally, and most significantly, it is well known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased. This has been demonstrated in a number of academic studies over the years. This issue is discussed at length in Exhibit JRW-16, Appendix B of this testimony. Hence, using these growth rates as a DCF growth rate will provide an overstated equity cost rate. On this issue, a study by Easton and Sommers (2007) found that optimism in analysts' growth rate forecasts leads to an upward bias in estimates of the cost of equity capital of almost 3.0 percentage points.[13]

Q. IS IT YOUR OPINION THAT STOCK PRICES REFLECT THE UPWARD BIAS IN THE EPS GROWTH RATE FORECASTS?

A. Yes, I believe that investors are well aware of the bias in analysts' EPS growth rate forecasts, and therefore, stock prices reflect the upward bias.

Q. HOW DOES THAT AFFECT THE USE OF THESE FORECASTS IN A DCF EQUITY COST RATE STUDY?

A. According to the DCF model, the equity cost rate is a function of the dividend yield and expected growth rate. Since stock prices reflect the bias, it would affect the dividend yield. In addition, the DCF growth rate needs to be adjusted downward from the projected EPS growth rate to reflect the upward bias.

[13] Peter D. Easton & Gregory A. Sommers, *Effect of Analysts' Optimism on Estimates of the Expected Rate of Return Implied by Earnings Forecasts*, 45 J. ACCT. RES. 983–1015 (August 2006).

Q. PLEASE DISCUSS THE HISTORICAL GROWTH OF THE COMPANIES IN THE PROXY GROUPS, AS PROVIDED BY *VALUE LINE.*

A. Page 3 of Exhibit JRW-10 provides the 5- and 10-year historical growth rates for EPS, DPS, and BVPS for the companies in the two proxy groups, as published in the *Value Line Investment Survey.* The median historical growth measures for EPS, DPS, and BVPS for the Electric Proxy Group, as provided in Panel A, range from 2.0% to 4.3%, with an average of 3.6%. For the Moul Proxy Group, as shown in Panel B of page 3 of Exhibit JRW-10, the historical growth measures in EPS, DPS, and BVPS, as measured by the medians, range from 3.0% to 5.0%, with an average of 4.0%.

Q. PLEASE SUMMARIZE *VALUE LINE'S* PROJECTED GROWTH RATES FOR THE COMPANIES IN THE PROXY GROUPS.

A. *Value Line's* projections of EPS, DPS and BVPS growth for the companies in the proxy groups are shown on page 4 of Exhibit JRW-10. As stated above, due to the presence of outliers, the medians are used in the analysis. For the Electric Proxy Group, as shown in Panel A of page 4 of Exhibit JRW-10, the medians range from 4.0% to 5.0%, with an average of 4.5%. For the Moul Proxy Group, as shown in Panel B of page 4 of Exhibit JRW-10, the medians range from 4.0% to 5.0%, with an average of 4.5%.

Also provided on page 4 of Exhibit JRW-10 are the prospective sustainable growth rates for the companies in the two proxy groups as measured by *Value Line*'s average projected retention rate and return on shareholders' equity. As noted above,

sustainable growth is a significant and a primary driver of long-run earnings growth. For the Electric Proxy Group and the Moul Proxy Group, the median prospective sustainable growth rates are 4.0% and 4.2%, respectively.

Q. PLEASE ASSESS GROWTH FOR THE PROXY GROUPS AS MEASURED BY ANALYSTS' FORECASTS OF EXPECTED 5-YEAR EPS GROWTH.

A. Yahoo, Zacks, and Reuters collect, summarize, and publish Wall Street analysts' long-term EPS growth rate forecasts for the companies in the proxy groups. These forecasts are provided for the companies in the proxy groups on page 5 of Exhibit JRW-10. I have reported both the mean and median growth rates for the two groups. The mean/median of analysts' projected EPS growth rates for the Electric and Moul Proxy Groups are 5.0%/4.9 and 4.7%/4.8%, respectively.[14] Since there is considerable overlap in analyst coverage between the three services, and not all of the companies have forecasts from the different services, I have averaged the expected five-year EPS growth rates from the three services for each company to arrive at an expected EPS growth rate by company.

Q. PLEASE SUMMARIZE YOUR ANALYSIS OF THE HISTORICAL AND PROSPECTIVE GROWTH OF THE PROXY GROUPS.

A. Page 6 of Exhibit JRW-10 shows the summary DCF growth rate indicators for the proxy groups.

[14] Given the higher mean of analysts' projected EPS growth rates for the Moul Proxy Group, I have also considered the mean figures in the growth rate analysis.

The historical growth rate indicators for my Electric Proxy Group imply a baseline growth rate of 3.6%. The average of the projected EPS, DPS, and BVPS growth rates from *Value Line* is 4.5%, and *Value Line*'s projected sustainable growth rate is 4.0%. The high end of the range for the Electric Proxy Group are the projected EPS growth rate of Wall Street analysts, which are 5.0% and 4.9% as measured by the mean and median growth rates. The overall range for the projected growth rate indicators is 3.6% to 5.0%. Giving more weight to the projected EPS growth rate of Wall Street analysts, I believe that a growth rate in the range of 4.75% to 5.0% is appropriate. I will use the midpoint of this range, 4.875%, as the DCF growth rate for the Electric Proxy Group. This growth rate figure is clearly in the upper end of the range of historic and projected growth rates for the Electric Proxy Group.

The historical growth rate indicators for the Moul Proxy Group indicate a growth rate of 4.0%. *Value Line*'s average projected EPS, DPS, and BVPS growth rate for the group is 4.5%, and *Value Line*'s projected sustainable growth rate is 4.2%. The mean/median projected EPS growth rates of Wall Street analysts for the group are 4.7.0% and 4.8%, respectively. The range for the projected growth rate indicators is 4.0% to 4.8%. Giving more weight to the projected EPS growth rate of Wall Street analysts, I use 4.75% as the DCF growth rate for the Moul Proxy Group. As with the Electric Proxy Group, this growth rate figure is in the upper end of the range of historic and projected growth rates.

Q. BASED ON THE ABOVE ANALYSIS, WHAT ARE YOUR INDICATED COMMON EQUITY COST RATES FROM THE DCF MODEL FOR THE GROUP?

A. My DCF-derived equity cost rates for the groups are summarized on page 1 of Exhibit JRW-10 and in the table below.

	Dividend Yield	1 + ½ Growth Adjustment	DCF Growth Rate	Equity Cost Rate
Electric Proxy Group	**3.80%**	**1.02438**	**4.88%**	**8.75%**
Moul Proxy Group	**4.10%**	**1.02375**	**4.75%**	**9.00%**

The DCF calculation for my Electric Proxy Group is the 3.80% dividend yield, times the 1 and ½ growth adjustment factor of 1.02438, plus the DCF growth rate of 4.875%, which results in an equity cost rate of 8.75%. The DCF calculation for the Moul Proxy Group include a dividend yield of 4.1%, times the 1 and ½ growth adjustment factor of 1.02375, plus the DCF growth rate of 4.75%, which results in an equity cost rate of 9.0%.

C. CAPITAL ASSET PRICING MODEL

Q. PLEASE DISCUSS THE CAPITAL ASSET PRICING MODEL ("CAPM").

A. The CAPM is a risk premium approach to gauging a firm's cost of equity capital. According to the risk premium approach, the cost of equity is the sum of the interest rate on a risk-free bond (R_f) and a risk premium (RP), as in the following:

$$k = R_f + RP$$

The yield on long-term U.S. Treasury securities is normally used as R_f. Risk premiums are measured in different ways. The CAPM is a theory of the risk and expected returns of common stocks. In the CAPM, two types of risk are associated with a stock: firm-specific risk or unsystematic risk, and market or systematic risk,

which is measured by a firm's beta. The only risk that investors receive a return for bearing is systematic risk.

According to the CAPM, the expected return on a company's stock, which is also the equity cost rate (K), is equal to:

$$K = (R_f) + ß * [E(R_m) - (R_f)]$$

Where:

- K represents the estimated rate of return on the stock;
- $E(R_m)$ represents the expected return on the overall stock market. Frequently, the 'market' refers to the S&P 500;
- (R_f) represents the risk-free rate of interest;
- $[E(R_m) - (R_f)]$ represents the expected equity or market risk premium—the excess return that an investor expects to receive above the risk-free rate for investing in risky stocks; and
- *Beta*—(ß) is a measure of the systematic risk of an asset.

To estimate the required return or cost of equity using the CAPM requires three inputs: the risk-free rate of interest (R_f), the beta (ß), and the expected equity or market risk premium $[E(R_m) - (R_f)]$. R_f is the easiest of the inputs to measure – it is represented by the yield on long-term U.S. Treasury bonds. ß, the measure of systematic risk, is a little more difficult to measure because there are different opinions about what adjustments, if any, should be made to historical betas due to their tendency to regress to 1.0 over time. And finally, an even more difficult input to measure is the expected equity or market risk premium $(E(R_m) - (R_f))$. I will discuss each of these inputs below.

Q. PLEASE DISCUSS EXHIBIT JRW-11.

A. Exhibit JRW-11 provides the summary results for my CAPM study. Page 1 shows the results, and the following pages contain the supporting data.

Q. PLEASE DISCUSS THE RISK-FREE INTEREST RATE.

A. The yield on long-term U.S. Treasury bonds has usually been viewed as the risk-free rate of interest in the CAPM. The yield on long-term U.S. Treasury bonds, in turn, has been considered to be the yield on U.S. Treasury bonds with 30-year maturities.

Q. WHAT RISK-FREE INTEREST RATE ARE YOU USING IN YOUR CAPM?

A. As shown on page 2 of Exhibit JRW-11, the yield on 30-year U.S. Treasury bonds has been in the 3.0% to 4.0% range over the 2013–2014 time period. These rates are currently in the 3.35% range. Given the recent range of yields and the higher recent interest rates, I use 4.0% as the risk-free rate, or R_f, in my CAPM.

Q. WHAT BETAS ARE YOU EMPLOYING IN YOUR CAPM?

A. Beta (ß) is a measure of the systematic risk of a stock. The market, usually taken to be the S&P 500, has a beta of 1.0. The beta of a stock with the same price movement as the market also has a beta of 1.0. A stock whose price movement is greater than that of the market, such as a technology stock, is riskier than the market and has a beta greater than 1.0. A stock with below average price movement, such as that of a regulated public utility, is less risky than the market and has a beta less than 1.0. Estimating a stock's beta involves running a linear regression of a stock's return on the market return.

As shown on page 3 of Exhibit JRW-11, the slope of the regression line is the stock's ß. A steeper line indicates that the stock is more sensitive to the return on the overall market. This means that the stock has a higher ß and greater-than-average market risk. A less steep line indicates a lower ß and less market risk.

Several online investment information services, such as Yahoo and Reuters, provide estimates of stock betas. Usually these services report different betas for the same stock. The differences are usually due to: (1) the time period over which the ß is measured; and (2) any adjustments that are made to reflect the fact that betas tend to regress to 1.0 over time. In estimating an equity cost rate for the proxy group, I am using the betas for the companies as provided in the *Value Line Investment Survey*. As shown on page 3 of Exhibit JRW-11, the median betas for the companies in the Electric and Moul Proxy Groups are 0.73 and 0.70, respectively.

Q. PLEASE DISCUSS THE ALTERNATIVE VIEWS REGARDING THE EQUITY RISK PREMIUM.

A. The equity or market risk premium - $(E(R_m) - R_f)$ - is equal to the expected return on the stock market (e.g., the expected return on the S&P 500, $E(R_m)$ minus the risk-free rate of interest (R_f)). The equity premium is the difference in the expected total return between investing in equities and investing in "safe" fixed-income assets, such as long-term government bonds. However, while the equity risk premium is easy to define conceptually, it is difficult to measure because it requires an estimate of the expected return on the market.

Q. PLEASE DISCUSS THE ALTERNATIVE APPROACHES TO ESTIMATING THE EQUITY RISK PREMIUM.

A. Page 4 of Exhibit JRW-11 highlights the primary approaches to, and issues in, estimating the expected equity risk premium. The traditional way to measure the equity risk premium was to use the difference between historical average stock and bond returns. In this case, historical stock and bond returns, also called *ex post* returns, were used as the measures of the market's expected return (known as the *ex ante* or forward-looking expected return). This type of historical evaluation of stock and bond returns is often called the "Ibbotson approach" after Professor Roger Ibbotson, who popularized this method of using historical financial market returns as measures of expected returns. Most historical assessments of the equity risk premium suggest an equity risk premium range of 5% to 7% above the rate on long-term U.S. Treasury bonds. However, this can be a problem because: (1) *ex post* returns are not the same as *ex ante* expectations; (2) market risk premiums can change over time, increasing when investors become more risk-averse and decreasing when investors become less risk-averse; and (3) market conditions can change such that *ex post* historical returns are poor estimates of *ex ante* expectations.

The use of historical returns as market expectations has been criticized in numerous academic studies as discussed later in my testimony. The general theme of these studies is that the large equity risk premium discovered in historical stock and bond returns cannot be justified by the fundamental data. These studies, which fall under the category "*Ex Ante* Models and Market Data," compute *ex ante* expected returns using market data to arrive at an expected equity risk premium. These studies

have also been called "Puzzle Research" after the famous study by Mehra and Prescott in which the authors first questioned the magnitude of historical equity risk premiums relative to fundamentals.[15]

In addition, there are a number of surveys of financial professionals regarding the equity risk premium. There have been several published surveys of academics on the equity risk premium. *CFO Magazine* conducts a quarterly survey of CFOs (Chief Financial Officers), which includes questions regarding their views on the current expected returns on stocks and bonds. Typically, over 350 CFOs normally participate in the survey.[16] Questions regarding expected stock and bond returns are also included in the Federal Reserve Bank of Philadelphia's annual survey of financial forecasters, which is published as the *Survey of Professional Forecasters*.[17] This survey of professional economists has been published for almost 50 years. In addition, Pablo Fernandez conducts occasional surveys of financial analysts and companies regarding the equity risk premiums they use in their investment and financial decision-making.[18]

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[15] Rajnish Mehra & Edward C. Prescott, *The Equity Premium: A Puzzle*, J. MONETARY ECON. 15 (1985).

[16] *See,* www.cfosurvey.org.

[17] Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters,* (February 14, 2014). The *Survey of Professional Forecasters* was formerly conducted by the American Statistical Association ("ASA") and the National Bureau of Economic Research ("NBER") and was known as the ASA/NBER survey. The survey, which began in 1968, is conducted each quarter. The Federal Reserve Bank of Philadelphia, in cooperation with the NBER, assumed responsibility for the survey in June 1990.

[18] Pablo Fernandez, Pablo Linares and Isabel Fernandez Acín, "Market Risk Premium used for 88 countries in 2014: a survey with 8,228 answers," June 20, 2014.

Q. PLEASE PROVIDE A SUMMARY OF THE EQUITY RISK PREMIUM STUDIES.

A. Derrig and Orr (2003), Fernandez (2007), and Song (2007) have completed the most comprehensive reviews to date of the research on the equity risk premium.[19] Derrig and Orr's study evaluated the various approaches to estimating equity risk premiums, as well as the issues with the alternative approaches and summarized the findings of the published research on the equity risk premium. Fernandez examined four alternative measures of the equity risk premium – historical, expected, required, and implied. He also reviewed the major studies of the equity risk premium and presented the summary equity risk premium results. Song provides an annotated bibliography and highlights the alternative approaches to estimating the equity risk summary.

Page 5 of Exhibit JRW-11 provides a summary of the results of the primary risk premium studies reviewed by Derrig and Orr, Fernandez, and Song, as well as other more recent studies of the equity risk premium. In developing page 5 of Exhibit JRW-11, I have categorized the studies as discussed on page 4 of Exhibit JRW-11. These include the results of: (1) the various studies of the historical risk premium, (2) *ex ante* equity risk premium studies, (3) equity risk premium surveys of CFOs, Financial Forecasters, analysts, companies and academics, and (4) the Building Block approaches to the equity risk premium. I have also included the results of the "Building Blocks" approach to estimating the equity risk premium, including a study

[19] *See* Richard Derrig & Elisha Orr, "Equity Risk Premium: Expectations Great and Small," Working Paper (version 3.0), Automobile Insurers Bureau of Massachusetts, (August 28, 2003); Pablo Fernandez, "Equity Premium: Historical, Expected, Required, and Implied," IESE Business School Working Paper, (2007); Zhiyi Song, "The Equity Risk Premium: An Annotated Bibliography," CFA Institute, (2007).

I performed, which is presented in Exhibit JRW-16, Appendix C1 of this testimony. The Building Blocks approach is a hybrid approach employing elements of both historical and *ex ante* models. There are results reported for over 30 studies and the median equity risk premium is 4.28%.

Q. PLEASE HIGHLIGHT THE RESULTS OF THE MORE RECENT RISK PREMIUM STUDIES AND SURVEYS.

A. The studies cited on page 5 of Exhibit JRW-11 include all equity risk premium studies and surveys I could identify that were published over the past decade and that provided an equity risk premium estimate. Most of these studies were published prior to the financial crisis of the past two years. In addition, some of these studies were published in the early 2000s at the market peak. It should be noted that many of these studies (as indicated) used data over long periods of time (as long as fifty years of data) and so were not estimating an equity risk premium as of a specific point in time (e.g., the year 2001). To assess the effect of the earlier studies on the equity risk premium, I have reconstructed page 5 of Exhibit JRW-11 on page 6 of Exhibit JRW-11; however, I have eliminated all studies dated before January 2, 2010. The median for this subset of studies is 4.90%.

Q. GIVEN THESE RESULTS, WHAT MARKET OR EQUITY RISK PREMIUM ARE YOU USING IN YOUR CAPM?

A. Much of the data indicates that the market risk premium is in the 4.0% to 6.0% range. I use the midpoint of this range, 5.0%, as the market or equity risk premium.

Q. IS YOUR *EX ANTE* EQUITY RISK PREMIUM CONSISTENT WITH THE EQUITY RISK PREMIUMS USED BY CFOS?

A. Yes. In the June, 2014 CFO survey conducted by *CFO Magazine* and Duke University, the expected 10-year equity risk premium was 3.9%.

Q. IS YOUR *EX ANTE* EQUITY RISK PREMIUM CONSISTENT WITH THE EQUITY RISK PREMIUMS OF PROFESSIONAL FORECASTERS?

A. Yes. The financial forecasters in the previously referenced Federal Reserve Bank of Philadelphia survey project both stock and bond returns. In the February 2014 survey, the median long-term expected stock and bond returns were 6.43% and 4.25%, respectively. This provides an *ex ante* equity risk premium of 2.18% (6.43%-4.25%).

Q. IS YOUR *EX ANTE* EQUITY RISK PREMIUM CONSISTENT WITH THE EQUITY RISK PREMIUMS OF FINANCIAL ANALYSTS AND COMPANIES?

A. Yes. Pablo Fernandez recently published the results of a 2014 survey of academics, financial analysts and companies.[20] This survey included over 8,000 responses. The median equity risk premium employed by U.S. analysts and companies was 5.0%.

Q. WHAT EQUITY COST RATE IS INDICATED BY YOUR CAPM ANALYSIS?

[20] Pablo Fernandez, Javier Auirreamalloa, and Javier Corres, "Market Risk Premium Used in 51 Countries in 2013: A survey with 6,237 Answers," June 26, 2013.

A. The results of my CAPM study for the proxy groups are summarized on page 1 of Exhibit JRW-11 and in the table below.

$$K = (R_f) + ß * [E(R_m) - (R_f)]$$

	Risk-Free Rate	Beta	Equity Risk Premium	Equity Cost Rate
Electric Proxy Group	**4.0%**	**0.73**	**5.0%**	**7.6%**
Moul Proxy Group	**4.0%**	**0.70**	**5.0%**	**7.5%**

For the Electric Proxy Group, the risk-free rate of 4.0% plus the product of the beta of 0.73 times the equity risk premium of 5.0% results in a 7.6% equity cost rate. For the Moul Proxy Group, the risk-free rate of 4.0% plus the product of the beta of 0.70 times the equity risk premium of 5.0% results in a 7.5% equity cost rate.

D. EQUITY COST RATE SUMMARY

Q. PLEASE SUMMARIZE YOUR EQUITY COST RATE STUDY.

A. My DCF analyses for the Electric and Moul Proxy Groups indicate equity cost rates of 8.75% and 9.0%, respectively. My CAPM analyses for the Electric and Moul Proxy Groups indicate equity cost rates of 7.6% and 7.5%.

	DCF	CAPM
Electric Proxy Group	**8.75%**	**7.6%**
Moul Proxy Group	**9.00%**	**7.5%**

Q. GIVEN THESE RESULTS, WHAT IS YOUR ESTIMATED EQUITY COST RATE FOR THE GROUPS?

A. Given these results, I conclude that the appropriate equity cost rate for companies in my Electric Group and the Moul Proxy Group is in the 7.5% to 9.0% range.

However, since I rely primarily on the DCF model, I am using the upper end of the range as the equity cost rate. Therefore, I conclude that the appropriate equity cost rate for FPUC is in the range of 8.75% and 9.0%.

Q. HOW DOES YOUR PREVIOUS DISCUSSION ON CAPITAL STRUCTURE AFFECT YOUR COST OF EQUITY RECOMMENDATION FOR FPUC?

A. I have estimated an equity cost rate in the range of 8.75% to 9.0% based on my evaluation of the Electric and Moul Proxy Groups. As previously discussed, the riskiness of FPUC as indicated by their NAIC bond rating is slightly below the riskiness of the two groups. Said differently, FPUC has less risk than the two proxy groups. Moreover, as shown on page 1 of Exhibit JRW-4, these two proxy groups have capital structures with median common equity ratios of 47.4% and 44.5%, respectively. As such, the equity cost rates computed using these groups are associated with much higher levels of financial risk than FPUC with a capital structure using a common equity ratio of 58.21%. To achieve a middle ground, and to be consistent with the Commission's order prior to FPUC's acquisition by CUC, I have recommended a capital structure for FPUC that includes a common equity ratio of 50.0%. To recognize the risk trade-off of the alternative proposed capital structures, I am recommending an equity cost rate of 8.75% if the Commission adopts FPUC's 58.21% equity capital structure. If the Commission adopts OPC's recommended capital structure with a common equity ratio of 50.0%, I recommend an equity cost rate of 9.0% for FPUC.

Q. PLEASE DISCUSS THE INCREASE IN INTEREST RATES OVER THE PAST TWO YEARS AND YOUR RECOMMENDATION.

A. As previously noted, interest rates have increased over the past two years as the economy has improved and the Federal Reserve has scaled back its bond buying program. The yield on 10-year U.S. Treasury bonds increased from 1.50% in July 2012 to about 3.0% in late 2013. These yields have since declined to about 2.55%. The extremely low rates in 2012 were largely attributable to slow economic growth and the Federal Reserve's QEIII program.

Q. PLEASE INDICATE WHY AN 8.75%-9.00% RETURN IS APPROPRIATE FOR FPUC AT THIS TIME.

A. There are a number of reasons why an 8.75% to 9.00% return on equity is appropriate and fair for FPUC in this case. First, as shown in Exhibit JRW-8, the electric utility industry is one of the lowest risk industries in the U.S. as measured by beta. As such, the cost of equity capital for this industry is amongst the lowest in the U.S., according to the CAPM.

Second, as shown in Exhibits JRW-2 and JRW-3, capital costs for utilities, as indicated by long-term bond yields, are still at historically low levels, even given the increase in these rates over the past two years. Furthermore, as previously discussed, interest rates and utility bond yields have decreased since the Federal Reserve announced the tapering of its QEIII program in December 2013.

Third, while the markets have recovered significantly over the past five years, the growth in the economy is tepid and unemployment is still at 6.3%. The continuation of the Fed's "highly accommodative" monetary and scaled back QEIII

illustrates the Federal Reserve's concern over the economy. The relatively slow economic growth is a major reason that interest rates and inflation are still at historically low levels, and hence the expected returns on financial assets remain low. Fourth, utility stocks have produced very good returns this year. The overall market, as measured by the S&P 500, began the year by dropping about 10% in January. However, by the end of the second quarter, the market had recovered and was up about 7% for the year. Meanwhile, utilities have been the best performing sector of the market. A comparsion of the performance of the Dow Jones Utilities (DJU) Index (blue shaded area) relative to the S&P 500 (red line) is provided on page 1 of Exhibit JRW-12. For the year, the DJU is up 13% while the S&P 500 is at 7%.

Finally, FPUC is a distribution-only electric utility that does not have the risks associated with the generation component of integrated utilities. The authorized ROEs for transmission/distribution utilities have been below those for integrated electric utilities in recent years. Page 2 of Exhibit JRW-12 provides the authorized ROEs in nineteen rate cases in 2013 and 2014 involving distribution-only electric utilities. There are no authorized ROEs of 10% or higher, and the average for the distribution-only electric is 9.48%.

VI. CRITIQUE OF FPUC'S RATE OF RETURN TESTIMONY

Q. PLEASE SUMMARIZE MR. MOUL'S RATE OF RETURN RECOMMENDATION FOR FPUC.

A. The Company's rate of return recommendation is summarized on page 1 of Exhibit JRW-13. FPUC's recommended capital structure from investor sources for ratemaking purposes includes 6.50% short-term debt, 35.30% long-term debt, and 58.21% common equity. FPUC uses a short-term debt cost rate of 3.70%, a legacy long-term cost rate of 12.74%, a parent company debt cost rate of 4.90% and an equity cost rate of 11.25%.

Q. WHAT ISSUES DO YOU HAVE WITH THE COMPANY'S COST OF CAPITAL POSITION?

A. The primary areas of disagreement in measuring FPUC's cost of capital are: (1) FPUC's proposed capital structure, short-term debt cost rate, and possibly the legacy long-term debt cost rate; (2) the DCF equity cost rate estimates, and in particular, Mr. Moul's DCF growth rate which is greater than his DCF growth rate indicators; (3) the base interest rate and market or equity risk premium in the RP and CAPM approaches; (4) the use of the CE approach which is outdated and not market-oriented; and (5) whether or not equity cost rate adjustments are needed to account for size and flotation costs. The proposed capital structure and short-term debt cost rate issues were previously addressed. The other issues are discussed below.

A. DCF APPROACH

Q. PLEASE SUMMARIZE MR. MOUL'S DCF ESTIMATES.

A. On pages 23-31 of his testimony and Schedules 5-7 of Exhibit PRM-1, Mr. Moul develops an equity cost rate by applying a DCF model to his group of electric companies. In the traditional DCF approach, the equity cost rate is the sum of the dividend yield and expected growth. Mr. Moul adjusts the dividend yield to reflect the quarterly payment of dividends and an ex-dividend adjustment to the stock price. Mr. Moul reviews a number of historical and projected measures of expected growth for his DCF model. He uses the projected EPS growth rate forecasts from Zack's, Morningstar, SNL, IBES-First Call and *Value Line*. Mr. Moul's DCF results are provided in Panel B of page 2 of Exhibit JRW-13. Based on these figures, Mr. Moul claims that the DCF equity cost rate for his group is 9.40%. Mr. Moul then makes a flotation cost adjustment to this figure to arrive at a DCF equity cost rate of 9.59% for FPUC.

Q. PLEASE EXPRESS YOUR CONCERNS WITH MR. MOUL'S DCF STUDY.

A. I have two issues with Mr. Moul's DCF equity cost rate: (1) the DCF growth rate; and (2) the flotation cost adjustment.

1. DCF Growth Rate

Q. PLEASE CRITIQUE MR. MOUL'S DCF GROWTH RATE OF 5.25%.

A. In Schedules 6 and 7 of Exhibit PRM-1, Mr. Moul provides 17 alternative measures of growth he claims to have reviewed in arriving at his 5.25% growth rate. The average of these growth rates is only 4.62%. In addition, only four of the 17 growth rates are as large as 5.25%. The data reviewed by Mr. Moul support a DCF growth rate at least 50 basis points below Mr. Moul's 5.25%. Using such a growth rate would produce a DCF equity cost rate of 9.0%.

2. Flotation Costs

Q. PLEASE DISCUSS MR. MOUL'S ADJUSTMENT FOR FLOTATION COSTS.

A. Mr. Moul claims that an upward adjustment to his DCF, RP, and CAPM equity cost rates are necessary to account for flotation costs. This adjustment factor is erroneous for several reasons.

First, he has not identified any flotation costs for FPUC. Therefore, FPUC is requesting annual revenues in the form of a higher return on equity for flotation costs that have not been identified.

Second, it is commonly argued that a flotation cost adjustment (such as that used by the Company) is necessary to prevent the dilution of the existing shareholders. In this case, Mr. Moul justifies a flotation cost adjustment by referring to bonds and the manner in which issuance costs are recovered by including the amortization of bond flotation costs in annual financing costs. However, this is incorrect for several reasons:

(1) If an equity flotation cost adjustment is similar to a debt flotation cost adjustment, the fact that the market-to-book ratios for electric utility companies are over 1.5X actually suggests that there should be a flotation cost reduction (and not an increase) to the equity cost rate. This is because when (a) a bond is issued at a price in excess of face or book value, and (b) the difference between market price and the book value is greater than the flotation or issuance costs, the cost of that debt is lower than the coupon rate of the debt. The amount by which market values of electric utility companies are in excess of book values is much greater than flotation costs. Hence, if common stock flotation costs were exactly like bond flotation costs, and one was making an explicit flotation cost adjustment to the cost of common equity, the adjustment would be downward;

(2) If a flotation cost adjustment is needed to prevent dilution of existing stockholders' investment, then the reduction of the book value of stockholder investment associated with flotation costs can occur only when a company's stock is selling at a market price at/or below its book value. As noted above, electric utility companies are selling at market prices well in excess of book value. Hence, when new shares are sold, existing shareholders realize an increase in the book value per share of their investment, not a decrease;

(3) Flotation costs consist primarily of the underwriting spread or fee and not out-of-pocket expenses. On a per-share basis, the underwriting spread is the difference between the price the investment banker receives from investors and the price the investment banker pays to the company. Therefore, these are not expenses that must be recovered through the regulatory process. Furthermore, the underwriting

spread is known to the investors who are buying the new issue of stock, and who are well aware of the difference between the price they are paying to buy the stock and the price that the Company is receiving. The offering price which they pay is what matters when investors decide to buy a stock based on its expected return and risk prospects. Therefore, the company is not entitled to an adjustment to the allowed return to account for those costs; and

(4) Flotation costs, in the form of the underwriting spread, are a form of a transaction cost in the market. They represent the difference between the price paid by investors and the amount received by the issuing company. Whereas the Company believes that it should be compensated for these transaction costs, it has not accounted for other market transaction costs in determining its cost of equity. Most notably, brokerage fees that investors pay when they buy shares in the open market are another market transaction cost. Brokerage fees increase the effective stock price paid by investors to buy shares. If the Company had included these brokerage fees or transaction costs in its DCF analysis, the higher effective stock prices paid for stocks would lead to lower dividend yields and equity cost rates. This would result in a downward adjustment to their DCF equity cost rate.

Q. IF THE COMPANY DOES HAVE EQUITY ISSUANCE COSTS, HOW WOULD YOU RECOMMEND THEY BE TREATED FOR REGULATORY PURPOSES?

A. I would recommend that the Company's out-of-pocket expenses be treated as a cost of service. I do not recommend an adjustment to the equity cost rate.

B. RISK PREMIUM ("RP") APPROACH

Q. PLEASE REVIEW MR. MOUL'S RP ANALYSIS.

A. On pages 31-35 of his testimony and Schedules 10 and 11 of Exhibit PRM-1, Mr. Moul develops an equity cost rate using the RP model. Mr. Moul's RP results are provided in Panel C Exhibit JRW-13. Mr. Moul's RP equity cost rate for his group is 12.00%. Mr. Moul then makes a flotation cost adjustment to this figure to arrive at a RP equity cost rate of 12.19% for FPUC.

Q. WHAT ARE THE ERRORS IN MR. MOUL'S RP ANALYSIS?

A. The errors in Mr. Moul's RP equity cost rate approach include: (1) an inflated base interest rate; (2) an excessive risk premium, which is based on the historical relationship between stock and bond returns; and (3) the flotation cost adjustment. The flotation cost issue was previously addressed.

1. Base Interest Rate

Q. PLEASE DISCUSS THE BASE YIELD OF MR. MOUL'S RP ANALYSIS.

A. The base yield in Mr. Moul's RP analysis is the prospective yield on long-term, 'A' rated public utility bonds. This is erroneous for two reasons. First, the 5.50% projected yield is more than 100 basis points above current long-term utility bond yields. Second, using the yield on these securities inflates the required return on equity for the Company in two ways: (1) long-term bonds are subject to interest rate risk, a risk which does not affect common stockholders since dividend payments (unlike bond interest payments)

are not fixed but tend to increase over time; and (2) the base yield in Mr. Moul's risk premium study is subject to credit risk since it is not default risk-free like an obligation of the U.S. Treasury. As a result, its yield-to-maturity includes a premium for default risk and, therefore, is above its expected return. Hence, using a bond's yield-to-maturity as a base yield, results in an overstatement of investors' return expectations.

Q. PLEASE REVIEW MR. MOUL'S RP STUDY.

A. Mr. Moul performs a historical RP study that appears in Schedules 10 and 11 of Exhibit PRM-1. This study involves an assessment of the historical differences between the arithmetic mean returns on large company common stocks and long-term corporate and U.S. Treasury bonds over various time periods between the years 1926-2013. Based on his review of the differences in the arithmetic mean returns between stock and bonds, and in particular he cites arithmetic mean equity risk premiums of 7.60% during low interest rate environments and 5.79% during all interest rate environments. Based on these figures, Mr. Moul selects a risk premium of 6.50%.

Q. WHAT ARE THE ERRORS IN MR. MOUL'S RISK PREMIUM OF 6.50%?

A. The risk premium of 6.50% is erroneous and should be ignored for three reasons. First, it is well known that electric utility stocks are less risky than stocks in general. However, Mr. Moul does not account for the lower risk of electric utility stock. Second, Mr. Moul has computed historical risk premiums during high, low, and all interest rate environments. His definition of these alternative environments, and the time period over which he computes the equity risk premium, are arbitrary and not

specified or analyzed by Mr. Moul. As such, the historical risk premium of 7.60% during low interest rate environments is an arbitrary figure created by Mr. Moul. Finally, it is well known that using the historical relationship between stock and bond returns to measure an *ex ante* equity risk premium is erroneous and overstates the true market equity risk premium.

Q. PLEASE ADDRESS THE ISSUES INVOLVED IN USING HISTORICAL STOCK AND BOND RETURNS TO COMPUTE A FORWARD-LOOKING OR *EX ANTE* RISK PREMIUM.

A. As previously discussed, it is common to compute a market risk premium as the difference between historic stock and bond returns. However, this approach can produce differing results depending on several factors, including the measure of central tendency used, the time period evaluated, and the stock and bond market index employed. In addition, there are a myriad of empirical problems in the approach, which result in historical market returns producing inflated estimates of expected risk premiums. Among the errors are the U.S. stock market survivorship bias (the "Peso Problem"), the company survivorship bias (only successful companies survive – poor companies do not survive), and unattainable return bias (the Ibbotson procedure presumes monthly portfolio rebalancing). These issues are discussed in Exhibit JRW-16, Appendix D of this testimony.

C. CAPM APPROACH

Q. PLEASE DISCUSS MR. MOUL'S CAPM.

A. On pages 35-39 of his testimony and Schedule 12 of Exhibit PRM-1, Mr. Moul develops an equity cost rate by applying a CAPM model to his group of electric utility companies. Mr. Moul's CAPM results are provided in Panel D of page 2 of Exhibit JRW-13. Mr. Moul uses a long-term risk-free rate of 4.50%, a beta of 0.73, and a market risk premium of 6.86%. Based on these figures, Mr. Moul estimates an equity cost rate using the CAPM of 9.51%. He then adds a size premium of 1.14% and a flotation cost adjustment of 0.19% to this figure to get a CAPM equity cost rate of 10.84% for FPUC.

Q. WHAT ARE THE ERRORS IN MR. MOUL'S CAPM ANALYSIS?

A. There are four flaws with Mr. Moul's CAPM analysis: (1) the risk-free interest rate; (2) the equity risk premium of 6.86%; (3) the size adjustment of 1.14%; and (4) the flotation cost adjustment. The flotation cost issue was previously addressed.

1. Risk-Free Interest Rate

Q. PLEASE DISCUSS THE BASE YIELD OF MR. MOUL'S RP ANALYSIS.

A. Mr. Moul uses a risk-free interest rate of 4.50% in his CAPM. This figure is highly inflated as the current yield on long-term Treasury bonds is only 3.37%.

2. Market Risk Premium

Q. PLEASE REVIEW THE ERRORS IN MR. MOUL'S EQUITY OR MARKET RISK PREMIUM USED IN HIS CAPM APPROACH.

A. The primary problem with Mr. Moul's CAPM analysis is the size of the market or equity risk premium. Mr. Moul develops a market risk premium of 6.86% which is the average of: (1) the 1926-2013 historic risk premium results from the Ibbotson study of 8.03%; and (2) a projected market risk premium of 5.69% which uses an expected market return that is the average of: (a) *Value Line's* 3-5 year annual return projection of 8.68% and (b) a DCF expected market return using the S&P 500 of 11.69%, minus the risk-free rate of 4.50%. The primary error with Mr. Moul's equity risk premium is that both the Ibbotson historic returns and Mr. Moul's projected market returns are poor measures of expected market risk premiums.

Q. PLEASE ADDRESS THE PROBLEMS WITH MR. MOUL'S HISTORIC RISK PREMIUM.

A. Mr. Moul computes a historic risk premium of 8.03% based on the difference between the arithmetic mean stock and bond income returns over the 1926-2013 period. There are two flaws to this approach. First, he uses total stock returns but not total bond returns. Using only the bond income returns decreases the return on bonds and hence inflates the indicated market risk premium. Second, as previously discussed, there are issues with computing an expected equity risk premium using historical stock and bond returns. In short, there are a myriad of empirical problems, which result in historical market returns producing inflated estimates of expected risk premiums. Among the errors are the U.S. stock market survivorship bias (the "Peso Problem"), the company survivorship bias (only successful companies survive – poor companies do not survive), and unattainable return bias (the Ibbotson procedure

presumes monthly portfolio rebalancing). These issues are addressed in Exhibit JRW-16, Appendix D of this testimony.

Q. PLEASE ASSESS MR. MOUL'S EQUITY RISK PREMIUM DERIVED FROM APPLYING THE DCF MODEL TO THE S&P 500.

A. Mr. Moul also estimated an expected market return of 11.69% by applying the DCF model to the S&P 500. This approach uses a dividend yield of 2.02% and an expected DCF growth rate of 9.67%. The primary error is that the expected DCF growth rate is the projected 5-year EPS growth rate for the companies in the S&P 500 as reported by First Call. As explained below, this produces an overstated expected market return and equity risk premium.

Q. WHAT EVIDENCE CAN YOU PROVIDE THAT MR. MOUL'S S&P 500 GROWTH RATE IS ERRONEOUS?

A. Mr. Moul's expected S&P 500 growth rate of 9.67% represents the forecasted 5-year EPS growth rates of Wall Street analysts. The error with this approach is that the EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased. This is detailed at length previously in my testimony. Further, a long-term growth rate of 9.67% is inconsistent with economic and earnings growth in the U.S. The long-term economic and earnings growth rate in the U.S. has only been in the 6% to 7% range. I have performed a study of the growth in nominal GDP, S&P 500 stock price appreciation, and S&P 500 EPS and DPS growth since 1960. The

results are provided on page 1 of Exhibit JRW-14, and a summary is given in the table below.

GDP, S&P 500 Stock Price, EPS, and DPS Growth 1960-Present

Nominal GDP	**6.69%**
S&P 500 Stock Price	**6.75%**
S&P 500 EPS	**6.92%**
S&P 500 DPS	**5.64%**
Average	**6.50%**

The results are presented graphically on page 2 of Exhibit JRW-14. In sum, the historical long-run growth rates for GDP, S&P EPS, and S&P DPS are in the 5% to 7% range. By comparison, Mr. Moul's long-run growth rate projection of 9.67% is vastly overstated. These estimates suggest that companies in the U.S. would be expected to: (1) increase their growth rate of EPS by over 50% in the future, and (2) maintain that growth indefinitely in an economy that is expected to grow at about one-half of his projected growth rates.

Q. DO MORE RECENT DATA SUGGEST THAT THE U.S. ECONOMY GROWTH IS FASTER OR SLOWER THAN THE LONG-TERM DATA?

A. The more recent trends suggest lower future economic growth than the long-term historic GDP growth. The historic GDP growth rates for 10-, 20-, 30-, 40- and 50-years, are presented in Panel A of page 3 of Exhibit JRW-14 and in the table below.

Historic GDP Growth Rates

10-Year Average	**3.9%**
20-Year Average	**4.6%**
30-Year Average	**5.2%**

40-Year Average	**6.4%**
50-Year Average	**6.8%**

These data clearly suggest that nominal GDP growth in recent decades has slowed to the 4.0% to 5.0% area.

Q. WHAT LEVEL OF GDP GROWTH IS FORECASTED BY ECONOMISTS AND VARIOUS GOVERNMENT AGENCIES?

A. There are several forecasts of annual GDP growth that are available from economists and government agencies. These are listed in Panel B of page 3 of Exhibit JRW-14. The mean 10-year nominal GDP growth forecast (as of February 2014) by economists in the recent *Survey of Professional Forecasters* is 4.9%. The Energy Information Administration (EIA), in its projections used in preparing *Annual Energy Outlook,* forecasts long-term nominal GDP growth of 4.5% for the period 2011-2040. The Congressional Budget Office, in its forecasts for the period 2014 to 2024, projects a nominal GDP growth rate of 4.8%.

Q. WHY IS GDP GROWTH RELEVANT IN YOUR DISCUSSION OF MR. MOUL'S USE OF THE LONG-TERM EPS GROWTH RATES IN DEVELOPING A MARKET RISK PREMIUM FOR HIS CAPM?

A. Because, as indicated in recent research, the long-term earnings growth rates of companies are limited to the growth rate in GDP.

Q. PLEASE HIGHLIGHT THE RESEARCH ON THE LINK BETWEEN ECONOMIC AND EARNINGS GROWTH AND EQUITY RETURNS.

A. Brad Cornell of the California Institute of Technology recently published a study on GDP growth, earnings growth, and equity returns. He finds that long-term EPS growth in the U.S. is directly related to GDP growth, with GDP growth providing an upward limit on EPS growth. In addition, he finds that long-term stock returns are determined by long-term earnings growth. He concludes with the following observations:[21]

> The long-run performance of equity investments is fundamentally linked to growth in earnings. Earnings growth, in turn, depends on growth in real GDP. This article demonstrates that both theoretical research and empirical research in development economics suggest relatively strict limits on future growth. In particular, real GDP growth in excess of 3 percent in the long run is highly unlikely in the developed world. In light of ongoing dilution in earnings per share, this finding implies that investors should anticipate real returns on U.S. common stocks to average no more than about 4–5 percent in real terms.

Given current inflation in the 2% to 3% range, the results imply nominal expected stock market returns in the 7% to 8% range. As such, Mr. Moul's projected earnings growth rates and implied expected stock market returns and equity risk premiums are not indicative of the realities of the U.S. economy and stock market. As such, his expected CAPM equity cost rate is significantly overstated.

Q. PLEASE PROVIDE A SUMMARY ASSESSMENT OF MR. MOUL'S PROJECTED EQUITY RISK PREMIUM DERIVED FROM EXPECTED MARKET RETURNS.

A. Mr. Moul's market risk premium derived from his DCF application to the S&P 500 is

[21] Bradford Cornell, "Economic Growth and Equity Investing," *Financial Analysts Journal* (January/February, 2010), p. 63.

inflated due to errors and bias in his study. Investment banks, consulting firms, and CFOs use the equity risk premium concept every day in making financing, investment, and valuation decisions. On this issue, the opinions of CFOs and financial forecasters are especially relevant. CFOs deal with capital markets on an ongoing basis since they must continually assess and evaluate capital costs for their companies. They are well aware of the historical stock and bond return studies of Ibbotson. The CFOs in the June 2014 *CFO Magazine* – Duke University Survey of over 350 CFOs forecast an expected return on the S&P 500 of 6.6% over the next ten years. In addition, the financial forecasters in the February 2014 Federal Reserve Bank of Philadelphia survey expect an annual market return of 6.43% over the next ten years. As such, with a more realistic equity or market risk premium, the appropriate equity cost rate for a public utility should be in the 8.0% to 9.0% range and not in the 10.0% to 11.0% range.

3. Size Adjustment

Q. PLEASE DISCUSS MR. MOUL'S SIZE ADJUSTMENT.

A. Mr. Moul includes a size adjustment of 1.14% in his CAPM approach for the size of the companies in his proxy group. There are three reasons that there is no need for a size premium: (1) FPUC's credit rating includes the size of the company: (2) the size premium is based on historical returns which are upwardly biased measures of expected risk premiums; and (3) empirical studies show that size premiums are not required for utilities.

First, FPUC's credit rating, as provided by NAIC, incorporates many different risk factors, including the size of the company. FPUC's NAIC designation of 1 relates to an A bond rating which is better than the average of the Electric and Moul Proxy Groups. Therefore, there is no valid reason to include a size premium in the equity cost rate.

Second, this size adjustment is based on the historical stock market returns studies as performed by Morningstar (formerly Ibbotson Associates). As discussed in Exhibit JRW-16, Appendix D of this testimony, there are numerous errors in using historical market returns to compute risk premiums. These errors provide inflated estimates of expected risk premiums. Among the errors are survivorship bias (only successful companies survive – poor companies do not survive) and unattainable return bias (the Ibbotson procedure presumes monthly portfolio rebalancing). The net result is that Ibbotson's size premiums are poor measures for risk adjustment to account for the size of the utility.

Third, Professor Annie Wong has tested for a size premium in utilities and concluded that, unlike industrial stocks, utility stocks do not exhibit a significant size premium.[22] As explained by Professor Wong, there are several reasons why such a size premium would not be attributable to utilities. Utilities are regulated closely by state and federal agencies and commissions, and hence, their financial performance is monitored on an ongoing basis by both the state and federal governments. In addition, public utilities must gain approval from government entities for common financial transactions such as the sale of securities. Furthermore, unlike their industrial

[22] Annie Wong, "Utility Stocks and the Size Effect: An Empirical Analysis," *Journal of the Midwest Finance Association*, pp. 95-101, (1993).

counterparts, accounting standards and reporting are fairly standardized for public utilities. Finally, a utility's earnings are predetermined to a certain degree through the ratemaking process in which performance is reviewed by state commissions and other interested parties. Overall, in terms of regulation, government oversight, performance review, accounting standards, and information disclosure, utilities are much different than industrials, which could account for the lack of a size premium.

Q. PLEASE DISCUSS OTHER RESEARCH ON THE SIZE PREMIUM IN ESTIMATING THE EQUITY COST RATE.

A. As noted, there are errors in using historical market returns to compute risk premiums. With respect to the small firm premium, Richard Roll (1983) found that one-half of the historic return premiums for small companies disappears once biases are eliminated and historic returns are properly computed. The error arises from the assumption of monthly portfolio rebalancing and the serial correlation in historic small firm returns.[23]

In another paper, Ching-Chih Lu (2009) estimated the size premium over the long-run. Mr. Lu acknowledges that many studies have demonstrated that smaller companies have historically earned higher stock market returns. However, Mr. Lu highlights that these studies rebalance the size portfolios on an annual basis. This means that at the end of each year the stocks are sorted based on size, split into decile, and the returns are computed over the next year for each stock decile.[24] This annual

[23] *See* Richard Roll, "On Computing Mean Returns and the Small Firm Premium," *Journal of Financial Economics*, pp. 371-386, (1983).

[24] By sorting data into deciles means that observations are ranked largest to smallest, and then placed into ten

rebalancing creates the problem. Using a size premium in estimating a CAPM equity cost rate requires that a firm carry the extra size premium in its discount factor for an extended period of time, not just for one year, which is the presumption with annual rebalancing. Through an analysis of small firm stock returns for longer time periods (and without annual rebalancing), Lu finds that the size premium disappears within two years. Lu's conclusion with respect to the size premium is:[25]

> However, an analysis of the evolution of the size premium will show that it is inappropriate to attach a fixed amount of premium to the cost of equity of a firm simply because of its current market capitalization. For a small stock portfolio which does not rebalance since the day it was constructed, its annual return and the size premium are all declining over years instead of staying at a relatively stable level. This confirms that a small firm should not be expected to have a higher size premium going forward sheerly because it is small now.

D. Comparable Earnings ("CE") Approach

Q. PLEASE DISCUSS MR. MOUL'S CE ANALYSIS.

A. On pages 39-42 of his testimony and Schedule 13 of Exhibit PRM-1, Mr. Moul develops an equity cost rate for the Company employing the CE approach. His methodology involves averaging historic and prospective returns on common equity for a proxy group of non-utility companies which are "comparable" in risk to his proxy group as determined from screening *Value Line's* Value Screen database. Mr. Moul screens the database on six risk measures and arrives at a group of eleven unregulated comparable companies. As shown in Panel E of page 2 of Exhibit JRW-

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different groups, with 1/10 of the observations in each group or decile.

[25] Ching-Chih Lu, "The Size Premium in the Long Run," 2009 Working Paper, SSRN abstract no. 1368705, at p. 5.

13, the average of the historic and projected median returns on common equity for the group is 13.3%.

This approach is fundamentally flawed for several reasons. Mr. Moul has not performed any analysis to examine whether his return on equity figures are likely measures of long-term earnings expectations. Second, the financial statistics for the companies suggest that these companies are not comparable to his utility proxy companies. Financial statistics for the group and Mr. Moul's proxy group are provided in Exhibit JRW-15. The data indicate that the "comparable group" is much less capital intensive (fixed asset turnover of 1.14 vs. 0.28), has a higher valuation level (median P/E of 18 vs. 15), has a higher projected ROE than the electric group (estimated ROE of 19.88% vs. 11.05%), has a market-to-book ratio more than twice the group (Price-to-Book Value of 5.84 vs. 2.08), and its projected long-term EPS growth rate is double that of the proxy group (projected EPS Growth Rate of 9.47% vs. 4.32%). In summary, the financial data indicates that Mr. Moul's "comparable group" is not very comparable to the group of proxy companies.

Finally, and more importantly, since Mr. Moul has not evaluated the market-to-book ratios for these companies, he cannot indicate whether the past and projected returns on common equity are above or below the investors' requirements. These returns on common equity are excessive if the market-to-book ratios for these companies are above 1.0. For example, Campbell Soup is one of the companies listed as being 'comparable' to FPUC. The average return on equity of Campbell Soup is 84.5%. However, I doubt if any financial analyst, including Mr. Moul, would suggest that Campbell Soup has an equity cost rate of 84.5%. Indeed, the market-to-

book ratio for the company is in excess of 10.0. This indicates that its return on equity is well above its cost of equity capital.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

CERTIFICATE OF SERVICE
DOCKET NO. 140025-EI

I HEREBY CERTIFY that a true and correct copy of the foregoing Direct Testimony of J. Randall Woolridge and has been furnished by electronic mail to the following parties on this 28th day of July, 2014:

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Exhibit JRW-1
Florida Public Utilities Company
Recommended Cost of Capital

Panel A: Recommended Cost of Capital with 50% Equity Capital Structure

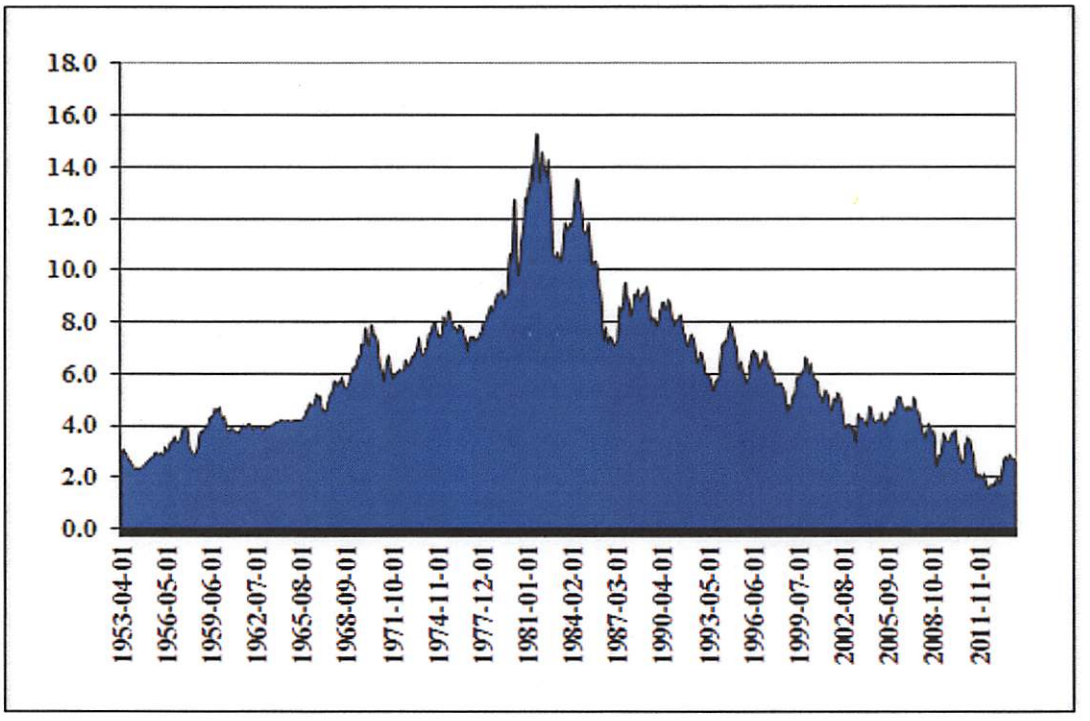
Capital Source	Capitalization Ratio	Cost Rate	Weighted Cost Rate
Short-Term Debt	7.78%	1.65%	0.13%
Long-Term Debt - Legacy	1.30%	12.74%	0.17%
Long-Term Debt - Parent Company	40.92%	4.90%	2.01%
Common Equity	50.00%	9.00%	4.50%
Total	100.00%		6.80%

Panel B: Recommended Cost of Capital with 58.21% Equity Capital Structure

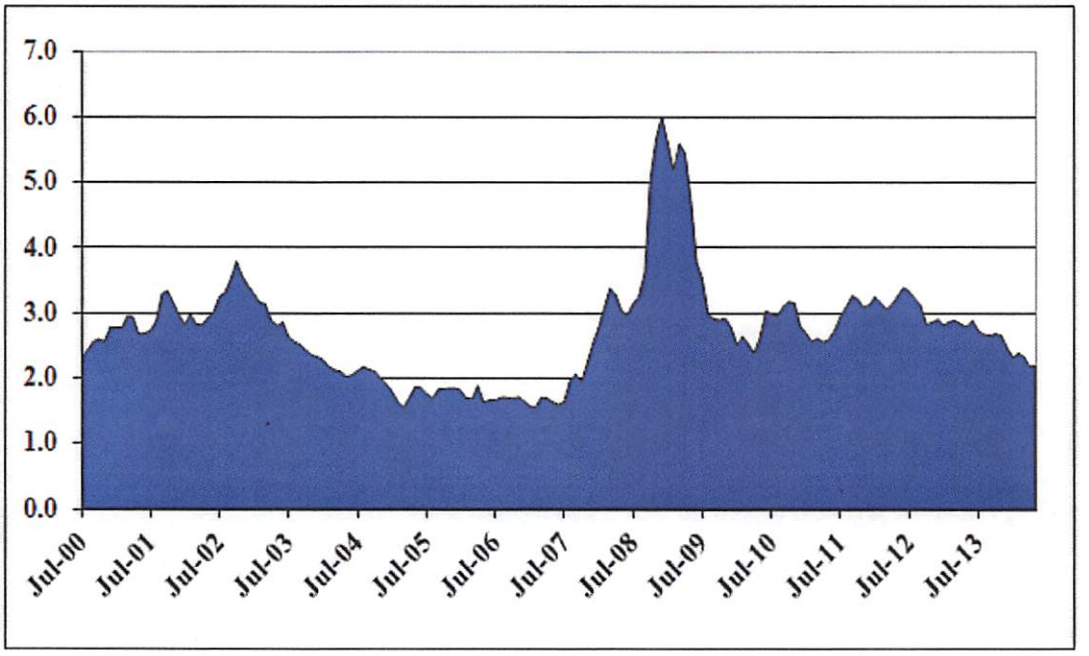
Capital Source	Capitalization Ratio	Cost Rate	Weighted Cost Rate
Short-Term Debt	6.50%	1.65%	0.11%
Long-Term Debt - Legacy	1.09%	12.74%	0.14%
Long-Term Debt - Parent Company	34.21%	4.90%	1.68%
Common Equity	58.21%	8.75%	5.09%
Total	100.00%		7.02%

Exhibit JRW-2

Panel A
Ten-Year Treasury Yields
1953-Present

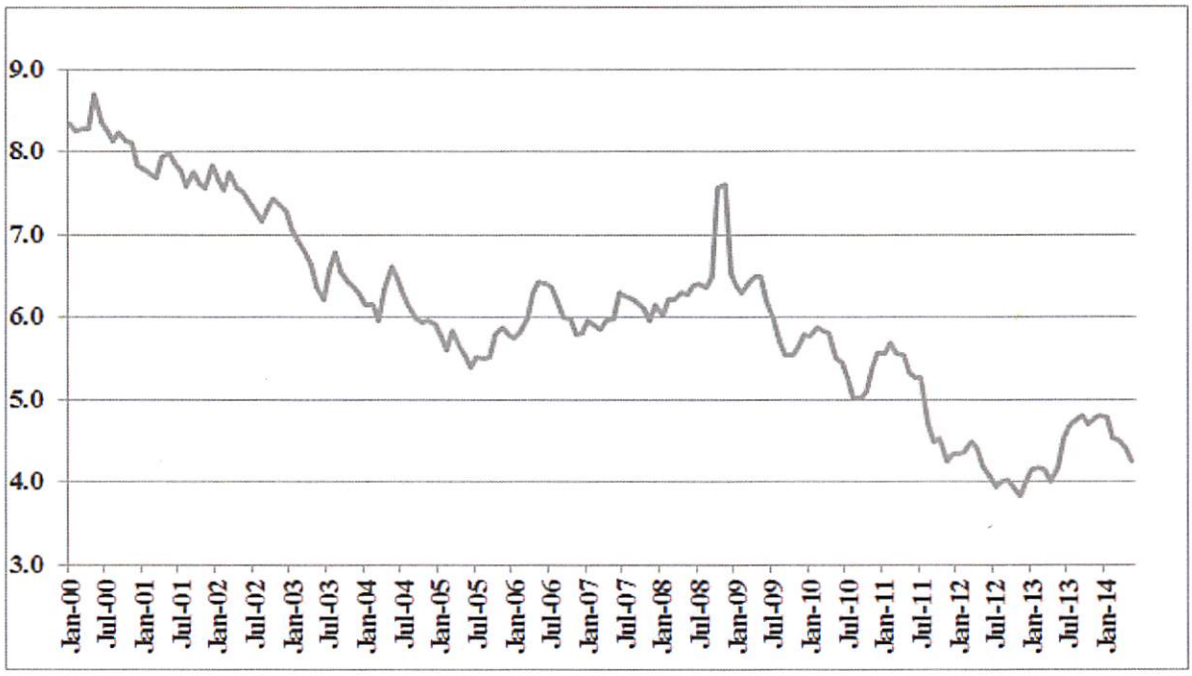


Panel B
Long-Term Moody's Baa Yields Minus Ten-Year Treasury Yields
2000-Present



Source: Federal Reserve Bank of St. Louis, FRED Database.

Exhibit JRW-3
Panel A
Long-Term, A-Rated Public Utility Yields



Panel B
Long-Term, A-Rated Public Utility Yields minus Twenty-Year Treasury Yields

Source: Mergent Bond Record

Exhibit JRW-4
Florida Public Utilities Company
Summary Financial Statistics

Panel A
Electric Proxy Group

Company	Operating Revenue ($mil)	Percent Elec Revenue	Percent Gas Revenue	Net Plant ($mil)	Market Cap ($mil)	S&P Bond Rating	Moody's Bond Rating	Pre-Tax Interest Coverage	Primary Service Area	Common Equity Ratio	Return on Equity	Market to Book Ratio
ALLETE, Inc. (NYSE-ALE)	1,051.1	90		2,905.1	2.07	A-	A3	3.6	MN, WI	53.5	8.0	1.47
Alliant Energy Corporation (NYSE-LNT)	3,370.0	81	15	8,426.2	6.29	A-	A2/A3	3.6	WS,IA,IL,MN	48.4	11.5	1.78
Ameren Corporation (NYSE-AEE)	5,957.0	81	19	16,425.0	9.35	BBB+/BBB	Baa1	3.3	IL,MO	49.2	8.3	1.44
American Electric Power Co. (NYSE-AEP)	16,179.0	86		41,530.0	24.90	BBB/BBB-	Baa1	3.7	10 States	45.8	10.5	1.52
Avista Corporation (NYSE-AVA)	1,626.6	63	33	3,227.6	1.92	A-	Baa1	3.4	WA,OR,ID	45.8	8.9	1.44
Black Hills Corporation (NYSE-BKH)	1,355.4	50	44	3,019.8	2.50	BBB	A3/Baa1	3.7	CO,SD,WY,MT	47.2	9.2	1.87
Cleco Corporation (NYSE-CNL)	1,140.2	95		3,111.1	3.06	BBB/BBB-	Baa1/Baa2	4.2	LA	54.5	10.3	1.94
CMS Energy Corporation (NYSE-CMS)	7,110.0	62	33	12,360.0	7.75	BBB+/BBB	A3/Baa1	3.1	MI	30.2	14.8	2.14
Consolidated Edison, Inc. (NYSE-ED)	12,958.0	70	15	28,148.0	15.90	A-/BBB+	A3	3.9	NY,PA	49.9	10.1	1.28
Dominion Resources, Inc. (NYSE-D)	13,227.0	56	3	33,127.0	40.18	A-	A3/Baa1	3.9	VA,NC,OH,WV	33.3	14	3.44
Duke Energy Corporation (NYSE-DUK)	25,324.0	83	2	66,355.0	49.70	BBB+	A3	3.4	NC,SC,FL,OH,KY	49.4	4.7	1.22
Edison International (NYSE-EIX)	12,875.0	100		30,741.0	17.61	BBB+	A2/A3	4.7	CA	43.3	8.4	1.76
El Paso Electric Company (NYSE-EE)	898.6	100		2,285.1	1.44	BBB+	Baa1	2.9	TX,NM	47.6	9.6	1.52
Empire District Electric Co. (NYSE-EDE)	622.9	90	9	1,787.9	1.02	A-	Baa1	3.6	KS,MO,OK,AR	50.5	9.6	1.34
Entergy Corporation (NYSE-ETR)	11,990.9	77	1	28,008.7	13.10	BBB+/BBB	Baa2/Baa3	3.5	LA,AR,MS,TX	41.5	9.8	1.31
Great Plains Energy Incorporated (NYSE-GXP)	2,489.2	100		7,859.7	3.88	BBB	Baa2	2.9	MO,KS	46.8	7.2	1.12
Hawaiian Electric Industries, Inc. (NYSE-HE)	3,238.2	92		3,908.4	2.43	BBB-	Baa2	4.3	HI	47.8	10.4	1.39
IDACORP, Inc. (NYSE-IDA)	1,274.0	100		3,692.9	2.71	A-	A3	3.5	ID	52.7	9.7	1.46
MGE Energy, Inc. (NYSE-MGEE)	633.9	65	35	1,174.3	1.28	AA-	Aa2	7.9	WI	61.2	13.0	2.01
Nextera Energy (NYSE-NEE)	15,531.0	69		53,306.0	41.29	A-/BBB+	A2/A3	3.4	FL	38.1	12.0	2.27
Northeast Utilities (NYSE-NU)	7,596.8	86	12	17,713.0	14.29	A-	A3/Baa1	4.5	CT,NH,MA	50.8	8.3	1.47
NorthWestern Corporation (NYSE-NWE)	1,211.2	73	26	2,706.6	1.97	NR	A3	2.7	SD,MT,NE	45.8	9.9	1.83
OGE Energy Corp. (NYSE-OGE)	2,526.7	93		6,762.3	7.01	BBB+	A3	4.9	OK,AR	50.1	14.3	2.31
PG&E Corporation (NYSE-PCG)	15,817.0	80	20	41,817.0	20.21	BBB/BBB-	A3/Baa1	2.5	CA	49.2	5.7	1.38
Pinnacle West Capital Corp. (NYSE-PNW)	3,454.2	100		10,810.6	6.04	BBB	A3/Baa1	4.4	AZ	53.0	9.6	1.43
PNM Resources, Inc. (NYSE-PNM)	1,399.2	100		3,962.6	2.23	BBB	Baa2	2.4	NM,TX	45.0	6.3	1.34
Portland General Electric Company (NYSE-POR)	1,830.0	100		5,009.0	2.56	A-	A3	2.5	OR	49.2	6.3	1.38
PPL Corporation (NYSE-PPL)	10,626.0	61		33,774.0	21.20	A-	Baa1/Baa2	2.7	PA,KY	36.2	8.9	1.67
SCANA Corporation (NYSE-SCG)	4,774.0	53	22	11,801.0	7.19	BBB+	Baa1/Baa2	3.3	SC,NC,GA	44.5	11.0	1.50
Southern Company (NYSE-SO)	17,834.0	94		51,573.0	38.14	A	A3/Baa1	5.3	GA,AL,FL,MS	45.2	9.9	1.92
Westar Energy, Inc. (NYSE-WR)	2,453.0	100		7,669.0	4.50	A-	A3/Baa1	3.4	KS	46.2	10.3	1.45
Xcel Energy Inc. (NYSE-XEL)	11,334.7	82	18	26,541.5	15.07	A-	A3	3.4	MN,WI,ND,SD,MI	44.3	10.3	1.55
Mean	6,865.9	82	19	17,860.6	12.1	BBB+	A3/Baa1	3.7		46.8	9.7	1.65
Median	3,412.1	85	19	9,618.4	6.6	BBB+	A3/Baa1	3.5		47.4	9.8	1.48
Chesapeake Utilities Corporation (NYSE-CPK)	489.9	18	42	643.1	0.63	NAIC - A	NR		DE,MD,FL	58.1	12.7	2.14

Data Source: *AUS Utility Reports*, June, 2014; Pre-Tax Interest Coverage and Primary Service Territory are from *Value Line Investment Survey*, 2014.

Panel B
Moul Proxy Group

Company	Operating Revenue ($mil)	Percent Elec Revenue	Percent Gas Revenue	Net Plant ($mil)	Market Cap ($mil)	S&P Bond Rating	Moody's Bond Rating	Pre-Tax Interest Coverage	Primary Service Area	Common Equity Ratio	Return on Equity	Market to Book Ratio
American Electric Power Co. (NYSE-AEP)	16,179.0	86		41,530.0	0.00	BBB/BBB-	Baa1	3.7	10 States	45.8	10.5	1.52
CenterPoint Energy (NYSE-CNP)	8,881.0	31	38	9,763.0	10.10	A-/BBB+	A3/Baa1	2.8	TX,AR,LA,MS,OK,MN	34.0	7.9	1.52
Cleco Corporation (NYSE-CNL)	1,140.2	95		3,111.1	3.06	BBB/BBB-	Baa1/Baa2	4.2	LA	54.5	10.3	1.94
Dominion Resources, Inc. (NYSE-D)	13,227.0	56	3	33,127.0	40.18	A-	A3/Baa1	3.9	VA,NC,OH,WV	33.3	14	3.44
Duke Energy Corporation (NYSE-DUK)	25,324.0	83	2	66,355.0	0.00	BBB+	A3	3.4	NC,SC,FL,OH,KY	49.4	4.7	1.22
Entergy Corporation (NYSE-ETR)	11,990.9	77	1	28,008.7	0.00	BBB+/BBB	Baa2/Baa3	3.5	ID	41.5	9.8	1.31
Nextera Energy (NYSE-NEE)	15,531.0	69		53,306.0	41.29	A-/BBB+	A2/A3	3.4	FL	38.1	12.0	2.27
OGE Energy Corp. (NYSE-OGE)	2,526.7	93		6,762.3	7.01	BBB+	A3	4.9	OK,AR	50.1	14.3	2.31
SCANA Corporation (NYSE-SCG)	4,774.0	53	22	11,801.0	7.19	BBB+	Baa1/Baa2	3.3	SC,NC,GA	44.5	11.0	1.50
Southern Company (NYSE-SO)	17,834.0	94		51,573.0	38.14	A	A3/Baa1	5.3	GA,AL,FL,MS	45.2	9.9	1.92
TECO Energy, Inc. (NYSE-TE)	2,874.3	69	14	6,233.8	3.70	BBB+/BBB	A3	2.9	ID	44.2	8.9	1.46
Mean	10,934.7	73	13	28,324.6	13.7	BBB+	A3/Baa1	3.8		43.7	10.3	1.85
Median	11,990.9	77	9	28,008.7	7.0	BBB+	A3/Baa1	3.5		44.5	10.3	1.52

Data Source: *AUS Utility Reports*, June, 2014; Pre-Tax Interest Coverage and Primary Service Territory are from *Value Line Investment Survey*, 2014.

Exhibit JRW-4
Florida Public Utilities Company
***Value Line* Risk Metrics**

Panel A
Electric Proxy Group

Company	Beta	Financial Strength	Safety	Earnings Predictability	Stock Price Stability
ALLETE, Inc. (NYSE-ALE)	0.75	A	2	80	95
Alliant Energy Corporation (NYSE-LNT)	0.75	A	2	75	100
Ameren Corporation (NYSE-AEE)	0.75	B++	2	90	100
American Electric Power Co. (NYSE-AEP)	0.65	B++	3	90	100
Avista Corporation (NYSE-AVA)	0.75	A	2	70	95
Black Hills Corporation (NYSE-BKH)	0.85	B+	3	40	85
Cleco Corporation (NYSE-CNL)	0.75	A	1	80	100
CMS Energy Corporation (NYSE-CMS)	0.75	B++	2	65	100
Consolidated Edison, Inc. (NYSE-ED)	0.60	A+	1	85	100
Dominion Resources, Inc. (NYSE-D)	0.70	B++	2	75	100
Duke Energy Corporation (NYSE-DUK)	0.60	A	2	75	100
Edison International (NYSE-EIX)	0.75	A	2	70	100
El Paso Electric Company (NYSE-EE)	0.70	B++	2	85	95
Empire District Electric Co. (NYSE-EDE)	0.65	B++	2	85	100
Entergy Corporation (NYSE-ETR)	0.70	B++	3	85	100
Great Plains Energy Incorporated (NYSE-GXP)	0.85	B+	3	65	95
Hawaiian Electric Industries, Inc. (NYSE-HE)	0.75	A	2	75	90
IDACORP, Inc. (NYSE-IDA)	0.80	B++	2	90	100
MGE Energy, Inc. (NYSE-MGEE)	0.70	A	1	95	100
Nextera Energy (NYSE-NEE)	0.70	A	2	80	100
Northeast Utilities (NYSE-NU)	0.75	B++	2	85	100
NorthWestern Corporation (NYSE-NWE)	0.70	B+	3	95	100
OGE Energy Corp. (NYSE-OGE)	0.85	A	2	100	90
PG&E Corporation (NYSE-PCG)	0.65	B+	3	80	100
Pinnacle West Capital Corp. (NYSE-PNW)	0.70	A+	1	65	100
PNM Resources, Inc. (NYSE-PNM)	0.85	B	3	20	85
Portland General Electric Company (NYSE-POR)	0.75	B++	2	65	95
PPL Corporation (NYSE-PPL)	0.65	B++	3	60	100
SCANA Corporation (NYSE-SCG)	0.70	B++	2	100	100
Southern Company (NYSE-SO)	0.60	A	2	100	100
Westar Energy, Inc. (NYSE-WR)	0.75	B++	2	80	100
Xcel Energy Inc. (NYSE-XEL)	0.65	B++	2	100	100
Mean	0.72	B++	2	78	98
Median	0.73	B++	2	80	100

Data Source: *Value Line Investment Survey*, 2014.

Chesapeake Utilities Corporation (NYSE-CPK)	0.70	B+	3	95	90

Panel B
Moul Proxy Group

Company	Beta	Financial Strength	Safety	Earnings Predictability	Stock Price Stability
American Electric Power Co. (NYSE-AEP)	0.65	B++	3	90	100
CenterPoint Energy (NYSE-CNP)	0.75	B++	2	90	95
Cleco Corporation (NYSE-CNL)	0.75	A	1	80	100
Dominion Resources, Inc. (NYSE-D)	0.70	B++	2	75	100
Duke Energy Corporation (NYSE-DUK)	0.60	A	2	75	100
Entergy Corporation (NYSE-ETR)	0.70	B++	3	85	100
Nextera Energy (NYSE-NEE)	0.70	A	2	80	100
OGE Energy Corp. (NYSE-OGE)	0.85	A	2	100	90
SCANA Corporation (NYSE-SCG)	0.70	B++	2	100	100
Southern Company (NYSE-SO)	0.60	A	2	100	100
TECO Energy, Inc. (NYSE-TE)	0.85	B++	2	70	95
Mean	0.71	B++	2	86	98
Median	0.70	B++	2	85	100

Data Source: *Value Line Investment Survey*, 2014.

Exhibit JRW-5
Florida Public Utilities Company
Capital Structure Ratios and Debt Cost Rates

Panel A -Florida Public Utilities Company's Proposed Capitalization Ratios and Debt Cost Rate

Capital Source	Capitalization Ratio	Cost Rate
Short-Term Debt	6.50%	3.70%
Long-Term Debt - Legacy	1.09%	12.74%
Long-Term Debt - Parent Company	34.21%	4.90%
Common Equity	58.21%	
Total	100.00%	

Panel B -Moul Proxy Group Average Quarterly Capitalization Ratios

Capital Source	Capitalization Ratio
Short-Term Debt	6.44%
Long-Term Debt	50.18%
Preferred Stock	0.20%
Common Equity	43.19%
Total	100.00%

Panel C -OPC's Proposed Capitalization Ratios and Cost Rates

Capital Source	Capitalization Ratio	Cost Rate
Short-Term Debt	7.78%	1.65%
Long-Term Debt - Legacy	1.30%	12.74%
Long-Term Debt - Parent Company	40.92%	4.90%
Common Equity	50.00%	
Total	100.00%	19.29%

Moul Proxy Group Capital Structures
Capital Structure Ratios With Short-Term Debt

AEP	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	3,004,000	2,396,000	2,686,000	3,468,000
Long-Term Debt	16,475,000	16,828,000	16,202,000	15,799,000
Preferred Stock	0	0	0	0
Common Equity	16,416,000	16,085,000	15,762,000	15,537,000
Total	35,895,000	35,309,000	34,650,000	34,804,000

AEP	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	8.37%	6.79%	7.75%	9.96%
Long-Term Debt	45.90%	47.66%	46.76%	45.39%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	45.73%	45.55%	45.49%	44.64%
Total	100.00%	100.00%	100.00%	100.00%

CNP	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	936,000	1,012,000	1,011,000	1,037,000
Long-Term Debt	8,056,000	7,817,000	7,758,000	7,919,000
Preferred Stock				
Common Equity	4,414,000	4,329,000	4,261,000	4,191,000
Total	13,406,000	13,158,000	13,030,000	13,147,000

CNP	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	6.98%	7.69%	7.76%	7.89%
Long-Term Debt	60.09%	59.41%	59.54%	60.23%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	32.93%	32.90%	32.70%	31.88%
Total	100.00%	100.00%	100.00%	100.00%

CNL	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	17,752	17,564	17,147	19,658
Long-Term Debt	1,296,965	1,315,500	1,290,990	1,323,765
Preferred Stock				
Common Equity	1,576,782	1,586,197	1,577,914	1,531,334
Total	2,891,499	2,919,261	2,886,051	2,874,757

CNL	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	0.61%	0.60%	0.59%	0.68%
Long-Term Debt	44.85%	45.06%	44.73%	46.05%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	54.53%	54.34%	54.67%	53.27%
Total	100.00%	100.00%	100.00%	100.00%

D	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	3,690,000	4,274,000	3,936,000	4,989,000
Long-Term Debt	20,458,000	19,330,000	18,548,000	18,043,000
Preferred Stock				
Common Equity	11,699,000	11,642,000	11,242,000	11,003,000
Total	35,847,000	35,246,000	33,726,000	34,035,000

D	9/30/11	6/30/11	3/31/11	12/31/10
Short Term Debt	10.29%	12.13%	11.67%	14.66%
Long-Term Debt	57.07%	54.84%	55.00%	53.01%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	32.64%	33.03%	33.33%	32.33%
Total	100.00%	100.00%	100.00%	100.00%

DUK	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	2,622,000	2,943,000	3,910,000	4,049,000
Long-Term Debt	39,000,000	38,152,000	37,402,000	37,359,000
Preferred Stock				
Common Equity	40,709,000	41,330,000	41,165,000	40,132,000
Total	82,331,000	82,425,000	82,477,000	81,540,000

DUK	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	3.18%	3.57%	4.74%	4.97%
Long-Term Debt	47.37%	46.29%	45.35%	45.82%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	49.45%	50.14%	49.91%	49.22%
Total	100.00%	100.00%	100.00%	100.00%

ETR	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	1,629,880	1,506,305	1,315,016	1,618,857
Long-Term Debt	12,230,249	12,171,367	12,308,306	12,128,154
Preferred Stock	94,000	94,000	94,000	94,000
Common Equity	9,948,428	9,632,466	9,408,451	9,274,517
Total	23,902,557	23,404,138	23,125,773	23,115,528

ETR	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	6.82%	6.44%	5.69%	7.00%
Long-Term Debt	51.17%	52.01%	53.22%	52.47%
Preferred Stock	0.39%	0.40%	0.41%	0.41%
Common Equity	41.62%	41.16%	40.68%	40.12%
Total	100.00%	100.00%	100.00%	100.00%

NEE	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	6,506,000	5,295,000	5,463,000	5,297,000
Long-Term Debt	23,824,000	23,969,000	23,862,000	23,514,000
Preferred Stock				
Common Equity	18,160,000	18,040,000	17,409,000	16,601,000
Total	48,490,000	47,304,000	46,734,000	45,412,000

NEE	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	13.42%	11.19%	11.69%	11.66%
Long-Term Debt	49.13%	50.67%	51.06%	51.78%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	37.45%	38.14%	37.25%	36.56%
Total	100.00%	100.00%	100.00%	100.00%

OGE	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	477,800	539,600	447,000	478,700
Long-Term Debt	2,549,400	2,300,100	2,400,000	2,400,200
Preferred Stock				
Common Equity	3,037,800	3,037,100	2,994,600	2,811,300
Total	6,065,000	5,876,800	5,841,600	5,690,200

OGE	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	7.88%	9.18%	7.65%	8.41%
Long-Term Debt	42.03%	39.14%	41.08%	42.18%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	50.09%	51.68%	51.26%	49.41%
Total	100.00%	100.00%	100.00%	100.00%

SCG	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	660,000	438,000	409,000	341,000
Long-Term Debt	5,388,000	5,395,000	5,431,000	5,432,000
Preferred Stock				
Common Equity	4,809,000	4,664,000	4,598,000	4,506,000
Total	10,857,000	10,497,000	10,438,000	10,279,000

SCG	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	6.08%	4.17%	3.92%	3.32%
Long-Term Debt	49.63%	51.40%	52.03%	52.85%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	44.29%	44.43%	44.05%	43.84%
Total	100.00%	100.00%	100.00%	100.00%

SO	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	1,366,000	1,951,000	2,057,000	3,727,000
Long-Term Debt	22,288,000	21,344,000	21,053,000	19,943,000
Preferred Stock	756,000	756,000	756,000	756,000
Common Equity	19,070,000	19,008,000	18,778,000	18,040,000
Total	43,480,000	43,059,000	42,644,000	42,466,000

SO	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	3.14%	4.53%	4.82%	8.78%
Long-Term Debt	51.26%	49.57%	49.37%	46.96%
Preferred Stock	1.74%	1.76%	1.77%	1.78%
Common Equity	43.86%	44.14%	44.03%	42.48%
Total	100.00%	100.00%	100.00%	100.00%

TE	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	167,400	88,500	90,100	900
Long-Term Debt	2,837,800	2,837,800	2,889,400	2,972,700
Preferred Stock				
Common Equity	2,333,700	2,323,900	2,300,500	2,293,500
Total	5,338,900	5,250,200	5,280,000	5,267,100

TE	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	3.14%	1.69%	1.71%	0.02%
Long-Term Debt	53.15%	54.05%	54.72%	56.44%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Common Equity	43.71%	44.26%	43.57%	43.54%
Total	100.00%	100.00%	100.00%	100.00%

Summary

	3/31/14	12/31/13	9/30/13	6/30/13
Short Term Debt	6.36%	6.18%	6.18%	7.03%
Long-Term Debt	50.15%	50.01%	50.26%	50.29%
Preferred Stock	0.19%	0.20%	0.20%	0.20%
Common Equity	43.30%	43.62%	43.36%	42.48%
Total	100.00%	100.00%	100.00%	100.00%

Exhibit JRW-5
Florida Public Utilities Company
Short-Term Debt Cost Rate

Panel A -Current LIBOR Rates

LIBOR, other interest rate indexes Updated 7/9/201

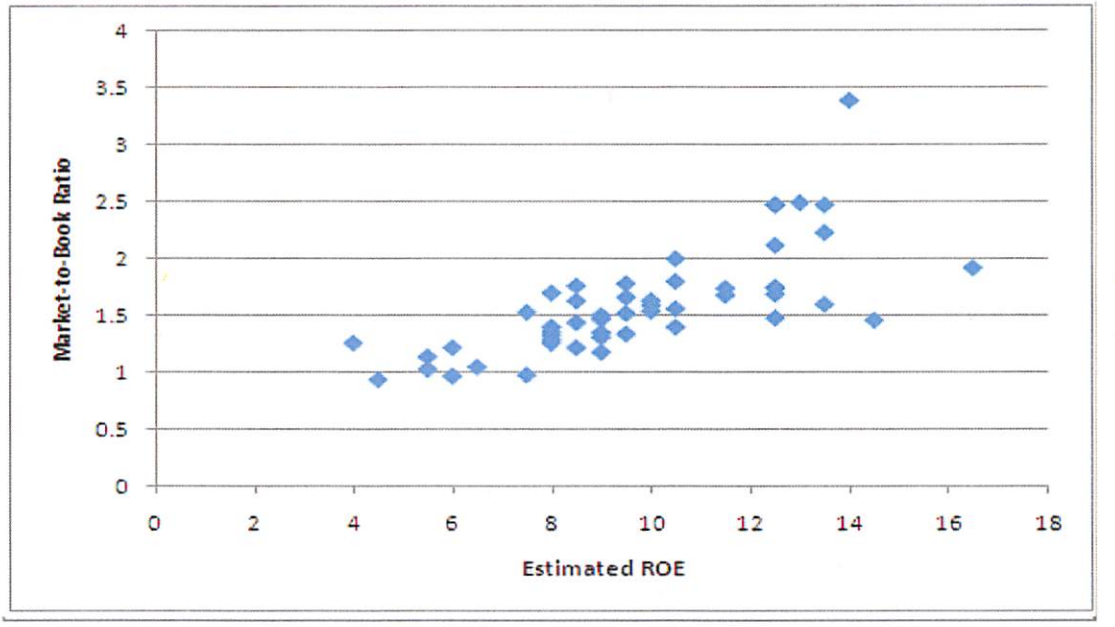
	This week	Month ago	Year ago
Bond Buyer's 20 bond index	4.31	4.37	4.39
FNMA 30 yr Mtg Com del 60 days	3.85	3.85	4.19
1 Month LIBOR Rate	0.15	0.15	0.19
3 Month LIBOR Rate	0.23	0.23	0.27
6 Month LIBOR Rate	0.33	0.32	0.41
Call Money	2.00	2.00	2.00
1 Year LIBOR Rate	0.55	0.53	0.69

Source: www.bankrate.com

Panel B -Short-Term Debt Cost Rate

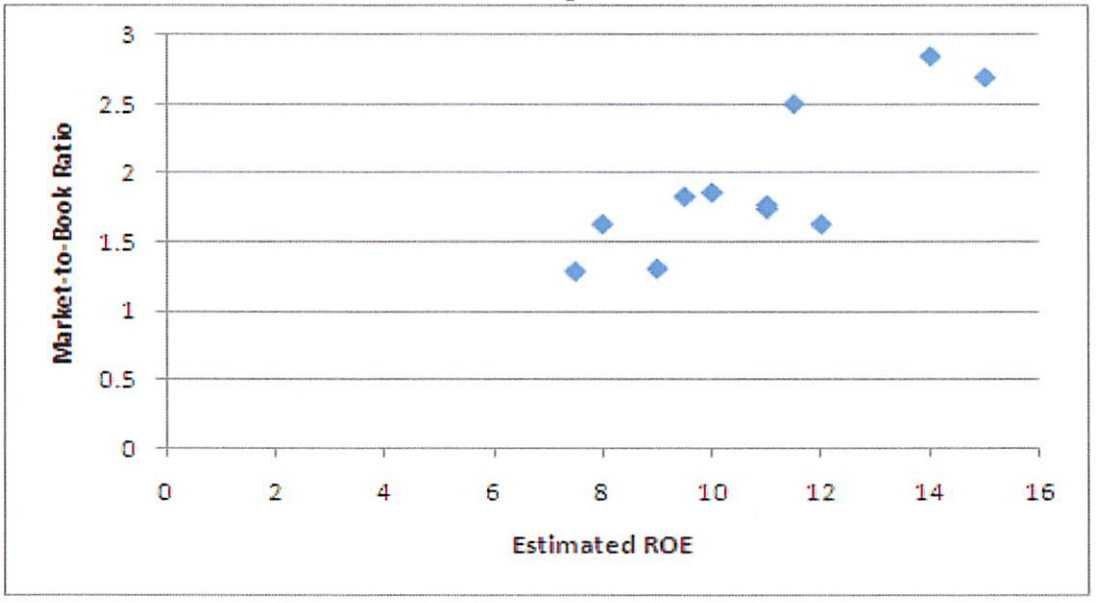
Current LIBOR Rate (average of 1-Month and 3-Month)	**0.19%**
Projected 2015 LIBOR Rate	**0.90%**
Average	**0.55%**
LIBOR Margin Under Credit Facility	**1.10%**
Short-Term Debt Cost Rate	**1.65%**

Exhibit JRW-6
Electric Utilities
Panel A



R-Square = .52, N=51.

Panel B
Gas Companies



R-Square = .71, N=11.

Exhibit JRW-6
Water Companies
Panel C

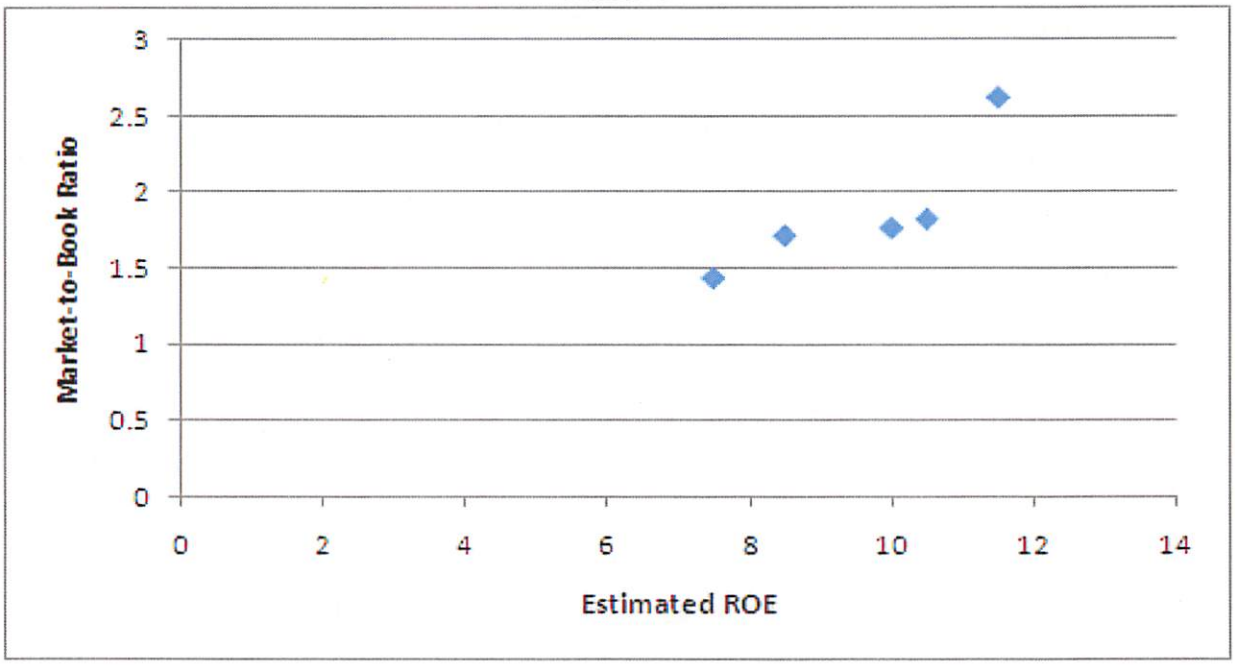


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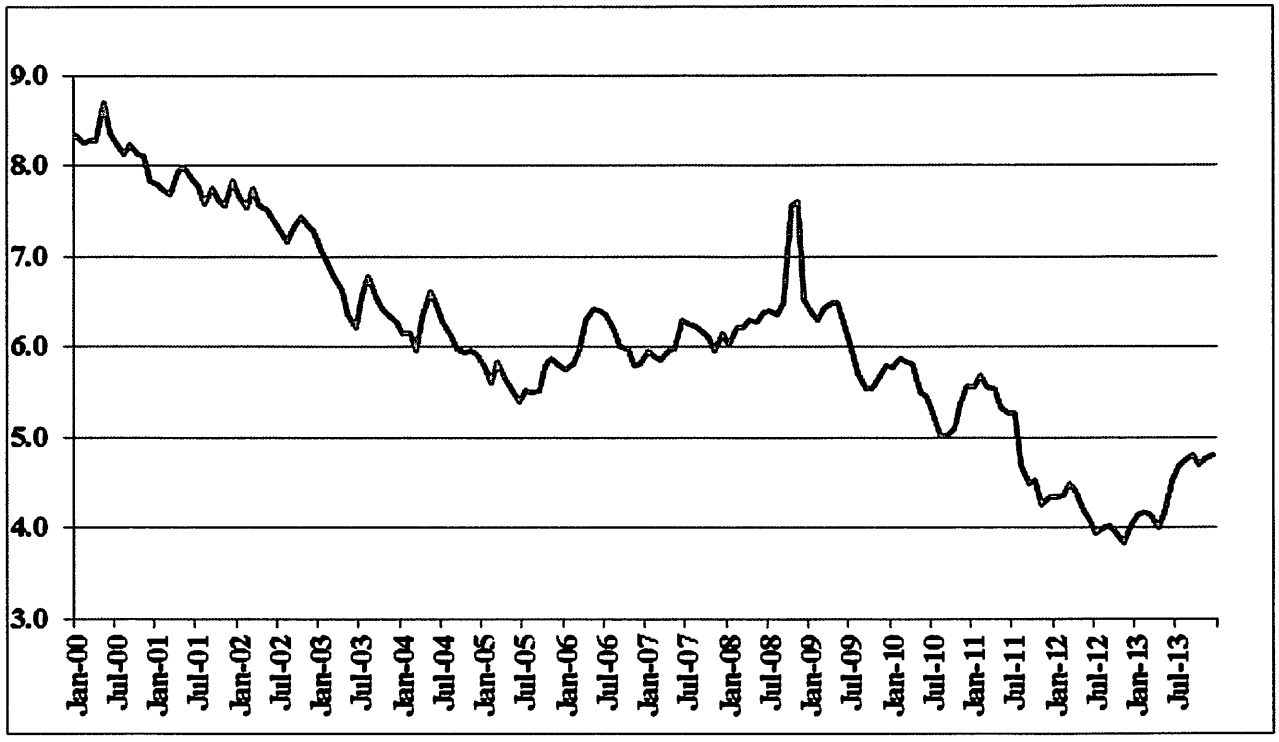
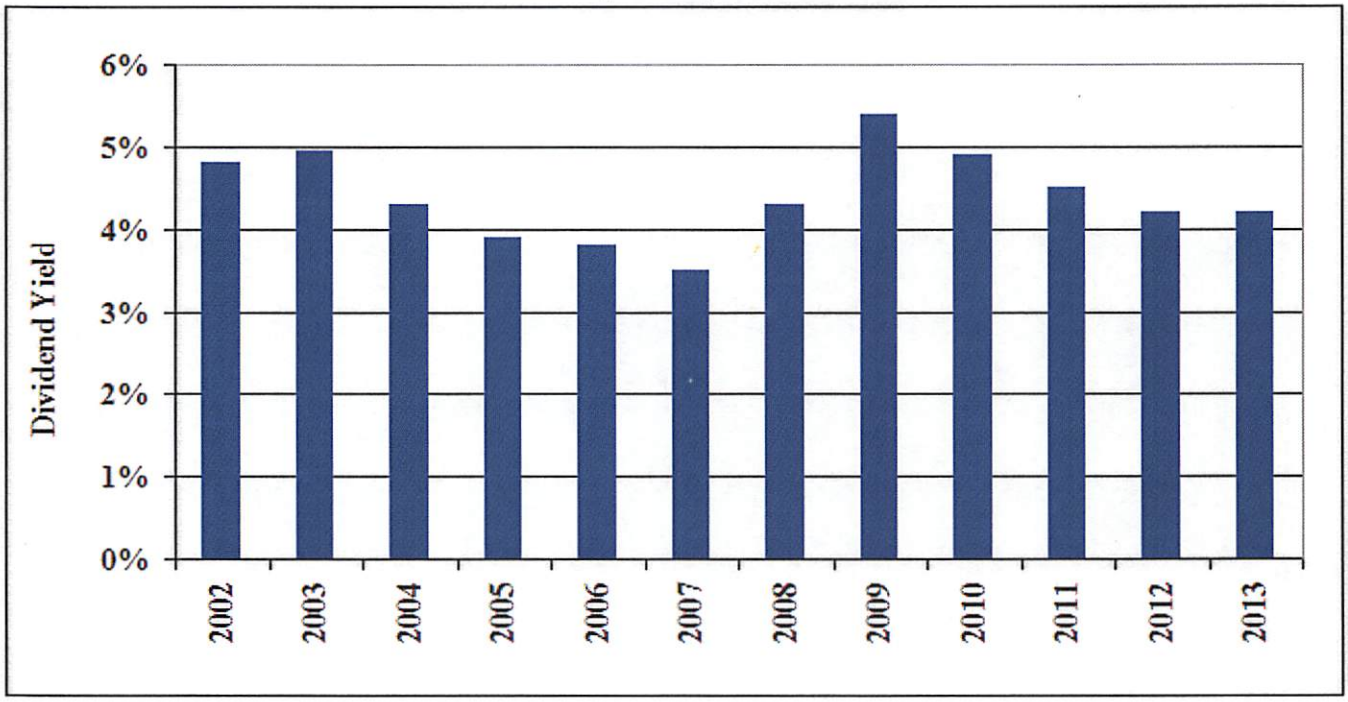
Exhibit JRW-7
Long-Term 'A' Rated Public Utility Bonds



Data Source: Mergent Bond Record

Exhibit JRW-7

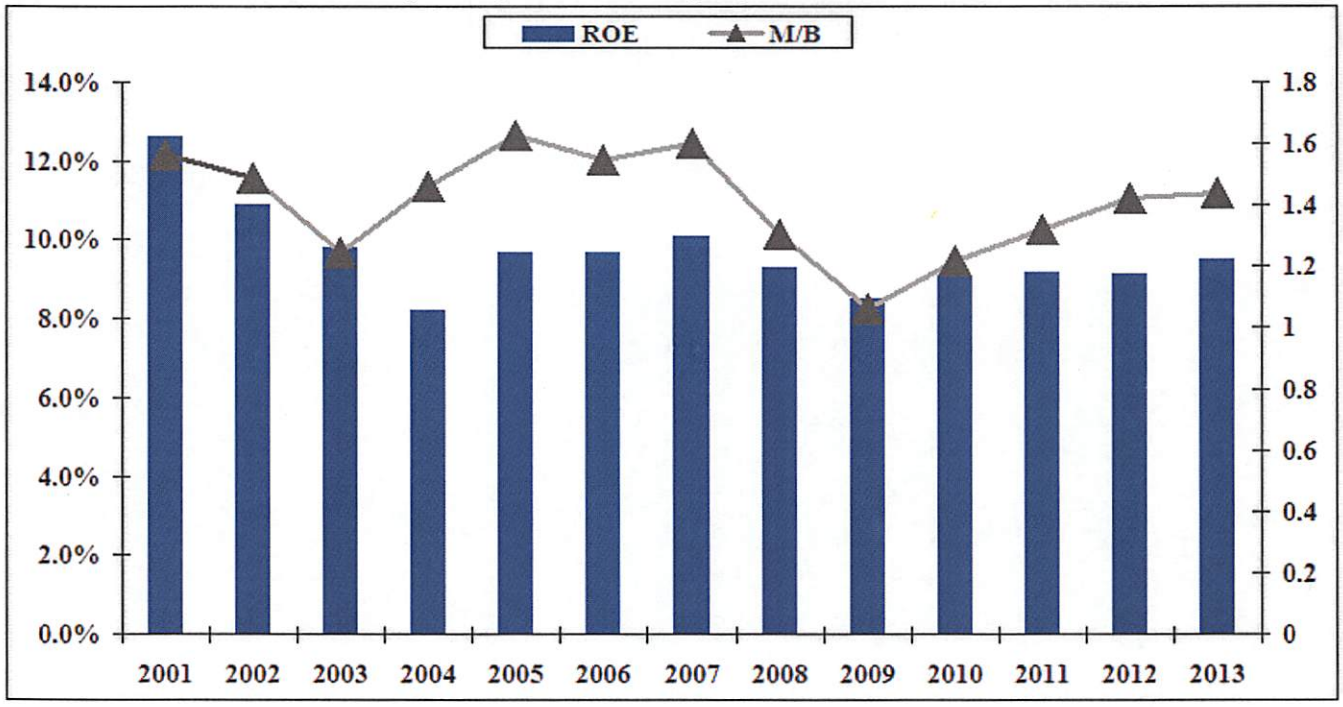
Electric Utility Average Dividend Yield



Data Source: *Value Line Investment Survey.*

Exhibit JRW-7

Electric Proxy Utility Return on Equity and Market-to-Book Ratios



Data Source: *Value Line Investment Survey.*

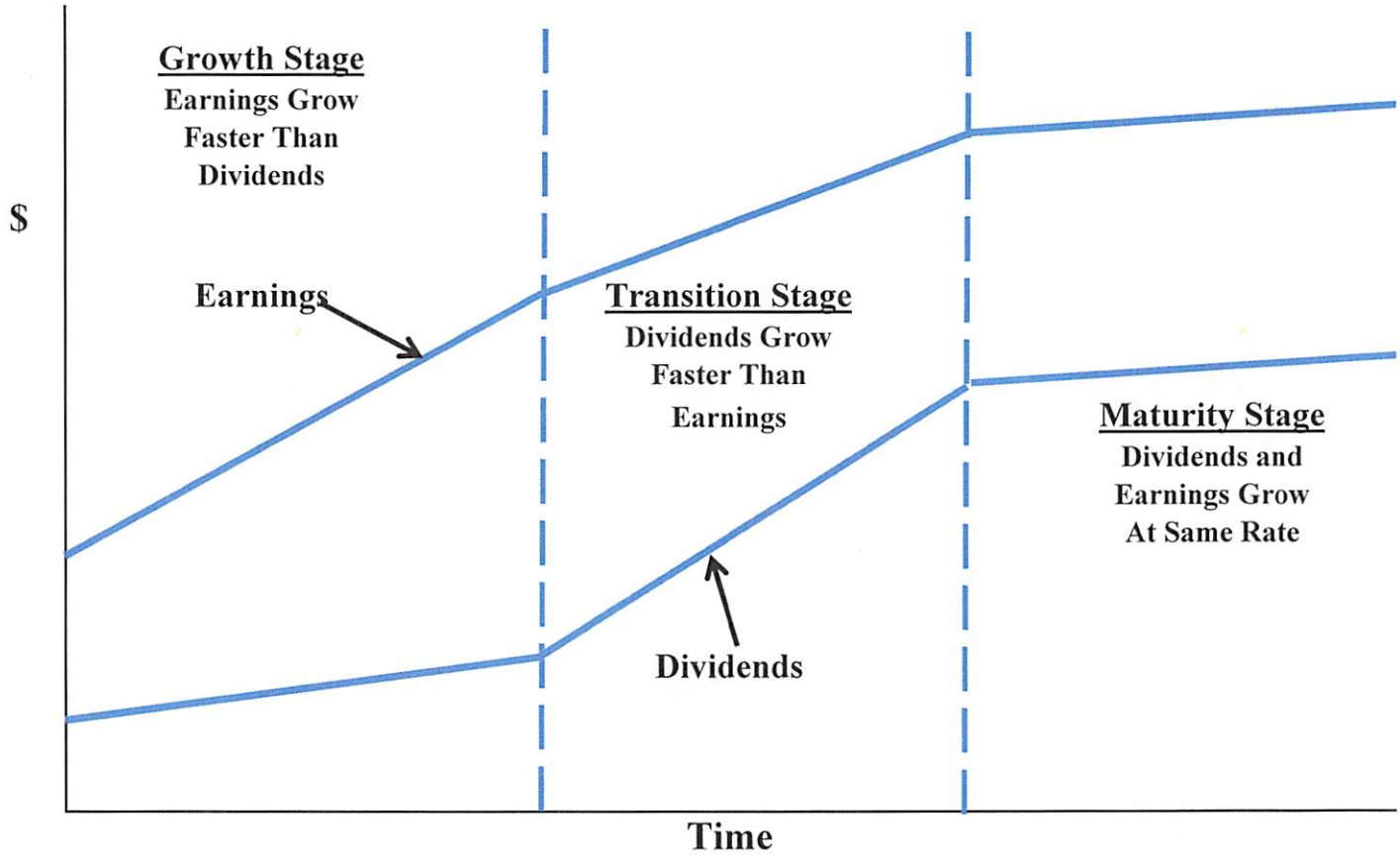
Exhibit JRW-8

Industry Average Betas

Industry Name	Beta	Industry Name	Beta	Industry Name	Beta
COAL	1.36	HOTELGAM	1.01	SOFTWARE	0.89
MINING	1.34	WIRELESS	1.01	FUNL SVC	0.89
HEAVYTRK	1.31	METALFAB	1.01	ELECTRNX	0.88
SEMI-EQP	1.30	ENTRTAIN	1.00	RESTRNT	0.88
HOMEBILD	1.30	RETAILHL	1.00	OILGAS	0.88
GASDIVRS	1.27	RECREATE	0.99	MEDICNON	0.88
STEEL	1.25	INSTRMNT	0.99	ITSERV	0.87
NWSPAPER	1.25	BIOTECH	0.99	CABLETV	0.87
OILFIELD	1.25	B2B	0.99	SHOE	0.86
OILINTEG	1.24	REIT	0.99	HOUSEPRD	0.85
MARITIME	1.22	MACHINE	0.98	MEDICINV	0.85
AUTOPRTS	1.20	PACKAGE	0.98	MEDSERV	0.84
OILPROD	1.16	CHEMSPEC	0.98	INTERNET	0.84
ENGCON	1.16	INFOSER	0.97	REINSUR	0.84
CHEMDIV	1.15	EDUC	0.97	TELESERV	0.83
CHEMICAL	1.15	PUBLISH	0.97	PIPEMLP	0.82
BUILDING	1.15	TELUTIL	0.96	ENVIRONM	0.82
PPEQ	1.15	ELECFGN	0.96	DRUGSTOR	0.82
SEMICOND	1.14	AIRTRANS	0.95	GROCERY	0.82
RAILROAD	1.14	RETAUTO	0.95	FOODPROC	0.81
TRUCKING	1.12	TELEQUIP	0.95	INSPRPTY	0.80
POWER	1.11	FINSERV	0.95	TOBACCO	0.76
PAPER	1.10	INDUSRV	0.94	BANKMID	0.75
HUMAN	1.08	APPAREL	0.94	UTILWEST	0.74
GOLDSILV	1.08	DIVERSIF	0.94	UTILCENT	0.74
BROKERS	1.06	ADVERT	0.94	BEVERAGE	0.73
INSLIFE	1.06	COMPUTER	0.94	GASDISTR	0.73
AUTO	1.06	ENTTECH	0.93	WATER	0.71
RETAILSL	1.04	RETAIL	0.92	UTILEAST	0.69
OFFICE	1.04	COSMETIC	0.91	BANK	0.68
ELECEQ	1.03	HLTHSYS	0.90	THRIFT	0.60
BUILDSUP	1.02	DEFENSE	0.90		
FURNITUR	1.02	DRUG	0.89		

Source: ValueLine Investment Survey, July, 2014.

Exhibit JRW-9
DCF Model



Source: William F. Sharpe, Gordon J. Alexander, and Jeffrey V. Bailey, Investments (Prentice-Hall, 1995), pp. 590-91.

Exhibit JRW-9
DCF Model
Consensus Earnings Estimates
Alliant Energy Corp ("LNT")
www.reuters.com
7/7/2014

	# of Estimates	Mean	High	Low
Earnings (per share)				
Quarter Ending Sep-14	4	1.56	1.75	1.46
Quarter Ending Dec-14	4	0.42	0.53	0.18
Year Ending Dec-14	10	3.51	3.55	3.47
Year Ending Dec-15	10	3.66	3.94	3.57
LT Growth Rate (%)	3	5.27	6.00	4.80

Data Source: www.reuters.com

Exhibit JRW-10

Florida Public Utilities Company
Discounted Cash Flow Analysis

Panel A
Electric Proxy Group

Dividend Yield*	3.80%
Adjustment Factor	1.02438
Adjusted Dividend Yield	3.9%
Growth Rate**	4.88%
Equity Cost Rate	8.75%

* Page 2 of Exhibit JRW-10

** Based on data provided on pages 3, 4, 5, and 6 of Exhibit JRW-10

Panel B
Moul Proxy Group

Dividend Yield*	4.10%
Adjustment Factor	1.02375
Adjusted Dividend Yield	4.2%
Growth Rate**	4.75%
Equity Cost Rate	9.00%

* Page 2 of Exhibit JRW-10

** Based on data provided on pages 3, 4, 5, and 6 of Exhibit JRW-10

Exhibit JRW-10
Florida Public Utilities Company
Monthly Dividend Yields

Panel A
Electric Proxy Group

Company	SMBL	Annual Dividend	Dividend Yield 30 Day	Dividend Yield 90 Day	Dividend Yield 180 Day
ALLETE, Inc. (NYSE-ALE)	ALE	1.96	4.0%	3.9%	4.0%
Alliant Energy Corporation (NYSE-LNT)	LNT	2.04	3.5%	3.6%	3.8%
Ameren Corporation (NYSE-AEE)	AEE	1.60	4.1%	4.0%	4.2%
American Electric Power Co. (NYSE-AEP)	AEP	2.00	3.7%	3.9%	4.1%
Avista Corporation (NYSE-AVA)	AVA	1.27	4.0%	4.1%	4.4%
Black Hills Corporation (NYSE-BKH)	BKH	1.56	2.6%	2.7%	2.9%
Cleco Corporation (NYSE-CNL)	CNL	1.60	3.0%	3.1%	3.3%
CMS Energy Corporation (NYSE-CMS)	CMS	1.08	3.6%	3.7%	3.9%
Consolidated Edison, Inc. (NYSE-ED)	ED	2.52	4.5%	4.5%	4.6%
Dominion Resources, Inc. (NYSE-D)	D	2.40	3.5%	3.4%	3.6%
Duke Energy Corporation (NYSE-DUK)	DUK	3.12	4.4%	4.4%	4.5%
Edison International (NYSE-EIX)	EIX	1.42	2.5%	2.6%	2.8%
El Paso Electric Company (NYSE-EE)	EE	1.06	2.8%	2.9%	3.0%
Empire District Electric Co. (NYSE-EDE)	EDE	1.02	4.2%	4.3%	4.4%
Entergy Corporation (NYSE-ETR)	ETR	3.32	4.2%	4.6%	5.0%
Great Plains Energy Incorporated (NYSE-GXP)	GXP	0.92	3.6%	3.5%	3.7%
Hawaiian Electric Industries, Inc. (NYSE-HE)	HE	1.24	5.0%	5.1%	5.0%
IDACORP, Inc. (NYSE-IDA)	IDA	1.72	3.1%	3.1%	3.2%
MGE Energy, Inc. (NYSE-MGEE)	MGEE	1.09	2.9%	2.9%	2.9%
Nextera Energy (NYSE-NEE)	NEE	2.90	3.0%	3.0%	3.2%
Northeast Utilities (NYSE-NU)	NU	1.57	3.4%	3.5%	3.6%
NorthWestern Corporation (NYSE-NWE)	NEW	1.60	3.3%	3.4%	3.5%
OGE Energy Corp. (NYSE-OGE)	OGE	0.90	2.4%	2.5%	2.5%
PG&E Corporation (NYSE-PCG)	PCG	1.82	3.9%	4.1%	4.3%
Pinnacle West Capital Corp. (NYSE-PNW)	PNW	2.27	4.1%	4.1%	4.2%
PNM Resources, Inc. (NYSE-PNM)	PNM	0.74	2.6%	2.7%	2.9%
Portland General Electric Company (NYSE-POR)	POR	1.12	3.4%	3.5%	3.6%
PPL Corporation (NYSE-PPL)	PPL	1.49	4.3%	4.5%	4.8%
SCANA Corporation (NYSE-SCG)	SCG	2.10	4.1%	4.1%	4.3%
Southern Company (NYSE-SO)	SO	2.10	4.8%	4.8%	5.0%
Westar Energy, Inc. (NYSE-WR)	WR	1.40	3.8%	4.0%	4.2%
Xcel Energy Inc. (NYSE-XEL)	XEL	1.20	3.9%	3.9%	4.1%
Mean			3.6%	3.7%	3.9%
Median			3.7%	3.8%	3.9%

Data Source: www.yahoo.com

Panel B
Moul Proxy Group

Company		Annual Dividend	Dividend Yield 30 Day	Dividend Yield 90 Day	Dividend Yield 180 Day
American Electric Power Co. (NYSE-AEP)	AEP	2.00	3.7%	3.9%	4.1%
CenterPoint Energy (NYSE-CNP)	CNP	0.95	3.9%	4.0%	4.0%
Cleco Corporation (NYSE-CNL)	CNL	1.60	3.0%	3.1%	3.3%
Dominion Resources, Inc. (NYSE-D)	D	2.40	3.5%	3.4%	3.6%
Duke Energy Corporation (NYSE-DUK)	DUK	3.12	4.4%	4.4%	4.5%
Entergy Corporation (NYSE-ETR)	ETR	3.32	4.2%	4.6%	5.0%
Nextera Energy (NYSE-NEE)	NEE	2.90	3.0%	3.0%	3.2%
OGE Energy Corp. (NYSE-OGE)	OGE	0.90	2.4%	2.5%	2.5%
SCANA Corporation (NYSE-SCG)	SCG	2.10	4.1%	4.1%	4.3%
Southern Company (NYSE-SO)	SO	2.10	4.8%	4.8%	5.0%
TECO Energy, Inc. (NYSE-TE)	TE	0.88	5.0%	5.1%	5.2%
Mean			3.8%	3.9%	4.1%
Median			3.9%	4.0%	4.1%

Exhibit JRW-10

Florida Public Utilities Company
DCF Equity Cost Growth Rate Measures
***Value Line* Historic Growth Rates**
Panel A
Electric Proxy Group

Company		*Value Line* Historic Growth					
		Past 10 Years			Past 5 Years		
		Earnings	Dividends	Book Value	Earnings	Dividends	Book Value
ALLETE, Inc. (NYSE-ALE)	ALE				-2.0	3.0	5.0
Alliant Energy Corporation (NYSE-LNT)	LNT	3.5	-1.5	2.0	4.0	8.0	3.5
Ameren Corporation (NYSE-AEE)	AEP	-2.5	-4.5	1.5	-4.0	-9.0	-2.0
American Electric Power Co. (NYSE-AEP)	AEE	0.5	-1.5	3.5	1.5	4.0	4.5
Avista Corporation (NYSE-AVA)	AVA	5.5	9.0	3.5	6.5	13.5	3.5
Black Hills Corporation (NYSE-BKH)	BKH	-3.0	2.5	3.5	2.0	1.5	2.0
Cleco Corporation (NYSE-CNL)	CNL	6.5	3.5	8.5	12.5	7.5	8.5
CMS Energy Corporation (NYSE-CMS)	CMS		1.0	1.5	13.0	nmf	4.0
Consolidated Edison, Inc. (NYSE-ED)	ED	2.0	1.0	4.0	3.0	1.0	4.0
Dominion Resources, Inc. (NYSE-D)	D	4.0	5.0	2.0	2.5	7.5	2.5
Duke Energy Corporation (NYSE-DUK)	DUK				4.5	11.5	0.5
Edison International (NYSE-EIX)	EIX	7.5		8.5	2.5	2.5	3.0
El Paso Electric Company (NYSE-EE)	EE	11.0		8.0	8.5		8.0
Empire District Electric Co. (NYSE-EDE)	EDE	3.0	-3.5	1.5	2.5	-7.0	1.5
Entergy Corporation (NYSE-ETR)	ETR	6.0	9.0	4.0	1.5	5.0	5.0
Great Plains Energy Incorporated (NYSE-GXP)	GXP	-3.5	-6.5	5.0	-2.0	-12.5	3.5
Hawaiian Electric Industries, Inc. (NYSE-HE)	HE			1.5	6.0		2.5
IDACORP, Inc. (NYSE-IDA)	IDA	5.5	-2.5	4.5	10.0	3.0	5.5
MGE Energy, Inc. (NYSE-MGEE)	MGEE	5.5	1.5	6.5	5.5	2.0	5.5
Nextera Energy (NYSE-NEE)	NEE	7.5	7.5	8.0	6.0	8.0	7.5
Northeast Utilities (NYSE-NU)	NU	6.0	9.5	5.0	9.0	11.0	8.0
NorthWestern Corporation (NYSE-NWE)	NWE				10.0	3.0	3.5
OGE Energy Corp. (NYSE-OGE)	OGE	9.5	2.0	8.0	7.5	3.0	8.5
PG&E Corporation (NYSE-PCG)	PCG	9.5		11.0	-5.5	5.0	4.5
Pinnacle West Capital Corp. (NYSE-PNW)	PNW	1.5	3.5	2.0	4.0	2.5	1.0
PNM Resources, Inc. (NYSE-PNM)	PNM	-2.5	0.5	1.5	8.0	-6.0	-1.0
Portland General Electric Company (NYSE-POR)	POR				3.0	4.5	2.0
PPL Corporation (NYSE-PPL)	PPL	4.0	8.0	10.0	0.5	3.5	6.0
SCANA Corporation (NYSE-SCG)	SCG	3.0	4.5	4.5	3.0	2.5	4.5
Southern Company (NYSE-SO)	SO	4.0	3.5	5.5	3.5	4.0	5.5
Westar Energy, Inc. (NYSE-WR)	WR	16.0			1.5	5.0	4.5
Xcel Energy Inc. (NYSE-XEL)	XEL	3.5	-0.5	2.5	5.5	3.5	4.5
Mean		4.4	2.2	4.7	4.2	3.1	4.0
Median		4.0	2.0	4.0	3.8	3.5	4.3
		Average of Median Figures =			3.6		

Data Source: *Value Line Investment Survey.*

Panel B
Moul Proxy Group

Company		*Value Line* Historic Growth					
		Past 10 Years			Past 5 Years		
		Earnings	Dividends	Book Value	Earnings	Dividends	Book Value
American Electric Power Co. (NYSE-AEP)	AEP	0.5	-1.5	3.5	1.5	4.0	4.5
CenterPoint Energy (NYSE-CNP)	CNP	-1.0	-2.0	-1.0	0.5	4.0	13.0
Cleco Corporation (NYSE-CNL)	CNL	6.5	3.5	8.5	12.5	7.5	8.5
Dominion Resources, Inc. (NYSE-D)	D	4.0	5.0	2.0	2.5	7.5	2.5
Duke Energy Corporation (NYSE-DUK)	DUK				4.5	11.5	0.5
Entergy Corporation (NYSE-ETR)	ETR	6.0	9.0	4.0	1.5	5.0	5.0
Nextera Energy (NYSE-NEE)	NEE	7.5	7.5	8.0	6.0	8.0	7.5
OGE Energy Corp. (NYSE-OGE)	OGE	9.5	2.0	8.0	7.5	3.0	8.5
SCANA Corporation (NYSE-SCG)	SCG	3.0	4.5	4.5	3.0	2.5	4.5
Southern Company (NYSE-SO)	SO	4.0	3.5	5.5	3.5	4.0	5.5
TECO Energy, Inc. (NYSE-TE)	TE	-2.0	-3.5	-1.5	0.5	2.5	3.0
Mean		3.8	2.8	4.2	4.0	5.4	5.7
Median		4.0	3.5	4.3	3.0	4.0	5.0
		Average of Median Figures =			4.0		

Data Source: *Value Line Investment Survey.*

Exhibit JRW-10

Florida Public Utilities Company
DCF Equity Cost Growth Rate Measures
***Value Line* Projected Growth Rates**

Panel A
Electric Proxy Group

Company		*Value Line* Projected Growth Est'd. '11-'13 to '17-'19			*Value Line* Sustainable Growth		
		Earnings	Dividends	Book Value	Return on Equity	Retention Rate	Internal Growth
ALLETE, Inc. (NYSE-ALE)	ALE	6.0	4.0	4.5	9.0%	36.0%	3.2%
Alliant Energy Corporation (NYSE-LNT)	LNT	6.0	4.5	4.0	11.5%	42.0%	4.8%
Ameren Corporation (NYSE-AEE)	AEE	4.5	2.0	2.0	9.5%	42.0%	4.0%
American Electric Power Co. (NYSE-AEP)	AEP	4.5	4.5	4.0	10.0%	36.0%	3.6%
Avista Corporation (NYSE-AVA)	AVA	5.5	4.5	3.0	9.0%	33.0%	3.0%
Black Hills Corporation (NYSE-BKH)	BKH	9.5	4.0	3.5	9.5%	43.0%	4.1%
Cleco Corporation (NYSE-CNL)	CNL	5.0	7.5	4.5	10.5%	43.0%	4.5%
CMS Energy Corporation (NYSE-CMS)	CMS	6.5	6.0	5.5	13.5%	41.0%	5.5%
Consolidated Edison, Inc. (NYSE-ED)	ED	1.0	2.0	3.0	8.5%	33.0%	2.8%
Dominion Resources, Inc. (NYSE-D)	D	5.5	5.0	5.5	15.0%	30.0%	4.5%
Duke Energy Corporation (NYSE-DUK)	DUK	5.0	2.0	2.5	8.0%	36.0%	2.9%
Edison International (NYSE-EIX)	EIX	2.5	7.5	5.5	11.0%	51.0%	5.6%
El Paso Electric Company (NYSE-EE)	EE	3.0	7.0	5.5	10.0%	52.0%	5.2%
Empire District Electric Co. (NYSE-EDE)	EDE	4.0	4.5	3.0	8.5%	35.0%	3.0%
Entergy Corporation (NYSE-ETR)	ETR	1.0	2.5	4.0	10.0%	41.0%	4.1%
Great Plains Energy Incorporated (NYSE-GXP)	GXP	6.0	7.0	3.0	8.0%	36.0%	2.9%
Hawaiian Electric Industries, Inc. (NYSE-HE)	HE	4.0	1.0	3.5	9.5%	33.0%	3.1%
IDACORP, Inc. (NYSE-IDA)	IDA	2.0	7.0	4.5	8.0%	45.0%	3.6%
MGE Energy, Inc. (NYSE-MGEE)	MGEE	9.0	4.0	6.0	13.0%	57.0%	7.4%
Nextera Energy (NYSE-NEE)	NEE	6.0	8.5	7.0	12.0%	43.0%	5.2%
Northeast Utilities (NYSE-NU)	NU	8.0	7.5	5.0	9.5%	42.0%	4.0%
NorthWestern Corporation (NYSE-NWE)	NWE	3.5	4.5	4.0	9.5%	38.0%	3.6%
OGE Energy Corp. (NYSE-OGE)	OGE	5.5	9.0	7.0	12.0%	47.0%	5.6%
PG&E Corporation (NYSE-PCG)	PCG	5.0	2.5	3.0	8.5%	31.0%	2.6%
Pinnacle West Capital Corp. (NYSE-PNW)	PNW	4.0	3.0	3.5	9.5%	36.0%	3.4%
PNM Resources, Inc. (NYSE-PNM)	PNM	12.0	12.5	4.0	9.5%	51.0%	4.8%
Portland General Electric Company (NYSE-POR)	POR	5.0	3.0	4.0	9.0%	50.0%	4.5%
PPL Corporation (NYSE-PPL)	PPL	0.0	2.0	4.0	10.5%	37.0%	3.9%
SCANA Corporation (NYSE-SCG)	SCG	5.0	3.0	5.5	10.0%	45.0%	4.5%
Southern Company (NYSE-SO)	SO	3.5	3.5	4.0	12.5%	28.0%	3.5%
Westar Energy, Inc. (NYSE-WR)	WR	6.0	3.0	5.0	9.5%	40.0%	3.8%
Xcel Energy Inc. (NYSE-XEL)	XEL	5.5	5.0	5.0	10.0%	41.0%	4.1%
Mean		5.0	4.8	4.3	10.1%	40.4%	4.1%
Median		5.0	4.5	4.0	9.5%	41.0%	4.0%
Average of Median Figures =			4.5				4.0%

Data Source: *Value Line Investment Survey.*

Panel B
Moul Proxy Group

Company		*Value Line* Projected Growth Est'd. '11-'13 to '17-'19			*Value Line* Sustainable Growth		
		Earnings	Dividends	Book Value	Return on Equity	Retention Rate	Internal Growth
American Electric Power Co. (NYSE-AEP)	AEP	4.5	4.5	4.0	10.0%	36.0%	3.6%
CenterPoint Energy (NYSE-CNP)	CNP	2.0	6.0	2.0	13.0%	21.0%	2.7%
Cleco Corporation (NYSE-CNL)	CNL	5.0	7.5	4.5	10.5%	43.0%	4.5%
Dominion Resources, Inc. (NYSE-D)	D	5.5	5.0	5.5	15.0%	30.0%	4.5%
Duke Energy Corporation (NYSE-DUK)	DUK	5.0	2.0	2.5	8.0%	36.0%	2.9%
Entergy Corporation (NYSE-ETR)	ETR	1.0	2.5	4.0	10.0%	41.0%	4.1%
Nextera Energy (NYSE-NEE)	NEE	6.0	8.5	7.0	12.0%	43.0%	5.2%
OGE Energy Corp. (NYSE-OGE)	OGE	5.5	9.0	7.0	12.0%	47.0%	5.6400%
SCANA Corporation (NYSE-SCG)	SCG	5.0	3.0	5.5	10.0%	45.0%	4.5%
Southern Company (NYSE-SO)	SO	3.5	3.5	4.0	12.5%	28.0%	3.5%
TECO Energy, Inc. (NYSE-TE)	TE	4.5	1.5	2.0	12.0%	35.0%	4.2%
Mean		4.3	4.8	4.4	11.4%	36.8%	4.1%
Median		5.0	4.5	4.0	12.0%	36.0%	4.2%
Average of Median Figures =			4.5				4.2%

Data Source: *Value Line Investment Survey.*

Florida Public Utilities Company
DCF Equity Cost Growth Rate Measures
Analysts Projected EPS Growth Rate Estimates

Panel A
Electric Proxy Group

Company	Yahoo	Zacks	Reuters	Mean
ALLETE, Inc. (NYSE-ALE)	6.0%	6.0%	na	6.0%
Alliant Energy Corporation (NYSE-LNT)	4.9%	5.5%	5.3%	5.2%
Ameren Corporation (NYSE-AEE)	2.0%	7.5%	na	4.8%
American Electric Power Co. (NYSE-AEP)	4.8%	4.8%	4.8%	4.8%
Avista Corporation (NYSE-AVA)	5.0%	na	na	5.0%
Black Hills Corporation (NYSE-BKH)	7.0%	na	na	7.0%
Cleco Corporation (NYSE-CNL)	7.0%	8.0%	7.0%	7.3%
CMS Energy Corporation (NYSE-CMS)	6.6%	6.1%	6.6%	6.4%
Consolidated Edison, Inc. (NYSE-ED)	2.5%	2.8%	2.5%	2.6%
Dominion Resources, Inc. (NYSE-D)	6.0%	5.6%	6.0%	5.9%
Duke Energy Corporation (NYSE-DUK)	4.2%	4.2%	4.4%	4.3%
Edison International (NYSE-EIX)	3.8%	2.6%	4.0%	3.5%
El Paso Electric Company (NYSE-EE)	7.0%	3.5%	na	5.3%
Empire District Electric Co. (NYSE-EDE)	3.0%	3.0%	3.0%	3.0%
Entergy Corporation (NYSE-ETR)	-0.7%	na	0.9%	0.1%
Great Plains Energy Incorporated (NYSE-GXP)	5.3%	5.1%	5.3%	5.2%
Hawaiian Electric Industries, Inc. (NYSE-HE)	3.2%	6.0%	3.8%	4.3%
IDACORP, Inc. (NYSE-IDA)	4.0%	4.0%	4.0%	4.0%
MGE Energy (NDQ-MGEE)	4.0%	na	na	4.0%
Nextera Energy (NYSE-NEE)	6.2%	6.4%	6.0%	6.2%
Northeast Utilities (NYSE-NU)	6.2%	6.9%	6.0%	6.4%
NorthWestern Corporation (NYSE-NWE)	7.0%	7.0%	7.0%	7.0%
OGE Energy Corp. (NYSE-OGE)	6.6%	5.9%	6.6%	6.4%
PG&E Corporation (NYSE-PCG)	6.4%	5.0%	6.4%	5.9%
Pinnacle West Capital Corp. (NYSE-PNW)	4.3%	4.1%	4.3%	4.2%
PNM Resources, Inc. (NYSE-PNM)	8.4%	8.5%	8.4%	8.4%
Portland General Electric Company (NYSE-POR)	11.2%	8.1%	11.2%	10.2%
PPL Corporation (NYSE-PPL)	0.7%	-0.8%	0.7%	0.2%
SCANA Corporation (NYSE-SCG)	4.6%	4.4%	4.6%	4.5%
Southern Company (NYSE-SO)	3.4%	3.5%	3.4%	3.4%
Westar Energy, Inc. (NYSE-WR)	2.9%	3.7%	2.9%	3.2%
Xcel Energy Inc. (NYSE-XEL)	4.5%	4.2%	5.1%	4.6%
Mean	4.9%	5.1%	5.0%	5.0%
Median	4.8%	5.0%	4.9%	4.9%

Data Sources: www.reuters.com, www.zacks.com, http://quote.yahoo.com, July 7, 2014.

Panel B
Moul Proxy Group

Company	Yahoo	Zacks	Reuters	Mean
American Electric Power Co. (NYSE-AEP)	4.8%	4.8%	4.8%	4.8%
CenterPoint Energy (NYSE-CNP)	3.5%	4.2%	na	3.9%
Cleco Corporation (NYSE-CNL)	7.0%	8.0%	7.0%	7.3%
Dominion Resources, Inc. (NYSE-D)	6.0%	5.6%	6.0%	5.9%
Duke Energy Corporation (NYSE-DUK)	4.2%	4.2%	4.4%	4.3%
Entergy Corporation (NYSE-ETR)	-0.7%	na	0.9%	0.1%
Nextera Energy (NYSE-NEE)	6.2%	6.4%	6.0%	6.2%
OGE Energy Corp. (NYSE-OGE)	6.6%	5.9%	6.6%	6.4%
SCANA Corporation (NYSE-SCG)	4.6%	4.4%	4.6%	4.5%
Southern Company (NYSE-SO)	3.4%	3.5%	3.4%	3.4%
TECO Energy, Inc. (NYSE-TE)	5.9%	5.0%	4.9%	5.3%
Mean	4.7%	5.2%	4.9%	4.7%
Median	4.8%	4.9%	4.9%	4.8%

Data Sources: www.reuters.com, www.zacks.com, http://quote.yahoo.com, July 7, 2014.

Exhibit JRW-10

Florida Public Utilities Company
DCF Growth Rate Indicators

Electric and Moul Proxy Groups
Summary Growth Rates

Growth Rate Indicator	Electric Proxy Group	Moul Proxy Group
Historic *Value Line* Growth in EPS, DPS, and BVPS	3.6	4.0
Projected *Value Line* Growth in EPS, DPS, and BVPS	4.5	4.5
Sustainable Growth ROE * Retention Rate	4.0%	4.2%
Projected EPS Growth from Yahoo, Zacks, and Reuters - Mean/Median	5.0%/4.9%	4.7%/4.8%

Exhibit JRW-11

Florida Public Utilities Company
Capital Asset Pricing Model

Panel A
Electric Proxy Group

Risk-Free Interest Rate	**4.00%**
Beta*	**0.73**
Ex Ante Equity Risk Premium**	**5.00%**
CAPM Cost of Equity	**7.6%**

* See page 3 of Exhibit JRW-11
** See pages 5 and 6 of Exhibit JRW-11

Panel B
Moul Proxy Group

Risk-Free Interest Rate	**4.00%**
Beta*	**0.70**
Ex Ante Equity Risk Premium**	**5.00%**
CAPM Cost of Equity	**7.5%**

* See page 3 of Exhibit JRW-11
** See pages 5 and 6 of Exhibit JRW-11

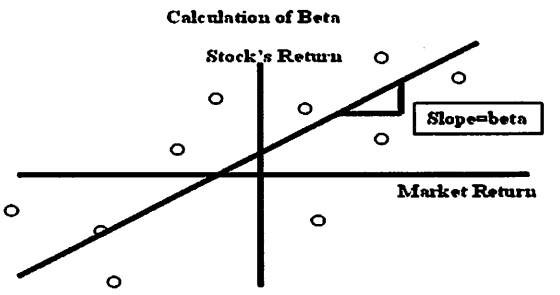
Exhibit JRW-11

Thirty-Year U.S. Treasury Yields
January 2006-Present

Source: Federal Reserve Bank of St. Louis, FRED Database.

Exhibit JRW-11

Panel A
Betas



Panel A
Electric Proxy Group

Company Name	Beta
ALLETE, Inc. (NYSE-ALE)	0.75
Alliant Energy Corporation (NYSE-LNT)	0.75
Ameren Corporation (NYSE-AEE)	0.75
American Electric Power Co. (NYSE-AEP)	0.65
Avista Corporation (NYSE-AVA)	0.75
Black Hills Corporation (NYSE-BKH)	0.85
Cleco Corporation (NYSE-CNL)	0.75
CMS Energy Corporation (NYSE-CMS)	0.75
Consolidated Edison, Inc. (NYSE-ED)	0.60
Dominion Resources, Inc. (NYSE-D)	0.70
Duke Energy Corporation (NYSE-DUK)	0.60
Edison International (NYSE-EIX)	0.75
El Paso Electric Company (NYSE-EE)	0.70
Empire District Electric Co. (NYSE-EDE)	0.65
Entergy Corporation (NYSE-ETR)	0.70
Great Plains Energy Incorporated (NYSE-GXP)	0.85
Hawaiian Electric Industries, Inc. (NYSE-HE)	0.75
IDACORP, Inc. (NYSE-IDA)	0.80
MGE Energy, Inc. (NYSE-MGEE)	0.70
Nextera Energy (NYSE-NEE)	0.70
Northeast Utilities (NYSE-NU)	0.75
NorthWestern Corporation (NYSE-NWE)	0.70
OGE Energy Corp. (NYSE-OGE)	0.85
PG&E Corporation (NYSE-PCG)	0.65
Pinnacle West Capital Corp. (NYSE-PNW)	0.70
PNM Resources, Inc. (NYSE-PNM)	0.85
Portland General Electric Company (NYSE-PO	0.75
PPL Corporation (NYSE-PPL)	0.65
SCANA Corporation (NYSE-SCG)	0.70
Southern Company (NYSE-SO)	0.60
Westar Energy, Inc. (NYSE-WR)	0.75
Xcel Energy Inc. (NYSE-XEL)	0.65
Mean	0.72
Median	0.73

Data Source: *Value Line Investment Survey, 2014.*

Panel B
Moul Proxy Group

Company Name	Beta
American Electric Power Co. (NYSE-AEP)	0.65
CenterPoint Energy (NYSE-CNP)	0.75
Cleco Corporation (NYSE-CNL)	0.75
Dominion Resources, Inc. (NYSE-D)	0.70
Duke Energy Corporation (NYSE-DUK)	0.60
Entergy Corporation (NYSE-ETR)	0.70
Nextera Energy (NYSE-NEE)	0.70
OGE Energy Corp. (NYSE-OGE)	0.85
SCANA Corporation (NYSE-SCG)	0.70
Southern Company (NYSE-SO)	0.60
TECO Energy, Inc. (NYSE-TE)	0.85
Mean	0.71
Median	0.70

Data Source: *Value Line Investment Survey, 2014.*

Exhibit JRW-11
Risk Premium Approaches

	Historical Ex Post Returns	**Surveys**	**Expected Return Models and Market Data**
Means of Assessing The Market Risk Premium	Historical Average Stock Minus Bond Returns	Surveys of CFOs, Financial Forecasters, Companies, Analysts on Expected Returns and Market Risk Premiums	Use Market Prices and Market Fundamentals (such as Growth Rates) to Compute Expected Returns and Market Risk Premiums
Problems/Debated Issues	Time Variation in Required Returns, Measurement and Time Period Issues, and Biases such as Market and Company Survivorship Bias	Questions Regarding Survey Histories, Responses, and Representativeness Surveys may be Subject to Biases, such as Extrapolation	Assumptions Regarding Expectations, Especially Growth

Source: Adapted from Antti Ilmanen, Expected Returns on Stocks and Bonds," *Journal of Portfolio Management*, (Winter 2003).

Exhibit JRW-11

Florida Public Utilities Company
Capital Asset Pricing Model
Equity Risk Premium

Category	Study Authors	Publication Date	Time Period Of Study	Methodology	Return Measure	Range Low	Range High	Midpoint of Range	Mean	Median
Historical Risk Premium										
	Ibbotson	2014	1926-2012	Historical Stock Returns - Bond Returns	Arithmetic				6.20%	
					Geometric				4.60%	
	Damodaran	2014	1928-2012	Historical Stock Returns - Bond Returns	Arithmetic				6.29%	
					Geometric				4.62%	
	Dimson, Marsh, Staunton	2014	1900-2013	Historical Stock Returns - Bond Returns	Arithmetic					
					Geometric				4.50%	
	Bate	2008	1900-2007	Historical Stock Returns - Bond Returns	Geometric				4.50%	
	Shiller	2006	1926-2005	Historical Stock Returns - Bond Returns	Arithmetic				7.00%	
					Geometric				5.50%	
	Siegel	2005	1926-2005	Historical Stock Returns - Bond Returns	Arithmetic				6.10%	
					Geometric				4.60%	
	Dimson, Marsh, and Staunton	2006	1900-2005	Historical Stock Returns - Bond Returns	Arithmetic				5.50%	
	Goyal & Welch	2006	1872-2004	Historical Stock Returns - Bond Returns					4.77%	
	Median									5.14%
Ex Ante Models (Puzzle Research)										
	Claus Thomas	2001	1985-1998	Abnormal Earnings Model					3.00%	
	Arnott and Bernstein	2002	1810-2001	Fundamentals - Div Yld + Growth					2.40%	
	Constantinides	2002	1872-2000	Historical Returns & Fundamentals - P/D & P/E					6.90%	
	Cornell	1999	1926-1997	Historical Returns & Fundamental GDP/Earnings		3.50%	5.50%	4.50%	4.50%	
	Easton, Taylor, et al	2002	1981-1998	Residual Income Model					5.30%	
	Fama French	2002	1951-2000	Fundamental DCF with EPS and DPS Growth		2.55%	4.32%		3.44%	
	Harris & Marston	2001	1982-1998	Fundamental DCF with Analysts' EPS Growth					7.14%	
	Best & Byrne	2001								
	McKinsey	2002	1962-2002	Fundamental (P/E, D/P, & Earnings Growth)		3.50%	4.00%		3.75%	
	Siegel	2005	1802-2001	Historical Earnings Yield	Geometric				2.50%	
	Grabowski	2006	1926-2005	Historical and Projected		3.50%	6.00%	4.75%	4.75%	
	Maheu & McCurdy	2006	1885-2003	Historical Excess Returns, Structural Breaks,		4.02%	5.10%	4.56%	4.56%	
	Bostock	2004	1960-2002	Bond Yields, Credit Risk, and Income Volatility		3.90%	1.30%	2.60%	2.60%	
	Bakshi & Chen	2005	1982-1998	Fundamentals - Interest Rates					7.31%	
	Donaldson, Kamstra, & Kramer	2006	1952-2004	Fundamental, Dividend yld., Returns,, & Volatility		3.00%	4.00%	3.50%	3.50%	
	Campbell	2008	1982-2007	Historical & Projections (D/P & Earnings Growth)		4.10%	5.40%		4.75%	
	Best & Byrne	2001	Projection	Fundamentals - Div Yld + Growth					2.00%	
	Fernandez	2007	Projection	Required Equity Risk Premium					4.00%	
	DeLong & Magin	2008	Projection	Earnings Yield - TIPS					3.22%	
	Siegel - Rethink ERP	2011	Projection	Real Stock Returns and Components					5.50%	
	American Appraisal Quarterly ERP	2013	Projection	Fundamental Economic and Market Factors					6.50%	
	Duarte & Rosa - NY Fed	2013	projection	Projections from 29 Models					5.40%	
	Duff & Phelps	2014	Projection	Normalized with 4.0% Long-Term Treasury Yield					5.00%	
	Damodaran	2014	Projection	Fundamentals - Implied from FCF to Equity Model					5.38%	
	Social Security									
	Office of Chief Actuary		1900-1995							
	John Campbell	2001	1860-2000	Historical & Projections (D/P & Earnings Growth)	Arithmetic	3.00%	4.00%	3.50%	3.50%	
			Projected for 75 Years		Geometric	1.50%	2.50%	2.00%	2.00%	
	Peter Diamond	2001	Projected for 75 Years	Fundamentals (D/P, GDP Growth)		3.00%	4.80%	3.90%	3.90%	
	John Shoven	2001	Projected for 75 Years	Fundamentals (D/P, P/E, GDP Growth)		3.00%	3.50%	3.25%	3.25%	
	Median									4.00%
Surveys										
	New York Fed	2013	Five-Year	Survey of Wall Street Firms					5.20%	
	Survey of Financial Forecasters	2014	10-Year Projection	About 50 Financial Forecastsers					2.18%	
	Duke - CFO Magazine Survey	2014	10-Year Projection	Approximately 350 CFOs					4.10%	
	Welch - Academics	2008	30-Year Projection	Random Academics		5.00%	5.74%	5.37%	5.37%	
	Fernandez - Academics, Analysts, and Compan	2014	Long-Term	Survey of Academics, Analysts, and Companies					5.00%	
	Median									4.55%
Building Block										
	Ibbotson and Chen	2014	Projection	Historical Supply Model (D/P & Earnings Growth)	Arithmetic			6.12%	5.10%	
					Geometric			4.08%		
	Chen - Rethink ERP	2010	20-Year Projection	Combination Supply Model (Historic and Projection)	Geometric				4.00%	
	Ilmanen - Rethink ERP	2010	Projection	Current Supply Model (D/P & Earnings Growth)	Geometric				3.00%	
	Grinold, Kroner, Siegel - Rethink ERP	2011	Projection	Current Supply Model (D/P & Earnings Growth)	Arithmetic			4.63%	4.12%	
					Geometric			3.60%		
	Woolridge		2014	Current Supply Model (D/P & Earnings Growth)					4.00%	
	Median									4.00%
Mean										4.42%
Median										4.28%

Exhibit JRW-11

Florida Public Utilities Company
Capital Asset Pricing Model
Equity Risk Premium

Summary of 2010-14 Equity Risk Premium Studies

Category	Study Authors	Publication Date	Time Period Of Study	Methodology	Return Measure	Range Low	Range High	Midpoint of Range	Mean	Average
Historical Risk Premium										
	Ibbotson	2014	1926-2013	Historical Stock Returns - Bond Returns	Arithmetic				6.20%	
					Geometric				4.60%	
	Damodaran	2014	1928-2013	Historical Stock Returns - Bond Returns	Arithmetic				6.29%	
					Geometric				4.62%	
	Dimson, Marsh, Staunton	2014	1900-2013	Historical Stock Returns - Bond Returns	Arithmetic					
					Geometric				4.50%	
	Median									5.24%
Ex Ante Models (Puzzle Research)										
	Siegel - Rethink ERP	2011	Projection	Real Stock Returns and Components					5.50%	
	American Appraisal Quarterly ERP	2013	Projection	Fundamental Economic and Market Factors					6.50%	
	Duarte & Rosa - NY Fed	2013	Projection	Projections from 29 Models					5.40%	
	Duff & Phelps	2014	Projection	Normalized with 4.0% Long-Term Treasury Yield					5.00%	
	Damodaran	2014	Projection	Fundamentals - Implied from FCF to Equity Model					5.38%	
	Median									5.40%
Surveys										
	New York Fed	2013	Five-Year	Survey of Wall Street Firms					5.20%	
	Survey of Financial Forecasters	2014	10-Year Projection	About 50 Financial Forecastsers					2.18%	
	Duke - CFO Magazine Survey	2014	10-Year Projection	Approximately 350 CFOs					4.10%	
	Fernandez - Academics, Analysts, and Companies	2014	Long-Term	Survey of Academics, Analysts, and Companies					5.00%	
	Median									4.55%
Building Block										
	Ibbotson and Chen	2014	Projection	Historical Supply Model (D/P & Earnings Growth)	Arithmetic			6.12%	5.10%	
					Geometric			4.08%		
	Chen - Rethink ERP	2010	20-Year Projection	Combination Supply Model (Historic and Projection)	Geometric				4.00%	
	Ilmanen - Rethink ERP	2010	Projection	Current Supply Model (D/P & Earnings Growth)	Geometric				3.00%	
	Grinold, Kroner, Siegel - Rethink ERP	2011	Projection	Current Supply Model (D/P & Earnings Growth)	Arithmetic			4.63%	4.12%	
					Geometric			3.60%		
	Woolridge	2014	Projection	Current Supply Model (D/P & Earnings Growth)	Geometric				4.00%	
	Median									4.00%
Mean										4.80%
Median										4.90%

Exhibit JRW-12
Dow Jones Utilities vs. S&P 500

Exhibit JRW-12
Authorized ROEs for Electric Distribution Companies
2013-2014

Date	State	Utility	Docket/Case Number	Authorized ROE
1/16/2013	Texas	Cross Texas	Docket No. 40604	9.60
1/16/2013	Texas	Wind Energy Transmission Texas	Docket No. 40606	9.60
2/22/2013	Maryland	Baltimore Gas and Electric Co.	Case No. 9299	9.75
3/14/2013	New York	Niagara Mohawk Power Corp.	Docket No. 12-E-0201	9.30
5/1/2013	Ohio	Duke Energy Ohio Inc.	Case No. 12-1682-EL-AIR	9.84
6/21/2013	New Jersey	Atlantic City Electric Co.	Docket No. ER-12121071	9.75
7/12/2013	Maryland	Potomac Electric Power Co.	Case No. 9311	9.36
8/14/2013	Connecticut	United Illuminating Co.	Docket No. 13-01-19	9.15
10/3/2013	Texas	Southwestern Electric Power Co	Docket No. 40443	9.65
12/9/2013	Illinois	Ameren Illinois	Docket No. 13-0301	8.72
12/13/2013	Maryland	Baltimore Gas and Electric Co.	Case No. 9326	9.75
12/18/2013	Illinois	Commonwealth Edison Co.	Docket No. 13-0318	8.72
2/20/2014	New York	Consolidated Edison Co. of NY	Case No. 13-E-0030	9.20
3/17/2014	New Hampshire	Liberty Utilities Granite St	Docket No. DE-13-063	9.55
3/26/2014	District of Columbia	Potomac Electric Power Co.	Formal Case No. 1103-2013-EL	9.40
4/2/2014	Delaware	Delmarva Power & Light Co.	Docket No. 13-115	9.70
5/16/2014	Texas	Entergy Texas Inc.	Docket No. 41791	9.80
5/30/2014	Massachusetts	Fitchburg Gas & Electric Light	DPU 13-90	9.70
7/2/2014	Maryland	Potomac Electric Power Co.	Case No. 9336	9.62
			Average	9.48

Exhibit JRW-13

Florida Public Utilities Company
Company's Proposed Cost of Capital

Capital Source	Capitalization Ratio	Cost Rate	Weighted Cost Rate
Short-Term Debt	6.50%	3.70%	0.24%
Long-Term Debt - Legacy	1.09%	12.74%	0.14%
Long-Term Debt - Parent C	34.21%	4.90%	1.68%

Summary of Mr. Moul's ROE Results

Panel A
Summary of Mr. Moul's Equity Cost Rate Approaches and Results

Approach	Equity Cost Rate
DCF	9.59%
RP	12.19%
CAPM	10.84%
CE	13.30%
Average	11.48%

Panel B
Summary of Mr. Moul's DCF Results

	Moul Proxy Group
Adjusted Dividend Yield	4.15%
Growth	5.25%
DCF Result	9.40%
Flotation Adjustment	1.02
Adjusted DCF Result	9.59%

Panel C
Summary of Mr. Moul Risk Premium Results

	RP
Base Yield	5.50%
Risk Premium	6.50%
RP Equity Cost Rate	12.00%
Flotation Adjustment	0.19%
Adjusted RP Result	12.19%

Panel D
Summary of Mr. Moul's CAPM Results

	CAPM
Risk-Free Rate	4.50%
Beta	0.73
Market Risk Premium	6.86%
CAPM Result	9.51%
+ Size Adjustment	1.14%
Adjusted CAPM Equity Cost Rate	10.65%
Flotation Adjustment	0.19%
Adjusted CAPM Result	10.84%

Panel E
Summary of Mr. Moul Comparable Earnings Results

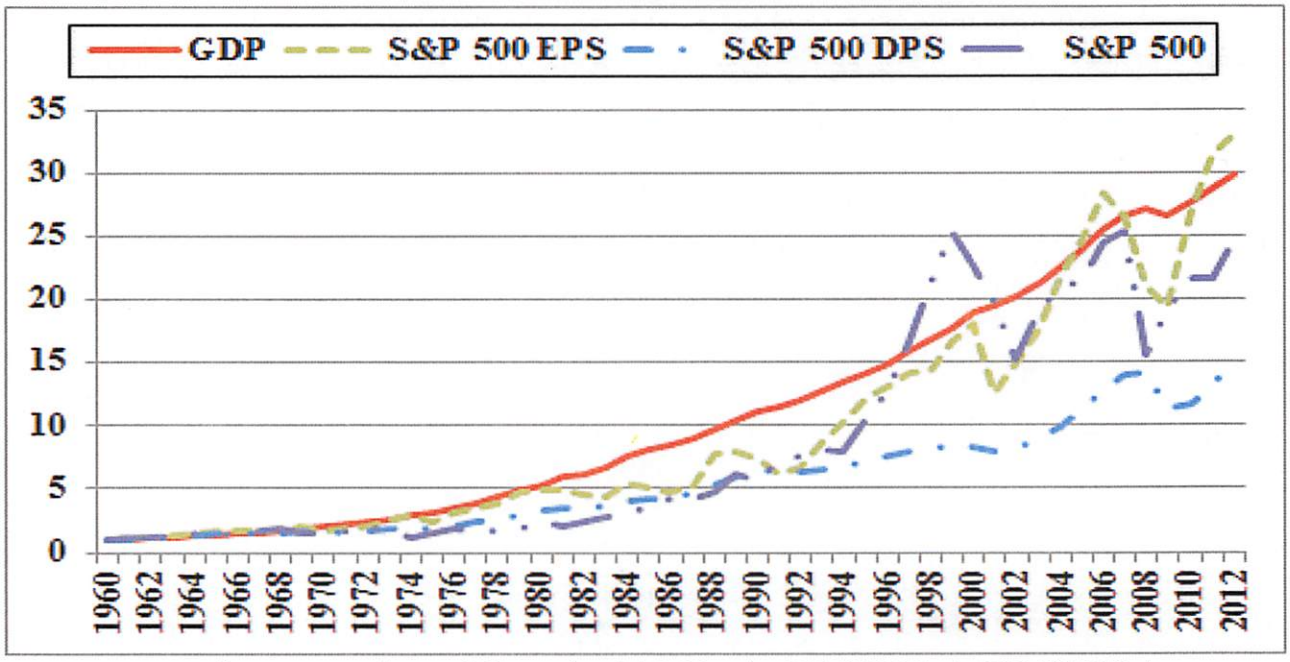
	CE
Historical ROEs	13.30%
Forecasted ROEs	13.30%
Average	13.30%

Growth Rates
GDP, S&P 500 Price, EPS, and DPS

	GDP	S&P 500	Earnings	Dividends	
1960	543.3	58.11	3.10	1.98	
1961	563.3	71.55	3.37	2.04	
1962	605.1	63.10	3.67	2.15	
1963	638.6	75.02	4.13	2.35	
1964	685.8	84.75	4.76	2.58	
1965	743.7	92.43	5.30	2.83	
1966	815.0	80.33	5.41	2.88	
1967	861.7	96.47	5.46	2.98	
1968	942.5	103.86	5.72	3.04	
1969	1019.9	92.06	6.10	3.24	
1970	1075.9	92.15	5.51	3.19	
1971	1167.8	102.09	5.57	3.16	
1972	1282.4	118.05	6.17	3.19	
1973	1428.5	97.55	7.96	3.61	
1974	1548.8	68.56	9.35	3.72	
1975	1688.9	90.19	7.71	3.73	
1976	1877.6	107.46	9.75	4.22	
1977	2086.0	95.10	10.87	4.86	
1978	2356.6	96.11	11.64	5.18	
1979	2632.1	107.94	14.55	5.97	
1980	2862.5	135.76	14.99	6.44	
1981	3210.9	122.55	15.18	6.83	
1982	3345.0	140.64	13.82	6.93	
1983	3638.1	164.93	13.29	7.12	
1984	4040.7	167.24	16.84	7.83	
1985	4346.7	211.28	15.68	8.20	
1986	4590.1	242.17	14.43	8.19	
1987	4870.2	247.08	16.04	9.17	
1988	5252.6	277.72	24.12	10.22	
1989	5657.7	353.40	24.32	11.73	
1990	5979.6	330.22	22.65	12.35	
1991	6174.0	417.09	19.30	12.97	
1992	6539.3	435.71	20.87	12.64	
1993	6878.7	466.45	26.90	12.69	
1994	7308.7	459.27	31.75	13.36	
1995	7664.0	615.93	37.70	14.17	
1996	8100.2	740.74	40.63	14.89	
1997	8608.5	970.43	44.09	15.52	
1998	9089.1	1229.23	44.27	16.20	
1999	9665.7	1469.25	51.68	16.71	
2000	10289.7	1320.28	56.13	16.27	
2001	10625.3	1148.09	38.85	15.74	
2002	10980.2	879.82	46.04	16.08	
2003	11512.2	1111.91	54.69	17.88	
2004	12277.0	1211.92	67.68	19.41	
2005	13095.4	1248.29	76.45	22.38	
2006	13857.9	1418.30	87.72	25.05	
2007	14480.3	1468.36	82.54	27.73	
2008	14720.3	903.25	65.39	28.05	
2009	14417.9	1115.10	59.65	22.31	
2010	14958.3	1257.64	83.66	23.12	
2011	15533.8	1257.60	97.05	26.02	Average
2012	16244.6	1426.19	102.47	30.44	
2013	16803.0	1848.36	107.45	36.28	
Growth Rates	**6.69**	**6.75**	**6.92**	**5.64**	**6.50**

Data Sources: GDPA -http://research.stlouisfed.org/fred2/series/GDPA/downloaddat
S&P 500, EPS and DPS - http://pages.stern.nyu.edu/~adamodar/

Long-Term Growth of GDP, S&P 500, S&P 500 EPS, and S&P 500 DPS



	GDP	S&P 500	S&P 500 EPS	S&P 500 DPS
Growth Rates	6.69%	6.75%	6.92%	5.64%

Panel A
Historic GDP Growth Rates

10-Year Average	3.9%
20-Year Average	4.6%
30-Year Average	5.2%
40-Year Average	6.4%
50-Year Average	6.8%

Calculated from Page 1 of Exhibit JRW-14

Panel B
Projected GDP Growth Rates

	Time Frame	Projected Nominal GDP Growth Rate
Congressional Budget Office	2014-2024	4.8%
Survey of Financial Forecasters	Ten Year	4.9%
Energy Information Administration	2011-2040	4.5%

Sources:
http://www.cbo.gov/topics/budget/budget-and-economic-outlook
http://www.eia.gov/forecasts/aeo/tables_ref.cfm Table 20
http://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/2014/survq114.cfm

Panel A
Moul Proxy Group

Company Name	Industry	Beta	Market Cap $ (Mil)	Annual Sales	Fixed Asset Turnover	Median P/E	Profit Margin	ROE	Dividend Payout	Common Equity Ratio	Avg Annual Dividend Yld	Price To Book Value	Estimated ROE	Proj EPS Growth Rate	Proj DPS Growth Rate
Amer. Elec. Power	UTILCENT	0.65	$ 26,101	$ 15,357	0.27	13	10.09	9.63	61.59	48.90	4.23	1.63	9.50	4.50	4.50
CenterPoint Energy	UTILCENT	0.75	$ 10,639	$ 8,106	0.37	15	6.61	12.38	66.23	35.60	3.57	2.48	11.00	2.00	6.00
Cleco Corp.	UTILCENT	0.75	$ 3,387	$ 1,097	0.26	14	14.65	10.13	53.76	54.70	3.11	2.15	9.00	5.00	7.50
Dominion Resources	UTILEAST	0.70	$ 40,212	$ 13,120	0.26	17	13.77	15.36	73.03	37.30	3.78	3.57	17.00	5.50	5.00
Duke Energy	UTILEAST	0.60	$ 51,159	$ 24,598	0.21		11.44	6.8	77.78	52.00	4.45	1.25	7.50	5.00	2.00
Entergy Corp.	UTILCENT	0.70	$ 13,663	$ 11,391	0.26	14	7.94	9.19	67.65	43.60	5.07	1.47	11.00	1.00	2.50
NextEra Energy	UTILEAST	0.70	$ 42,556	$ 15,136	0.22	14	13.62	11.43	54.41	42.90	3.30	2.37	11.50	6.00	8.50
OGE Energy	UTILCENT	0.85	$ 7,398	$ 2,868	0.31	14	13.52	12.76	42.7	56.90	2.48	2.45	12.50	5.50	9.00
SCANA Corp.	UTILEAST	0.70	$ 7,434	$ 4,495	0.30	14	10.48	10.09	59.66	46.40	4.15	1.60	10.50	5.00	3.00
Southern Co.	UTILEAST	0.60	$ 39,686	$ 17,087	0.26	16	14.27	12.48	74.95	45.80	4.61	2.22	12.50	3.50	3.50
TECO Energy	UTILEAST	0.85	$ 3,919	$ 2,851	0.38	15	6.94	8.47	96.66	45.10	5.07	1.68	9.50	4.50	1.50
Average		0.71	$ 22,378	$ 10,555	0.28	15	11.21	10.79	66.22	46.29	3.98	2.08	11.05	4.32	4.82

Panel B
Moul Comparable Corporate Group

Company Name	Industry	Beta	Market Cap $ (Mil)	Annual Sales	Fixed Asset Turnover	Median P/E	Profit Margin	ROE	Dividend Payout	Common Equity Ratio	Avg Annual Dividend Yld	Price To Book Value	Estimated ROE	Proj EPS Growth Rate	Proj DPS Growth Rate
Alleghany Corp.	INSPRPTY	0.65	$ 7,253					10.96	0	100.00	0.00	1.13		5.00	
AmerisourceBergen	MEDICNON	0.75	$ 16,541	$ 87,959	4.65	15	0.84	31.88	26.47	62.40	1.74	7.20	33.00	14.00	11.50
AptarGroup	PACKAGE	0.90	$ 4,260	$ 2,520	1.01	19	7.52	12.8	34.9	80.70	1.71	2.88	13.00	8.00	8.00
Ball Corp.	PACKAGE	0.80	$ 8,843	$ 8,468	1.08	14	4.80	33.86	18.5	27.40	1.13	7.62	42.50	12.00	13.50
BCE Inc.	TELUTIL	0.70	$ 35,171	$ 19,975	0.49	14	15.28	25.77	59.48	39.60	5.18	4.42		5.00	6.50
Bemis Co.	PACKAGE	0.85	$ 4,038	$ 5,030	1.22	17	4.71	14.06	45.36	54.20	2.65	2.44	14.50	7.00	3.00
Berkley (W.R.)	INSPRPTY	0.70	$ 5,832			10		9.68	12.46	68.30	0.90	1.37	10.00	12.50	9.50
Bio-Rad Labs. 'A'	MEDICNON	0.90	$ 3,353	$ 2,133	0.63	19	3.65	3.55	0	83.40	0.00	1.55	6.50	12.00	
Brown & Brown	FINSERV	0.80	$ 4,413	$ 1,363	0.37	20	15.93	10.81	24.66	84.10	1.18	2.20	11.00	14.00	6.00
Campbell Soup	FOODPROC	0.60	$ 13,647	$ 8,052	0.97	16	9.76	64.58	46.69	32.40	2.91	11.29	48.50	5.00	5.00
Cincinnati Financial	INSPRPTY	0.90	$ 7,793		0.00	16		7.67	56.44	87.90	3.47	1.29	6.50	10.50	1.50
Clorox Co.	HOUSEPRD	0.60	$ 11,827	$ 5,623	1.30	19	10.21		58.36	6.30	3.36	81.12		10.50	6.50
Commerce Bancshs.	BANKMID	0.90	$ 4,307			15		11.80	31.46	95.40	2.10	1.95	11.50	4.50	4.00
ConAgra Foods	FOODPROC	0.70	$ 12,849	$ 15,491	0.76	16	5.82	17.11	44.47	37.20	3.32	2.43	16.50	8.50	7.00
Cullen/Frost Bankers	BANK	0.85	$ 4,707			16		9.75	53.11	86.60	2.97	2.10	9.50	6.00	2.50
DaVita HealthCare	MEDSERV	0.80	$ 15,711	$ 11,764	0.69	15	6.95	18.44	0	35.30	0.00	3.42	15.50	11.00	
Dentsply Int'l	MEDICINV	1.00	$ 6,561	$ 2,928	0.59	19	10.90	14.45	9.85	64.40	0.58	2.98	13.00	8.50	9.00
Dollar General	RETAIL	0.65	$ 16,503	$ 17,504	1.61		5.86	18.97	0	66.30	0.00	3.24	20.00	14.50	
Ecolab Inc.	CHEMSPEC	0.80	$ 33,016	$ 13,253	0.67	24	8.16	14.71	20.18	54.90	1.08	4.47	15.00	10.50	10.50
Equifax Inc.	INFOSER	0.90	$ 8,985	$ 2,304	0.51	16	19.83	19.51	25.65	67.10	1.44	3.80	18.00	10.00	8.00
Fidelity National	FINSERV	0.90	$ 16,180	$ 6,071	0.43	24	8.09	7.46	52.18	60.30	2.00	2.48	9.50	10.00	10.00
Fiserv Inc.	ITSERV	0.90	$ 15,587	$ 4,814	0.51	15	16.51	22.17	0	48.80	0.00	4.50	21.00	9.50	
Gallagher (Arthur J.)	FINSERV	0.80	$ 6,223	$ 3,180	0.46	19	8.45	12.87	67.98	71.70	3.26	2.85	11.00	11.50	2.50
Hanover Insurance	INSPRPTY	0.80	$ 2,713			13		8.76	26.4	74.20	2.65	1.06	9.50	22.50	8.50
Henry (Jack) & Assoc	ITSERV	0.90	$ 5,014	$ 1,027	0.63	20	15.09	15.76	24.6	90.30	1.37	5.23	17.00	12.00	14.00
Hershey Co.	FOODPROC	0.60	$ 20,582	$ 7,146	1.33	21	11.81	52.59	46.66	47.20	2.01	13.04	46.00	11.50	12.50
Hormel Foods	FOODPROC	0.70	$ 12,650	$ 8,752	1.78	17	6.01	15.86	33.13	93.00	1.76	3.82	16.00	11.00	10.50
Int'l Flavors & Frag.	CHEMSPEC	0.90	$ 8,400	$ 2,953	0.89	16	12.46	25.14	23.74	61.10	1.84	5.77	24.00	7.50	8.00
Kellogg	FOODPROC	0.55	$ 23,596	$ 14,792	0.96	17	9.33	38.92	47.33	35.90	2.89	6.77	40.00	6.50	5.50
Kroger Co.	GROCERY	0.70	$ 23,901	$ 98,375	3.36	13	1.52	27.78	21.32	35.80	1.72	4.68	30.00	9.50	13.00
L-3 Communic.	DEFENSE	0.95	$ 10,424	$ 12,629	0.90	12	6.16	12.91	25.58	62.40	2.48	1.74	11.50	4.00	7.00
Laboratory Corp.	MEDSERV	0.75	$ 8,940	$ 5,808	0.83	15	10.99	25.61	0	46.30	0.00	3.58	20.00	5.50	
Lorillard Inc.	TOBACCO	0.70	$ 21,776	$ 6,950	1.97		16.82	-56.62	70.41	-138.00	4.97			11.00	10.00
Mercury General	INSPRPTY	0.70	$ 2,559			15		6.57	112.46	90.60	5.59	1.42	7.50	6.50	2.00
Molson Coors Brewing	BEVERAGE	0.80	$ 13,728	$ 4,206	0.27		13.44	6.54	42.22	72.90	2.55	1.60	9.00	8.50	5.50
Motorola Solutions	TELEQUIP	0.80	$ 16,508	$ 8,696	0.73		14.72	34.98	22.81	59.80	1.89	4.57	32.00	8.00	14.00
NeuStar Inc.	TELEQUIP	0.95	$ 1,636	$ 902	0.60		18.04	27.6	0	49.10	0.00	2.81	23.50	9.00	
Owens & Minor	MEDICNON	0.85	$ 2,170	$ 9,072	3.90	17	1.22	10.81	54.77	82.70	2.82	2.10	11.50	12.00	6.00
Paychex Inc.	ITSERV	0.85	$ 15,139	$ 2,326	0.38	24	24.46	32.08	83.78	100.00	3.92	8.67	34.50	8.00	6.50
Philip Morris Int'l	TOBACCO	0.80	$ 133,269	$ 80,029	2.10		10.72		66.7	-47.80	4.01			7.50	6.00
Praxair Inc.	CHEMSPEC	0.95	$ 38,571	$ 11,925	0.59	19	14.72	26.55	40.34	45.20	2.04	5.85	26.50	10.00	11.50
RLI Corp.	INSPRPTY	0.80	$ 1,919			12		13.53	25.67	100.00	3.34	2.34	11.00	6.00	5.00
Rollins Inc.	INDUSRV	0.95	$ 4,226	$ 1,337	1.81	26	9.22	28.13	42.66	100.00	1.40	9.65	27.00	11.50	12.50
Ross Stores	RETAILSL	0.75	$ 13,159	$ 10,230	2.63	16	8.19	41.71	17.67	93.00	1.05	6.67	39.00	9.00	14.00
Stericycle Inc.	ENVIRONM	0.75	$ 10,041	$ 2,143	0.55	28	15.35	18.78	0	57.70	0.00	5.76	17.00	12.00	
Synopsys Inc.	SOFTWARE	0.85	$ 6,044	$ 1,962	0.45	20	16.00	11.25	0	97.40	0.00	2.15	10.50	6.00	
Teleflex Inc.	MEDICINV	0.90	$ 4,356	$ 1,696	0.40	17	8.95	7.93	36.85	67.30	1.65	2.26	7.00	15.50	5.00
Tim Hortons	RESTRNT	0.80	$ 7,529	$ 3,044	1.34		13.03	55.75	36.79	44.10	1.83	10.97	64.50	10.50	12.50
Total System Svcs.	FINSERV	0.90	$ 5,904	$ 2,132	0.58	18	11.48	15.48	23.09	52.40	1.51	3.75	15.00	9.50	2.00
United Parcel Serv.	AIRTRANS	0.90	$ 94,438	$ 55,438	1.53	19	7.89	67.53	51.69	37.40	2.79	14.88		7.50	7.00
Waste Management	ENVIRONM	0.85	$ 20,506	$ 13,983	0.62	17	7.21	17.66	67.76	37.50	3.59	3.61	18.00	7.50	3.00
Weis Markets	GROCERY	0.65	$ 1,177	$ 2,693	2.35	16	2.81	9.06	42.72	100.00	2.63	1.42	7.50	2.00	-2.50
West Pharmac. Svcs.	MEDICNON	0.85	$ 2,804	$ 1,368	0.82	18	8.21	12.39	23.86	70.90	1.05	3.10	13.50	14.50	9.00
Average		0.80	$ 15,043	$ 13,112	1.14	17	10.20	19.68	33.95	59.12	2.01	5.84	19.88	9.47	7.56

Data: Value Line Investment Analyzer, 2014

Exhibit JRW-16
Appendix A
Educational Background, Research, and Related Business Experience
J. Randall Woolridge

J. Randall Woolridge is a Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed Faculty Fellow in Business Administration in the College of Business Administration of the Pennsylvania State University in University Park, PA. In addition, Professor Woolridge is Director of the Smeal College Trading Room and President and CEO of the Nittany Lion Fund, LLC.

Professor Woolridge received a Bachelor of Arts degree in Economics from the University of North Carolina, a Master of Business Administration degree from the Pennsylvania State University, and a Doctor of Philosophy degree in Business Administration (major area-finance, minor area-statistics) from the University of Iowa. He has taught Finance courses including corporation finance, commercial and investment banking, and investments at the undergraduate, graduate, and executive MBA levels.

Professor Woolridge's research has centered on empirical issues in corporation finance and financial markets. He has published over 35 articles in the best academic and professional journals in the field, including the *Journal of Finance,* the *Journal of Financial Economics,* and the *Harvard Business Review.* His research has been cited extensively in the business press. His work has been featured in the *New York Times*, *Forbes, Fortune, The Economist*, *Barron's*, *Wall Street Journal*, *Business Week*, *Investors' Business Daily*, *USA Today*, and other publications. In addition, Dr. Woolridge has appeared as a guest to discuss the implications of his research on CNN's *Money Line*, CNBC's *Morning Call* and *Business Today*, and Bloomberg's *Morning Call.*

Professor Woolridge's stock valuation book, *The StreetSmart Guide to Valuing a Stock* (McGraw-Hill, 2003), was released in its second edition. He has also co-authored *Spinoffs and Equity Carve-Outs: Achieving Faster Growth and Better Performance* (Financial Executives Research Foundation, 1999) as well as a textbook entitled *Basic Principles of Finance* (Kendall Hunt, 2011).

Professor Woolridge has also consulted with corporations, financial institutions, and government agencies. In addition, he has directed and participated in university- and company-sponsored professional development programs for executives in 25 countries in North and South America, Europe, Asia, and Africa.

Over the past twenty-five years Dr. Woolridge has prepared testimony and/or provided consultation services in regulatory rate cases in the rate of return area in following states: Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Indiana, Kansas, Kentucky, Massachusetts, Missouri, Nebraska, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, Utah, Vermont, Washington, and Washington, D.C. He has also prepared testimony which was submitted to the Federal Energy Regulatory Commission.

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Academic Experience

Professor of Finance, the Smeal College of Business Administration, the Pennsylvania State University (July 1, 1990 to the present).

President, Nittany Lion Fund LLC, (January 1, 2005 to the present)

Director, the Smeal College Trading Room (January 1, 2001 to the present)

Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration (July 1, 1987 to the present).

Associate Professor of Finance, College of Business Administration, the Pennsylvania State University (July 1, 1984 to June 30, 1990).

Assistant Professor of Finance, College of Business Administration, the Pennsylvania State University (September, 1979 to June 30, 1984).

Education

Doctor of Philosophy in Business Administration, the University of Iowa (December, 1979). Major field: Finance.

Master of Business Administration, the Pennsylvania State University (December, 1975).

Bachelor of Arts, the University of North Carolina (May, 1973) Major field: Economics.

Books

James A. Miles and J. Randall Woolridge, *Spinoffs and Equity Carve-Outs: Achieving Faster Growth and Better Performance* (Financial Executives Research Foundation), 1999

Patrick Cusatis, Gary Gray, and J. Randall Woolridge, *The StreetSmart Guide to Valuing a Stock* (2nd Edition, McGraw-Hill), 2003.

J. Randall Woolridge and Gary Gray, *The New Corporate Finance, Capital Markets, and Valuation: An Introductory Text* (Kendall Hunt, 2003).

Research

Dr. Woolridge has published over 35 articles in the best academic and professional journals in the field, including the *Journal of Finance,* the *Journal of Financial Economics,* and the *Harvard Business Review.*

Exhibit JRW-16
Appendix B
The Research on Analysts' Long-Term EPS Growth Rate Forecasts

Most of the attention given to the accuracy of analysts' EPS forecasts comes from media coverage of companies' quarterly earnings announcements. When companies' announced earnings beat Wall Street's EPS estimates ("a positive surprise"), their stock prices usually go up. When a company's EPS figure misses or is below Wall Street's forecasted EPS ("a negative surprise"), their stock price usually declines, sometimes precipitously so. Wall Street's estimate is the consensus forecast for quarterly EPS made by analysts who follow the stock as of the announcement date. And so Wall Street's so-called "estimate" is analysts' consensus quarterly EPS forecast made in the days leading up to the EPS announcement.

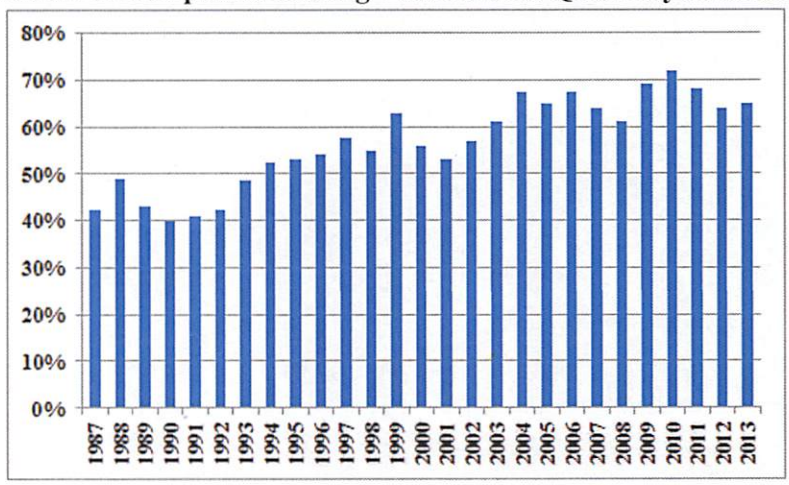
In recent years, it has become more common for companies to beat Wall Street's quarterly EPS estimate. A *Wall Street Journal* article summarized the results for the first quarter of 2012:

> While this "positive surprise ratio" of 70% is above the 20 year average of 58% and also higher than last quarter's tally, it is just middling since the current bull market began in 2009. In the past decade, the ratio only dipped below 60% during the financial crisis. Look before 2002, though, and 70% would have been literally off the chart. From 1993 through 2001, about half of companies had positive surprises, . . [1]

Figure 1 below provides the record for companies beating Wall Street's EPS estimate on an annual basis over the past twenty-five years.

[1] Spencer Jakab, "Earnings Surprises Lose Punch," *Wall Street Journal* (May6, 2012), p. C1.

Figure 1
Percent of Companies Beating Wall Street's Quarterly Estimates



A. RESEARCH ON THE ACCURACY OF ANALYSTS' NEAR-TERM EPS ESTIMATES

There is a long history of studies that evaluate how well analysts forecast near-term EPS estimates and long-term EPS growth rates. Most of these studies have evaluated the accuracy of earnings forecasts for the current quarter or year. Many of the early studies indicated that analysts make overly optimistic EPS earnings forecasts for quarter-to-quarter EPS (Stickel (1990); Brown (1997); Chopra (1998)).[2] More recent studies have shown that the optimistic bias tends to be larger for longer-term forecasts and smaller for forecasts made nearer to the EPS announcement date. Richardson, Teoh, and Wysocki (2004) report that the upward bias in earnings growth rates declines in the quarters

[2] S. Stickel, "Predicting Individual Analyst Earnings Forecasts," *Journal of Accounting Research*, Vol. 28, 409-417, 1990. Brown, L.D., "Analyst Forecasting Errors: Additional Evidence," *Financial Analysts Journal*, Vol. 53, 81-88, 1997, and Chopra, V.K., "Why So Much Error in Analysts' Earnings Forecasts?" *Financial Analysts Journal*, Vol. 54, 35-42 (1998).

leading up to the earnings announcement date.[3] They call this result the "walk-down to beatable analyst forecasts." They hypothesize that the walk-down might be driven by the "earning-guidance game," in which analysts give optimistic forecasts at the start of a fiscal year, then revise their estimates downwards until the firm can beat the forecasts at the earnings announcement date.

However, two regulatory developments over the past decade have potentially impacted analysts' EPS growth rate estimates. First, Regulation Fair Disclosure ("Reg FD") was introduced by the Securities and Exchange Commission ("SEC") in October of 2000. Reg FD prohibits private communication between analysts and management so as to level the information playing field in the markets. With Reg FD, analysts are less dependent on gaining access to management to obtain information and, therefore, are not as likely to make optimistic forecasts to gain access to management. Second, the conflict of interest within investment firms with investment banking and analyst operations was addressed in the Global Analysts Research Settlements ("GARS"). GARS, as agreed upon on April 23, 2003, between the SEC, NASD, NYSE and ten of the largest U.S. investment firms, includes a number of regulations that were introduced to prevent investment bankers from pressuring analysts to provide favorable projections.

The previously cited *Wall Street Journal* article acknowledged the impact of the new regulatory rules in explaining the recent results:[4]

[3] S. Richardson, S. Teoh, and P. Wysocki, "The Walk-Down to Beatable Analyst Forecasts: The Role of Equity Issuance and Insider Trading Incentives," *Contemporary Accounting Research*, pp. 885–924, (2004).
[4] Spencer Jakab, "Earnings Surprises Lose Punch," *Wall Street Journal* (May 6, 2012), p. C1.

Exhibit JRW-16
Appendix B
The Research on Analysts' Long-Term EPS Growth Rate Forecasts

> What changed? One potential reason is the tightening of rules governing analyst contacts with management. Analysts now must rely on publicly available guidance or, gasp, figure things out by themselves. That puts companies, with an incentive to set the bar low so that earnings are received positively, in the driver's seat. While that makes managers look good short-term, there is no lasting benefit for buy-and-hold investors.

These comments on the impact of regulatory developments on the accuracy of short-term EPS estimates was addressed in a study by Hovakimian and Saenyasiri (2010).[5] The authors investigate analysts' forecasts of annual earnings for the following time periods: (1) the time prior to Reg FD (1984-2000); (2) the time period after Reg FD but prior to GARS (2000-2002);[6] and (3) the time period after GARS (2002-2006). For the pre-Reg FD period, Hovakimian and Saenyasiri find that analysts generally make overly optimistic forecasts of annual earnings. The forecast bias is higher for early forecasts and steadily declines in the months leading up to the earnings announcement. The results are similar for the time period after Reg FD but prior to GARS. However, the bias is lower in the later forecasts (the forecasts made just prior to the announcement). For the time period after GARS, the average forecasts declined significantly, but a positive bias remains. In sum, Hovakimian and Saenyasiri find that: (1) analysts make overly optimistic short-term forecasts of annual earnings; (2) Reg FD had no effect on this bias; and (3) GARS did result in a significant reduction in the bias, but analysts' short-term forecasts of annual earnings still have a small positive bias.

[5] A. Hovakimian and E. Saenyasiri, "Conflicts of Interest and Analysts Behavior: Evidence from Recent Changes in Regulation," *Financial Analysts Journal*, Vol. 66, pp. 96-107 (2010).

[6] Whereas the GARS settlement was signed in 2003, rules addressing analysts' conflict of interest by separating the research and investment banking activities of analysts went into effect with the passage of NYSE and NASD rules in July of 2002.

B. RESEARCH ON THE ACCURACY OF ANALYSTS' LONG-TERM EPS GROWTH RATE FORECASTS

There have been very few studies regarding the accuracy of analysts' long-term EPS growth rate forecasts. Cragg and Malkiel (1968) studied analysts' long-term EPS growth rate forecasts made in 1962 and 1963 by five brokerage houses for 185 firms. They concluded that analysts' long-term earnings growth forecasts are on the whole no more accurate than naive forecasts based on past earnings growth. Harris (1999) evaluated the accuracy of analysts' long-term EPS forecasts over the 1982-1997 time period using a sample of 7,002 firm-year observations.[7] He concluded the following: (1) the accuracy of analysts' long-term EPS forecasts is very low; (2) a superior long-run method to forecast long-term EPS growth is to assume that all companies will have an earnings growth rate equal to historic GDP growth; and (3) analysts' long-term EPS forecasts are significantly upwardly biased, with forecasted earnings growth exceeding actual earnings growth by seven percent per annum. Subsequent studies by DeChow, P., A. Hutton, and R. Sloan (2000), and Chan, Karceski, and Lakonishok (2003) also conclude that analysts' long-term EPS growth rate forecasts are overly optimistic and upwardly biased.[8] The Chan, Karceski, and Lakonishok (2003) study evaluated the accuracy of analysts' long-term EPS growth rate forecasts over the 1982-98 time period. They reported a median IBES growth forecast of 14.5%, versus a median realized five-year growth rate of about 9%. They also found the IBES forecasts of EPS beyond two years are not accurate.

[7] R.D. Harris, "The Accuracy, Bias, and Efficiency of Analysts' Long Run Earnings Growth Forecasts," *Journal of Business Finance & Accounting*, Vol. 26(5)&(6), pp. 725-55 (June/July 1999).

[8] P. DeChow, A. Hutton, and R. Sloan, "The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings," *Contemporary Accounting Research,* Vol. 17, pp. 1-22 *(2000)* and K. Chan, L., Karceski, J., & Lakonishok, J., "The Level and Persistence of Growth Rates," *The Journal of Finance,* Vol. 58, pp. 643–684, (2003).

They concluded the following: "Over long horizons, however, there is little forecastability in earnings, and analysts' estimates tend to be overly optimistic." Id. at 683

Lacina, Lee, and Xu (2011) evaluated the accuracy of analysts' long-term earnings growth rate forecasts over the 1983-2003 time period.[9] The study included 27,081 firm year observations, and compared the accuracy of analysts' EPS forecasts to those produced by two naïve forecasting models: (1) a random walk model ("RW") where the long-term EPS (t+5) is simply equal to last year's EPS figure (t-1); and (2) a RW model with drift ("RWGDP"), where the drift or growth rate is GDP growth for period t-1. In this model, long-term EPS (t+5) is simply equal to last year's EPS figure (t-1) times (1 + GDP growth (t-1)). The authors conclude that that using the RW model to forecast EPS in the next 3-5 years proved to be just as accurate as using the EPS estimates from analysts' long-term earnings growth rate forecasts. They find that the RWGDP model performs better than the pure RW model, and that both models perform as well as analysts in forecasting long-term EPS. They also discover an optimistic bias in analysts' long-term EPS forecasts. In the authors' opinion, these results indicate that analysts' long-term earnings growth rate forecasts should be used with caution as inputs for valuation and cost of capital purposes.

[9] M. Lacina, B. Lee and Z. Xu, "An Evaluation of Financial Analysts and Naïve Methods in Forecasting Long-term Earnings," *Advances in Business and Management Forecasting,* (Vol. 8), Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101

C. ISSUES REGARDING THE SUPERIORITY OF ANALYSTS' EPS FORECASTS OVER HISTORIC AND TIME-SERIES ESTIMATES OF LONG-TERM EPS GROWTH

As highlighted by the classic study by Brown and Rozeff (1978) and the other studies that followed, analysts' forecasts of quarterly earnings estimates are superior to the estimates derived from historic and time-series analyses.[10] This is often attributed to the information and timing advantage that analysts have over historic and time-series analyses. These studies relate to analysts' forecasts of quarterly and/or annual forecasts, and not to long-term EPS growth rate forecasts. The previously cited studies by Harris (1999), Chan, Karceski, and Lakonishok (2003), and Lacina, Lee, and Xu (2011) all conclude that analysts' forecasts are no better than time-series models and historic growth rates in forecasting long-term EPS. Harris (1999) and Lacina, Lee, and Xu (2011) concluded that historic GDP growth was superior to analysts' forecasts for long run earnings growth. These overall results are similar to the findings by Bradshaw, Drake, Myers, and Myers (2010) that discovered that time-series estimates of annual earnings are more accurate over longer horizons than analysts' forecasts of earnings. As the authors conclude these findings suggest an incomplete and misleading generalization about the superiority of analysts' forecasts over even simple time-series-based earnings forecasts.[11]

[10] L. Brown and M. Rozeff, "The Superiority of Analyst Forecasts as Measures of Expectations: Evidence from Earnings," *The Journal of Finance*, Vol. 33 (1): pp. 1-16 (1978).
[11] M. Bradshaw, M. Drake, J. Myers, and L. Myers, "A Re-examination of Analysts' Superiority Over Time-Series Forecasts of Annual Earnings," Workings paper, (2010), http://ssrn.com/abstract=1528987.

D. STUDY OF THE ACCURACY OF ANALYSTS' LONG-TERM EARNINGS GROWTH RATES

To evaluate the accuracy of analysts' EPS forecasts, I have compared actual 3-5 year EPS growth rates with forecasted EPS growth rates on a quarterly basis over 20 years for all companies covered by the I/B/E/S data base. In Panel A of page 1 of Attachment JRW-B1, I show the average analysts' forecasted 3-5 year EPS growth rate with the average actual 3-5 year EPS growth rate for twenty years.

The following example shows how the results can be interpreted. For the 3-5 year period prior to the first quarter of 1999, analysts had projected an EPS growth rate of 15.13%, but companies only generated an average annual EPS growth rate over the 3-5 years of 9.37%. This projected EPS growth rate figure represented the average projected growth rate for over 1,510 companies, with an average of 4.88 analysts' forecasts per company. For the entire twenty-year period of the study, for each quarter there were on average 5.6 analysts' EPS projections for 1,281 companies. Overall, my findings indicate that forecast errors for long-term estimates are predominantly positive, which indicates an upward bias in growth rate estimates. The mean and median forecast errors over the observation period are 143.06% and 75.08%, respectively. The forecasting errors are negative for only eleven of the eighty quarterly time periods: five consecutive quarters starting at the end of 1995 and six consecutive quarters starting in 2006. As shown in Panel A of page 1 of Attachment JRW-B1, the quarters with negative forecast errors were for the 3-5 year periods following earnings declines associated with the 1991 and 2001 economic recessions in the U.S. Thus, there is evidence of a persistent upward bias in long-term EPS growth forecasts.

Exhibit JRW-16
Appendix B
The Research on Analysts' Long-Term EPS Growth Rate Forecasts

The average 3-5 year EPS growth rate projections for all companies provided in the I/B/E/S database on a quarterly basis from 1988 to 2008 are shown in Panel B of page 1 of Attachment JRW-B1. In this graph, no comparison to actual EPS growth rates is made, and hence, there is no follow-up period. Therefore, since companies are not lost from the sample due to a lack of follow-up EPS data, these results are for a larger sample of firms. The average projected growth rate increased to the 18.0% range in 2006, and has since decreased to about 14.0%.

The upward bias in analysts' long-term EPS growth rate forecasts appears to be known in the markets. Page 2 of Attachment JRW-B1 provides an article published in the *Wall Street Journal*, dated March 21, 2008, that discusses the upward bias in analysts' EPS growth rate forecasts.[12] In addition, a recent *Bloomberg Businessweek* article also highlighted the upward bias in analysts' EPS forecasts, citing a study by McKinsey Associates. This article is provided on pages 3 and 4 of Attachment JRW-B1. The article concludes with the following:[13]

The bottom line: *Despite reforms intended to improve Wall Street research, stock analysts seem to be promoting an overly rosy view of profit prospects.*

E. REGULATORY DEVELOPMENTS AND THE ACCURACY OF ANALYSTS' LONG-TERM EARNINGS GROWTH RATES FORECASTS

Whereas Hovakimian and Saenyasiri evaluated the impact of regulations on analysts' short-term EPS estimates, there is little research on the impact of Reg FD and

[12] Andrew Edwards, "Study Suggests Bias in Analysts' Rosy Forecasts," *Wall Street Journal* (March 21, 2008), p. C6.
[13] Roben Farzad, "For Analysts, Things are Always Looking Up," *Bloomberg Businessweek*, pp. 39-40 (June10, 2010).

GARS on the long-term EPS forecasts of Wall Street analysts. My study with Patrick Cusatis did find that the long-term EPS growth rate forecasts of analysts did not decline significantly and have continued to be overly optimistic in the post-Reg FD and GARS period.[14] Analysts' long-term EPS growth rate forecasts before and after GARS are about two times the level of historic GDP growth. These observations are supported by a *Wall Street Journal* article entitled "Analysts Still Coming Up Rosy – Over-Optimism on Growth Rates is Rampant – and the Estimates Help to Buoy the Market's Valuation." The following quote provides insight into the continuing bias in analysts' forecasts:

> "Hope springs eternal," says Mark Donovan, who manages Boston Partners Large Cap Value Fund. "You would have thought that, given what happened in the last three years, people would have given up the ghost. But in large measure they have not."
>
> These overly optimistic growth estimates also show that, even with all the regulatory focus on too-bullish analysts allegedly influenced by their firms' investment-banking relationships, a lot of things haven't changed: Research remains rosy and many believe it always will.[15]

These observations are echoed in a recent McKinsey study entitled "Equity Analysts: Still too Bullish" which involved a study of the accuracy on analysts long-term EPS growth rate forecasts. The authors conclude that after a decade of stricter regulation, analysts' long-term earnings forecasts continue to be excessively optimistic. They made the following observation (emphasis added): [16]

---

[14] P. Cusatis and J. R. Woolridge, "The Accuracy of Analysts' Long-Term EPS Growth Rate Forecasts," Working Paper (July 2008).
[15] Ken Brown, "Analysts: Still Coming Up Rosy – Over-Optimism on Growth Rates is Rampant, and the Estimates Help to Buoy the Market's Valuation," *Wall Street Journal*, p. C1 (January 27, 2003).
[16] Marc H. Goedhart, Rishi Raj, and Abhishek Saxena, "Equity Analysts: Still Too Bullish," *McKinsey on Finance*, pp. 14-17 (2010).

> Alas, a recently completed update of our work only reinforces this view—despite a series of rules and regulations, dating to the last decade, that were intended to improve the quality of the analysts' long-term earnings forecasts, restore investor confidence in them, and prevent conflicts of interest. For executives, many of whom go to great lengths to satisfy Wall Street's expectations in their financial reporting and long-term strategic moves, this is a cautionary tale worth remembering.
>
> . . .
>
> This pattern confirms our earlier findings that analysts typically lag behind events in revising their forecasts to reflect new economic conditions. When economic growth accelerates, the size of the forecast error declines; when economic growth slows, it increases. So as economic growth cycles up and down, the actual earnings S&P 500 companies report occasionally coincide with the analysts' forecasts, as they did, for example, in 1988, from 1994 to 1997, and from 2003 to 2006.
>
> Moreover, analysts have been persistently overoptimistic for the past 25 years, with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth of 6 percent. Over this time frame, actual earnings growth surpassed forecasts in only two instances, both during the earnings recovery following a recession. On average, analysts' forecasts have been almost 100 percent too high.
> (footnotes and citation omitted)

F. ANALYSTS' LONG-TERM EPS GROWTH RATE FORECASTS FOR UTILITY COMPANIES

To evaluate whether analysts' EPS growth rate forecasts are upwardly biased for utility companies, I conducted a study similar to the one described above using a group of electric utility and gas distribution companies. The results are shown on Panels A and B of page 5 of Attachment JRW-B1. The projected EPS growth rates for electric utilities have been in the 4% to 6% range over twenty years, with the most recent figures at approximately 5%. As shown, the achieved EPS growth rates have been volatile and, on

average, below the projected growth rates. Over the entire period, the average quarterly 3-5 year projected and actual EPS growth rates are 4.59% and 2.90%, respectively.

For gas distribution companies, the projected EPS growth rates have declined from about 6% in the 1990s to about 5% in the 2000s. The achieved EPS growth rates have been volatile. Over the entire period, the average quarterly 3-5 year projected and actual EPS growth rates are 5.15% and 4.53%, respectively.

Overall, the upward bias in EPS growth rate projections for electric utility and gas distribution companies is not as pronounced as it is for all companies. Nonetheless, the results here are consistent with the results for companies in general -- analysts' projected EPS growth rate forecasts are upwardly biased for utility companies.

G. *VALUE LINE*'S LONG-TERM EPS GROWTH RATE FORECASTS

To assess *Value Line*'s earnings growth rate forecasts, I used the *Value Line Investment Analyzer*. The results are summarized in Panel A of Page 6 of Attachment JRW-B1. I initially filtered the database and found that *Value Line* has 3-5 year EPS growth rate forecasts for 2,333 firms. The average projected EPS growth rate was 14.70%. This is high given that the average historical EPS growth rate in the U.S. is about 7%. A major factor seems to be that *Value Line* only predicts negative EPS growth for 43 companies. This is less than two percent of the companies covered by *Value Line*. Given the ups and downs of corporate earnings, this is unreasonable.

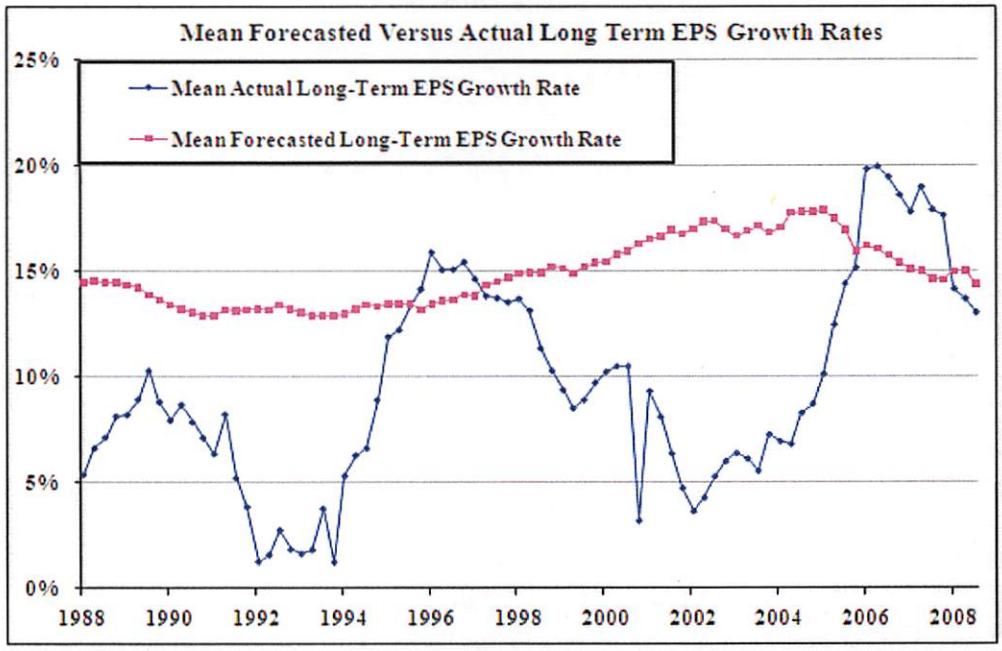
To put this figure in perspective, I screened the *Value Line* companies to see what percent of companies covered by *Value Line* had experienced negative EPS growth rates

over the past five years. *Value Line* reported a five-year historic growth rate for 2,219 companies. The results are shown in Panel B of page 6 of Attachment JRW-B1 and indicate that the average 5-year historic growth rate was 3.90%, and *Value Line* reported negative historic growth for 844 firms which represents 38.0% of these companies.

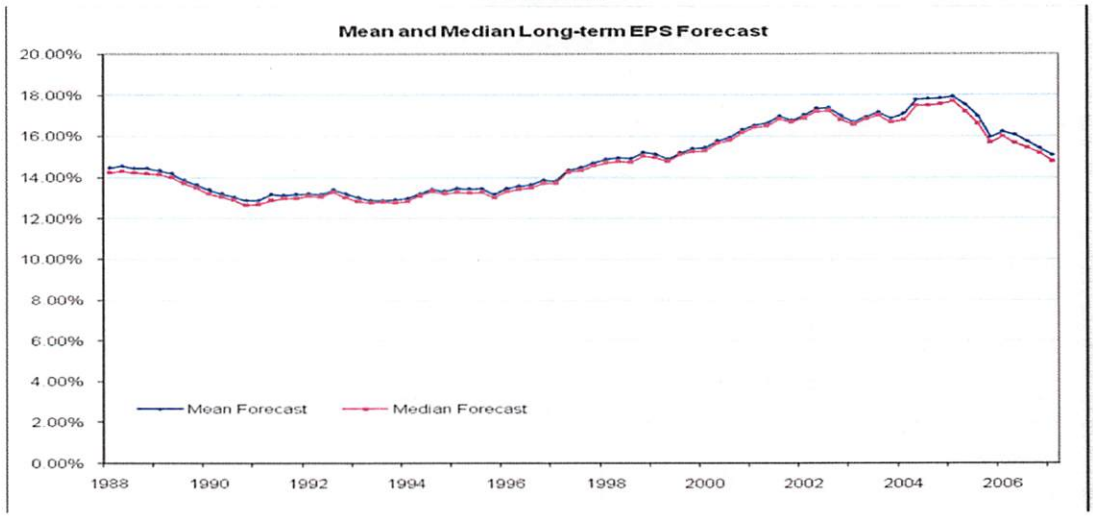
These results indicate that *Value Line*'s EPS forecasts are excessive and unrealistic. It appears that the analysts at *Value Line* are similar to their Wall Street brethren in that they are reluctant to forecast negative earnings growth.

Attachment JRW-B1
Analysts' Long-Term Projected EPS Growth Rate Analysis
Page 1

Panel A
Long-Term Forecasted Versus Actual EPS Growth Rates
1988-2009



Panel B
Long-Term Forecasted EPS Growth Rates
1988-2007



Source: Patrick J. Cusatis and J. Randall Woolridge, "The Accuracy of Analysts' Long-Term Earnings Per Share Growth Rate Forecasts," (July, 2008).

THE WALL STREET JOURNAL.

Study Suggests Bias in Analysts' Rosy Forecasts

By ANDREW EDWARDS
March 21, 2008; Page C6

Despite an economy teetering on the brink of a recession -- if not already in one -- analysts are still painting a rosy picture of earnings growth, according to a study done by Penn State's Smeal College of Business.

The report questions analysts' impartiality five years after then-New York Attorney General Eliot Spitzer forced analysts to pay $1.5 billion in damages after finding evidence of bias.

"Wall Street analysts basically do two things: recommend stocks to buy and forecast earnings," said J. Randall Woolridge, professor of finance. "Previous studies suggest their stock recommendations do not perform well, and now we show that their long-term earnings-per-share growth-rate forecasts are excessive and upwardly biased."

The report, which examined analysts' long-term (three to five years) and one-year per-share earnings expectations from 1984 through 2006 found that companies' long-term earnings growth surpassed analysts' expectations in only two instances, and those came right after recessions.

Over the entire time period, analysts' long-term forecast earnings-per-share growth averaged 14.7%, compared with actual growth of 9.1%. One-year per-share earnings expectations were slightly more accurate: The average forecast was for 13.8% growth and the average actual growth rate was 9.8%.

"A significant factor in the upward bias in long-term earnings-rate forecasts is the reluctance of analysts to forecast" profit declines, Mr. Woolridge said. The study found that nearly one-third of all companies experienced profit drops over successive three-to-five-year periods, but analysts projected drops less than 1% of the time.

The study's authors said, "Analysts are rewarded for biased forecasts by their employers, who want them to hype stocks so that the brokerage house can garner trading commissions and win underwriting deals."

They also concluded that analysts are under pressure to hype stocks to generate trading commissions, and they often don't follow stocks they don't like.

Write to Andrew Edwards at andrew.edwards@dowjones.com

Markets & Finance June 10, 2010, 5:00PM EST

Bloomberg Businessweek

For Analysts, Things Are Always Looking Up

They're raising earnings estimates for U.S. companies at a record pace

By Roben Farzad

For years, the rap on Wall Street securities analysts was that they were shills, reflexively producing upbeat research on companies they cover to help their employers win investment banking business. The dynamic was well understood: Let my bank take your company public, or advise it on this acquisition, and—wink, wink—I will recommend your stock through thick or thin. After the Internet bubble burst, that was supposed to change. In April 2003 the Securities & Exchange Commission reached a settlement with 10 Wall Street firms in which they agreed, among other things, to separate research from investment banking.

Seven years on, Wall Street analysts remain a decidedly optimistic lot. Some economists look at the global economy and see troubles—the European debt crisis, persistently high unemployment worldwide, and housing woes in the U.S. Stock analysts as a group seem unfazed. Projected 2010 profit growth for companies in the Standard & Poor's 500-stock index has climbed seven percentage points this quarter, to 34 percent, data compiled by Bloomberg show. According to Sanford C. Bernstein (AB), that's the fastest pace since 1980, when the Dow Jones industrial average was quoted in the hundreds and Nancy Reagan was getting ready to order new window treatments for the Oval Office.

Among the companies analysts expect to excel: Intel (INTL) is projected to post an increase in net income of 142 percent this year. Caterpillar, a multinational that gets much of its revenue abroad, is expected to boost its net income by 47 percent this year. Analysts have also hiked their S&P 500 profit estimate for 2011 to $95.53 a share, up from $92.45 at the beginning of January, according to Bloomberg data. That would be a record, surpassing the previous high reached in 2007.

With such prospects, it's not surprising that more than half of S&P 500-listed stocks boast overall buy ratings. It is telling that the proportion has essentially held constant at both the market's October 2007 high and March 2009 low, bookends of a period that saw stocks fall by more than half. If the analysts are correct, the market would appear to be attractively priced right now. Using the $95.53 per share figure, the price-to-earnings ratio of the S&P 500 is a modest 11 as of June 9. If, however, analysts end up being too high by, say, 20 percent, the P/E would jump to almost 14.

If history is any guide, chances are good that the analysts are wrong. According to a recent McKinsey report by Marc Goedhart, Rishi Raj, and Abhishek Saxena, "Analysts have been persistently over-optimistic for 25 years," a stretch that saw them peg earnings growth at 10 percent to 12 percent a year when the actual number was ultimately 6 percent. "On average," the researchers note, "analysts' forecasts have been almost 100 percent too high," even after regulations were enacted to weed out conflicts and improve the rigor of their calculations. As the chart below shows, in most years analysts have been forced to lower their estimates after it became apparent they had set them too high.

While a few analysts, like Meredith Whitney, have made their names on bearish calls, most are chronically bullish. Part of the problem is that despite all the reforms they remain too aligned with the companies they cover. "Analysts still need to get the bulk of their information from companies, which have an incentive to be over-optimistic," says Stephen Bainbridge, a professor at UCLA Law School who specializes in the securities industry. "Meanwhile, analysts don't want to threaten that ongoing access by being too negative." Bainbridge says that with the era of the overpaid, superstar analyst long over, today's job description calls for resisting the urge to be an iconoclast. "It's a matter of herd behavior," he says.

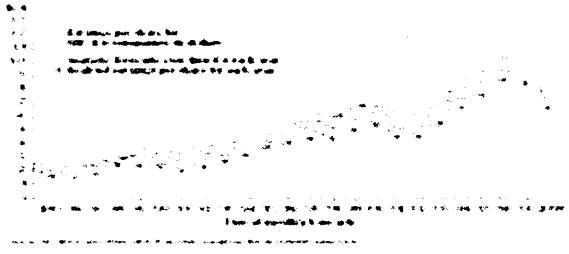
So what's a more plausible estimate of companies' earning power? Looking at factors including the strengthening dollar, which hurts exports, and higher corporate borrowing costs, David Rosenberg, chief economist at Toronto-based investment shop Gluskin Sheff + Associates, says "disappointment looms." Bernstein's Adam Parker says every 10 percent drop in the value of the euro knocks U.S. corporate earnings down by 2.5 percent to 3 percent. He sees the S&P 500 earning $86 a share next year.

As realities hit home, "It's only natural that analysts will have to revise down their views," says Todd Salamone, senior vice-president at Schaeffer's Investment Research. The market may be making its own downward adjustment, as the S&P 500 has already fallen 14 percent from its high in April. If precedent holds, analysts are bound to curb their enthusiasm belatedly, telling us next year what we really needed to know this year.

The bottom line: *Despite reforms intended to improve Wall Street research, stock analysts seem to be promoting an overly rosy view of profit prospects.*

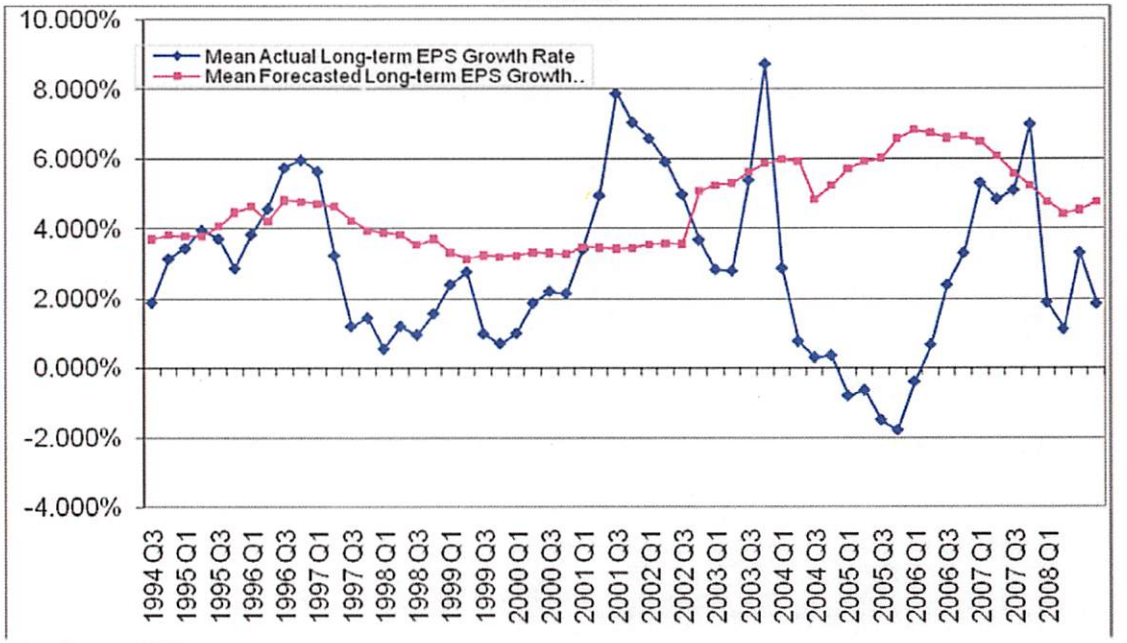
Bloomberg Businessweek Senior Writer Farzad covers Wall Street and international finance.

The Earnings Roller Coaster



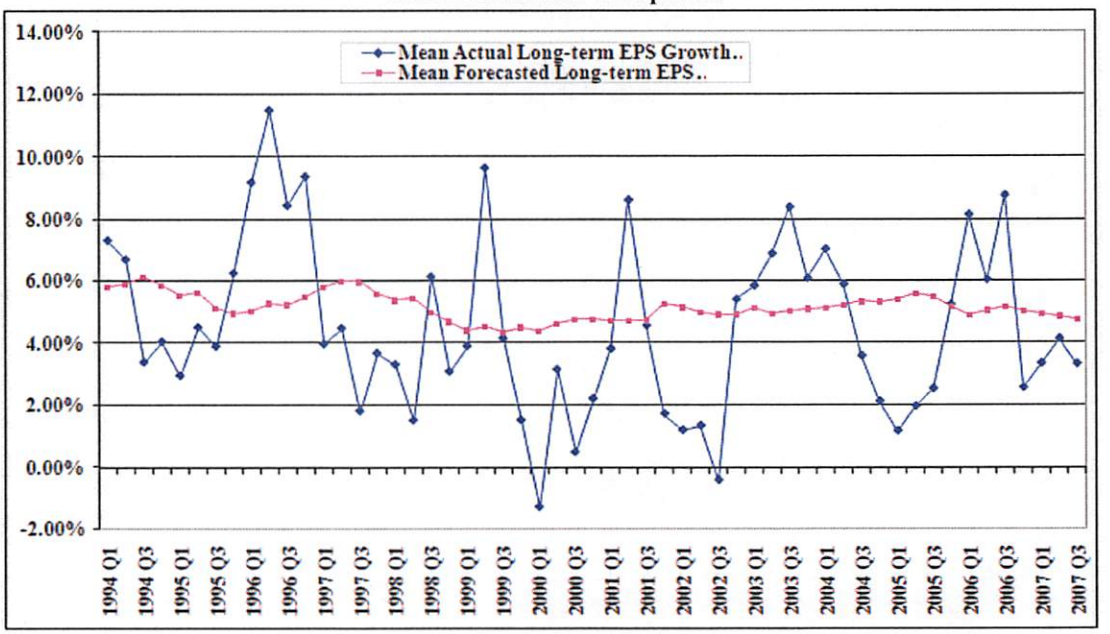
Attachment JRW-B1
Analysts' Long-Term Projected EPS Growth Rate Analysis
Page 5

Panel A
Long-Term Forecasted Versus Actual EPS Growth Rates
Electric Utility Companies
1988-2008



Data Source: IBES

Panel B
Long-Term Forecasted Versus Actual EPS Growth Rates
Gas Distribution Companies



Attachment JRW-B1
Analysts' Long-Term Projected EPS Growth Rate Analysis
Page 6

Panel A
Value Line 3-5 year EPS Growth Rate Forecasts

	Average Projected EPS Growth rate	Number of Negative EPS Growth Projections	Percent of Negative EPS Growth Projections
2,333 Companies	14.70%	43	1.80%

Value Line Investment Survey, June, 2012

Panel B
Historical Five-Year EPS Growth Rates for Value Line Companies

	Average Historical EPS Growth rate	Number with Negative Historical EPS Growth	Percent with Negative Historical EPS Growth
2,219 Companies	3.90%	844	38.00%

Value Line Investment Survey, June, 2012

Exhibit JRW-16
Appendix C
Building Blocks Equity Risk Premium

A. THE BUILDING BLOCKS MODEL

Ibbotson and Chen (2003) evaluate the *ex post* historical mean stock and bond returns in what is called the Building Blocks approach.[1] They use 75 years of data and relate the compounded historical returns to the different fundamental variables employed by different researchers in building *ex ante* expected equity risk premiums. Among the variables included were inflation, real EPS and DPS growth, ROE and book value growth, and price-earnings ("P/E") ratios. By relating the fundamental factors to the *ex post* historical returns, the methodology bridges the gap between the *ex post* and *ex ante* equity risk premiums. Ilmanen (2003) illustrates this approach using the geometric returns and five fundamental variables – inflation ("CPI"), dividend yield ("D/P"), real earnings growth ("RG"), repricing gains ("PEGAIN"), and return interaction/reinvestment ("INT").[2] This is shown on page 1 of Exhibit JRW-C1. The first column breaks down the 1926-2000 geometric mean stock return of 10.7% into the different return components demanded by investors: the historical U.S. Treasury bond return (5.2%), the excess equity return (5.2%), and a small interaction term (0.3%). This 10.7% annual stock return over the 1926-2000 period can then be broken down into the following fundamental elements: inflation (3.1%), dividend yield (4.3%), real earnings growth (1.8%), repricing gains (1.3%) associated with higher P/E ratios, and a small interaction term (0.2%).

[1] Roger Ibbotson and Peng Chen, "Long Run Returns: Participating in the Real Economy," *Financial Analysts Journal*, Vol. 54, pp. 88-98(January 2003).

[2] Antti Ilmanen, "Expected Returns on Stocks and Bonds," *Journal of Portfolio Management*, pp. 11, 7-27 (Winter 2003).

The third column in the graph on page 1 of Exhibit JRW-C1 shows current inputs to estimate an *ex ante* expected market return. These inputs include the following:

CPI – To assess expected inflation, I have employed expectations of the short-term and long-term inflation rate. Long-term inflation forecasts are available in the Federal Reserve Bank of Philadelphia's publication entitled *Survey of Professional Forecasters*. While this survey is published quarterly, only the first quarter survey includes long-term forecasts of gross domestic product ("GDP") growth, inflation, and market returns. In the first quarter 2014 survey, published on February 14, 2014, the median long-term (10-year) expected inflation rate as measured by the CPI was 2.30% (see Panel A of page 2 of Exhibit JRW-C1).

The University of Michigan's Survey Research Center surveys consumers on their short-term (one-year) inflation expectations on a monthly basis. As shown on page 3 of Exhibit JRW-C1, the current short-term expected inflation rate is 3.1 %.

As a measure of expected inflation, I will use the average of the long-term (2.3%) and short-term (3.0%) inflation rate measures, or 2.65%.

D/P – As shown on page 4 of Exhibit JRW-C1, the dividend yield on the S&P 500 has fluctuated from 1.0% to almost 3.5% from 2000-2010. Ibbotson and Chen (2003) reports that the long-term average dividend yield of the S&P 500 is 4.3%. As of February 2014, the indicated S&P 500 dividend yield was 2.1%. I will use this figure in my *ex ante* risk premium analysis.

RG – To measure expected real growth in earnings, I use the historical real earnings growth rate S&P 500 and the expected real GDP growth rate. The S&P 500 was created in 1960 and includes 500 companies which come from ten different sectors of the economy. On page 5 of Exhibit JRW-C1, real EPS growth is computed using the CPI as a measure of inflation. The real growth figure over 1960-2011 period for the S&P 500 is 2.8%.

The second input for expected real earnings growth is expected real GDP growth. The rationale is that over the long-term, corporate profits have averaged 5.50% of U.S. GDP.[3] Expected real GDP growth, according to the Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters,* is 2.6% (see Panel B of page 2 of Exhibit JRW-C1).

Given these results, I will use 2.75%, for real earnings growth.

PEGAIN – PEGAIN is the repricing gain associated with an increase in the P/E ratio. It accounted for 1.3% of the 10.7% annual stock return in the 1926-2000 period. In estimating an *ex ante* expected stock market return, one issue is whether investors expect P/E ratios to increase from their current levels. The P/E ratios for the S&P 500 over the past 25 years are shown on page 4 of Exhibit JRW-C1. The run-up and eventual peak in P/Es in the year 1999 is very evident in the chart. The average P/E declined until late 2006, and then increased to higher high levels, primarily due to the decline in EPS as a result of the financial crisis and the recession. As of February, 2014, the average P/E for the S&P 500 was 15.1X, which is in line with the historic

[3]Marc. H. Goedhart, et al, "The Real Cost of Equity," *McKinsey on Finance,* pp. 14, 11-15 (Autumn 2002).

average. Since the current figure is near the historic average, a PEGAIN would not be appropriate in estimating an ex ante expected stock market return.

Expected Return form Building Blocks Approach - The current expected market return is represented by the last column on the right in the graph entitled "Decomposing Equity Market Returns: The Building Blocks Methodology" set forth on page 1 of Exhibit JRW-C1. As shown, the expected market return of 7.50% is composed of 2.75% expected inflation, 2.10% dividend yield, and 2.65% real earnings growth rate.

This expected return of 7.50% is consistent with other expected return forecasts.

1. In the first quarter 2014 *Survey of Financial Forecasters*, published on February 15, 2014 by the Federal Reserve Bank of Philadelphia, the mean long-term expected return on the S&P 500 was 6.43% (see Panel D of page 2 of Exhibit JRW-C1).
2. John Graham and Campbell Harvey of Duke University conduct a quarterly survey of corporate CFOs. The survey is a joint project of Duke University and *CFO Magazine*. In the July, 2014 survey, the mean expected return on the S&P 500 over the next ten years was 6.60%.[4]

[4] The survey results are available at www.cfosurvey.org.

B. THE BUILDING BLOCKS EQUITY RISK PREMIUM

The current 30-year U.S. Treasury yield is 3.5%. This ex ante equity risk premium is simply the expected market return from the Building Blocks methodology minus this risk-free rate:

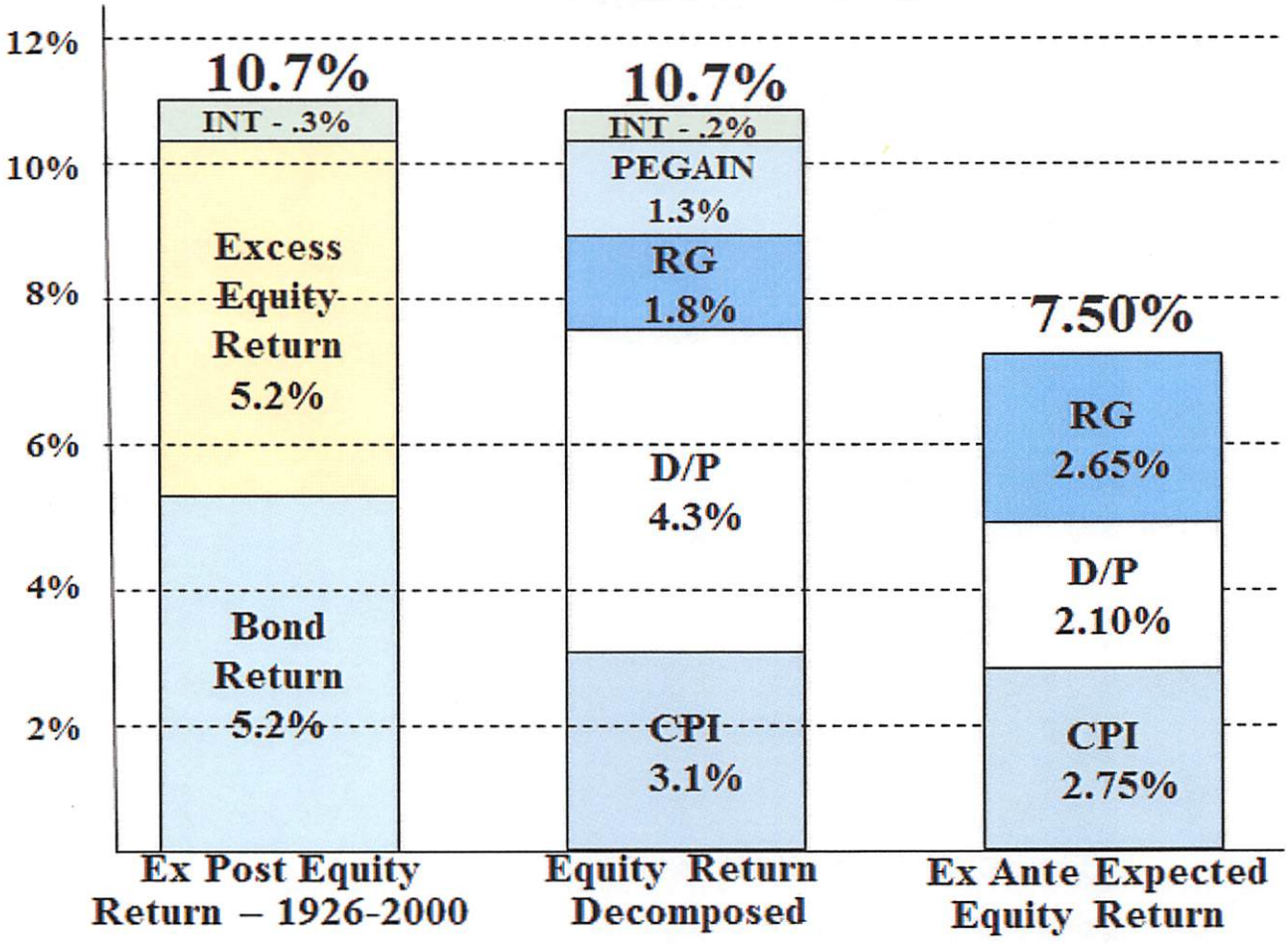
Ex Ante Equity Risk Premium = 7.50% - 3.50% = 4.0%

This is only one estimate of the equity risk premium. As shown on page 6 of Exhibit JRW-11, I am also using the results of many other studies and surveys to determine an equity risk premium for my CAPM.

Attachment JRW-C1
Building Blocks Equity Risk Premium
Page 1

Attachment JRW-C1

Decomposing Equity Market Returns
The Building Blocks Methodology



Attachment JRW-C1

2014 Survey of Professional Forecasters
Philadelphia Federal Reserve Bank
Long-Term Forecasts

Table Seven
LONG-TERM (10 YEAR) FORECASTS

Panel A

SERIES: CPI INFLATION RATE	
STATISTIC	
MINIMUM	1.21
LOWER QUARTILE	2.05
MEDIAN	2.30
UPPER QUARTILE	2.50
MAXIMUM	3.40
MEAN	2.29
STD. DEV.	0.39
N	40
MISSING	5

Panel B

SERIES: REAL GDP GROWTH RATE	
STATISTIC	
MINIMUM	1.75
LOWER QUARTILE	2.40
MEDIAN	2.60
UPPER QUARTILE	2.80
MAXIMUM	3.50
MEAN	2.57
STD. DEV.	0.39
N	38
MISSING	7

Panel C

SERIES: PRODUCTIVITY GROWTH	
STATISTIC	
MINIMUM	1.00
LOWER QUARTILE	1.50
MEDIAN	1.80
UPPER QUARTILE	2.00
MAXIMUM	2.40
MEAN	1.76
STD. DEV.	0.37
N	29
MISSING	16

Panel D

SERIES: STOCK RETURNS (S&P 500)	
STATISTIC	
MINIMUM	2.70
LOWER QUARTILE	5.00
MEDIAN	6.00
UPPER QUARTILE	7.20
MAXIMUM	12.00
MEAN	6.43
STD. DEV.	2.07
N	27
MISSING	18

Panel E

SERIES: BOND RETURNS (10-YEAR)	
STATISTIC	
MINIMUM	2.70
LOWER QUARTILE	4.00
MEDIAN	4.35
UPPER QUARTILE	4.70
MAXIMUM	5.30
MEAN	4.25
STD. DEV.	0.64
N	33
MISSING	12

Panel F

SERIES: BILL RETURNS (3-MONTH)	
STATISTIC	
MINIMUM	0.10
LOWER QUARTILE	1.92
MEDIAN	2.50
UPPER QUARTILE	2.88
MAXIMUM	4.20
MEAN	2.37
STD. DEV.	0.85
N	32
MISSING	13

Source: Philadelphia Federal Researve Bank, Survey of Professional Forecasters, February 15, 2014.

Attachment JRW-C1

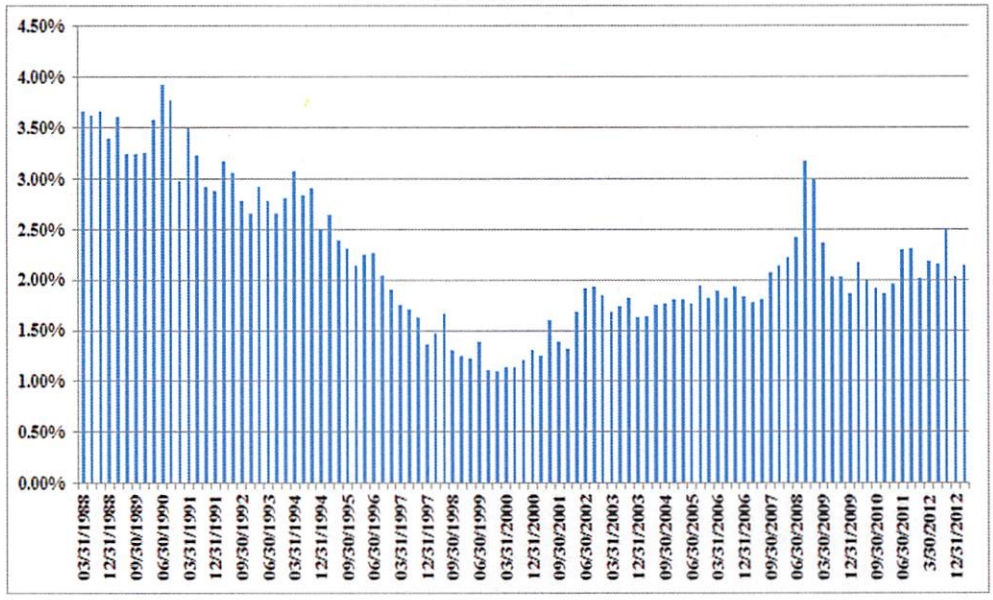
University of Michigan Survey Research Center
Expected Short-Term Inflation Rate

Data Source: http://research.stlouisfed.org/fred2/series/MICH?cid=98

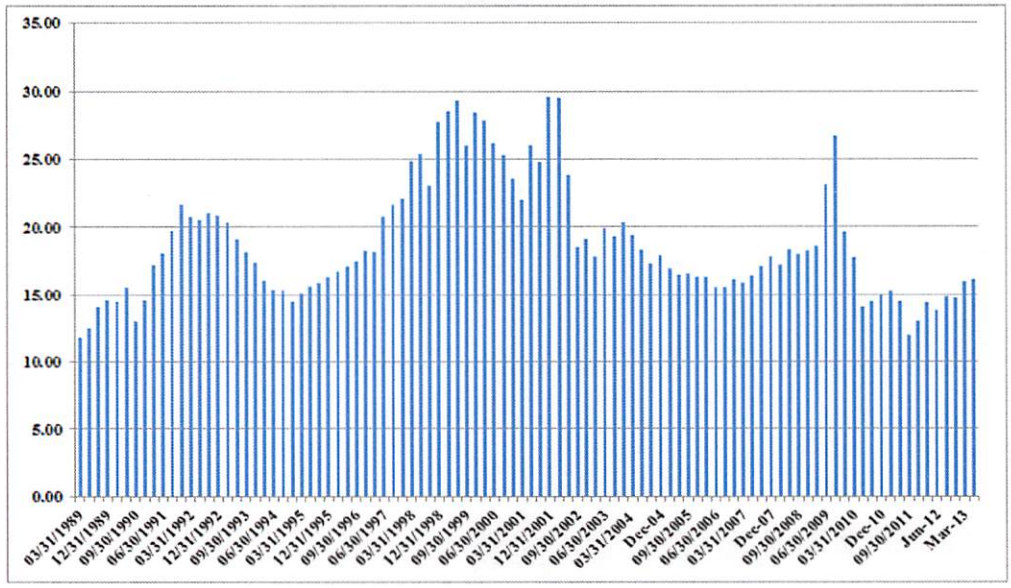
Attachment JRW-C1

Decomposing Equity Market Returns
The Building Blocks Methodology

S&P 500 Dividend Yield



S&P 500 P/E Ratio



Attachment JRW-C1

Real S&P 500 EPS Growth Rate

Year	S&P 500 EPS	Annual Inflation CPI	Inflation Adjustment Factor	Real S&P 500 EPS	
1960	3.10	1.48%	1.00	3.10	
1961	3.37	0.67%	1.01	3.35	
1962	3.67	1.22%	1.02	3.60	
1963	4.13	1.65%	1.04	3.99	
1964	4.76	1.19%	1.05	4.54	
1965	5.30	1.92%	1.07	4.96	
1966	5.41	3.35%	1.10	4.90	
1967	5.46	3.04%	1.14	4.80	
1968	5.72	4.72%	1.19	4.80	
1969	6.10	6.11%	1.26	4.83	
1970	5.51	5.49%	1.33	4.13	10-Year
1971	5.57	3.36%	1.38	4.04	2.91%
1972	6.17	3.41%	1.43	4.33	
1973	7.96	8.80%	1.55	5.13	
1974	9.35	12.20%	1.74	5.37	
1975	7.71	7.01%	1.86	4.14	
1976	9.75	4.81%	1.95	4.99	
1977	10.87	6.77%	2.08	5.22	
1978	11.64	9.03%	2.27	5.12	
1979	14.55	13.31%	2.57	5.65	
1980	14.99	12.40%	2.89	5.18	10-Year
1981	15.18	8.94%	3.15	4.82	2.29%
1982	13.82	3.87%	3.27	4.22	
1983	13.29	3.80%	3.40	3.91	
1984	16.84	3.95%	3.53	4.77	
1985	15.68	3.77%	3.67	4.28	
1986	14.43	1.13%	3.71	3.89	
1987	16.04	4.41%	3.87	4.14	
1988	24.12	4.42%	4.04	5.97	
1989	24.32	4.65%	4.23	5.75	
1990	22.65	6.11%	4.49	5.05	10-Year
1991	19.30	3.06%	4.63	4.17	-0.26%
1992	20.87	2.90%	4.76	4.38	
1993	26.90	2.75%	4.89	5.50	
1994	31.75	2.67%	5.02	6.32	
1995	37.70	2.54%	5.15	7.32	
1996	40.63	3.32%	5.32	7.64	
1997	44.09	1.70%	5.41	8.15	
1998	44.27	1.61%	5.50	8.05	
1999	51.68	2.68%	5.64	9.16	
2000	56.13	3.39%	5.84	9.62	10-Year
2001	38.85	1.55%	5.93	6.56	6.66%
2002	46.04	2.38%	6.07	7.59	
2003	54.69	1.88%	6.18	8.85	
2004	67.68	3.26%	6.38	10.60	
2005	76.45	3.52%	6.61	11.57	
2006	87.72	2.03%	6.74	13.01	
2007	82.54	4.08%	7.02	11.76	
2008	65.39	0.90%	7.08	9.24	
2009	59.65	2.72%	7.27	8.20	
2010	83.66	1.50%	7.38	11.33	10-Year
2011	97.05	2.96%	7.60	12.77	1.65%
2012	102.47	1.74%	7.73	13.25	
2013	107.45	0.015	7.85	13.69	
Data Source: http://pages.stern.nyu.edu/~adamodar/				Real EPS Growth	2.8%

Exhibit JRW-16
Appendix D
The Use of Historical Returns to Measure an Expected Risk Premium

It is quite common for analysts to estimate an equity or market risk premium as the difference between historical stock and bond returns. However, using the historical relationship between stock and bond returns to measure an *ex ante* equity risk premium can produce an inflated measure of the true market or equity risk premium. The equity risk premium is based on expectations of the future. When past market conditions vary significantly from the present, historic data does not provide a realistic or accurate barometer of expectations of the future. More significantly, there are a number of empirical issues that can result in historical returns being poor measures of the expected risk premium.

There are a number of issues in using historic returns over long time periods to estimate expected equity risk premiums. These issues include:

(A) Biased historical bond returns

(B) Use of the arithmetic versus the geometric mean return

(C) The large error in measuring the equity risk premium using historical returns

(D) Unattainable and biased historical stock returns

(E) Company Survivorship bias

(F) The "Peso Problem" - U.S. stock market survivorship bias

(G) One of the Biggest Mistakes in Teaching Finance

These issues will be addressed in order.

A. Biased Historical Bond Returns

An essential assumption of this approach is that over long periods of time, investors'

expectations are realized. However, the experienced returns of bondholders in the past invalidate this critical assumption. Historic bond returns are biased downward as a measure of expectancy because of capital losses suffered by bondholders in the past. As such, risk premiums derived from this data are biased upwards.

B. The Arithmetic versus the Geometric Mean Return

The measure of investment return has a significant effect on the interpretation of the risk premium results. When analyzing a single security price series over time (i.e., a time series), the best measure of investment performance is the geometric mean return. Using the arithmetic mean overstates the return experienced by investors. In a study entitled "Risk and Return on Equity: The Use and Misuse of Historical Estimates," Carleton and Lakonishok make the following observation: "The geometric mean measures changes in wealth over more than one period on a buy and hold (with dividends reinvested) strategy."[1] When a historic stock and bond return study covers more than one period (and he assumes that dividends are reinvested), he should be employing the geometric mean and not the arithmetic mean.

To demonstrate the upward bias of the arithmetic mean, consider the following example. Assume that you have a stock (that pays no dividend) that is selling for $100 today, increases to $200 in one year, and then falls back to $100 in two years. The table below shows the prices and returns.

[1] Willard T. Carleton and Josef Lakonishok, "Risk and Return on Equity: The Use and Misuse of Historical Estimates," *Financial Analysts Journal*, pp. 39, 38-47 (January-February, 1985).

Exhibit JRW-16
Appendix D
The Use of Historical Returns to Measure an Expected Risk Premium

Time Period	Stock Price	Annual Return
0	$100	
1	$200	100%
2	$100	-50%

The arithmetic mean return is simply (100% + (-50%))/2 = 25% per year. The geometric mean return is $((2 * .50)^{(1/2)}) - 1 = 0\%$ per year. Therefore, the arithmetic mean return suggests that your stock has appreciated at an annual rate of 25%, while the geometric mean return indicates an annual return of 0%. Since after two years, your stock is still only worth $100, the geometric mean return is the appropriate return measure. For this reason, when stock returns and earnings growth rates are reported in the financial press, they are generally reported using the geometric mean. This is because of the upward bias of the arithmetic mean. As further evidence of the appropriate mean return measure, the SEC requires equity mutual funds to report historic return performance using geometric mean and not arithmetic mean returns.[2] Therefore, the historic arithmetic mean return measures are biased and should be disregarded.

Nonetheless, in measuring historic returns to develop an expected equity risk premium, finance texts will often recommend the use of an arithmetic mean return as a measure of central tendency. A common justification for using the arithmetic mean return is that since annual stock returns are not serially correlated, the best measure of a return for next year is the arithmetic mean of past returns. On the other hand, Damodaran suggests that such an estimate is not appropriate in estimating an equity risk premium:[3]

> There are, however, strong arguments that can be made for the use of geometric averages. First, empirical studies seem to indicate that returns on stocks are

[2] SEC, Form N-1A.

[3] Aswath. Damodaran, "Equity Risk Premiums (ERP): Determinants, Estimation and Implications – The 2013 Edition" NYU Working Paper, pp. 26, 1-114 (March 2013).

negatively correlated over time. Consequently, the arithmetic average return is likely to over state the premium. Second, while asset pricing models may be

single period models, the use of these models to get expected returns over long periods (such as five or ten years) suggests that the estimation period may be much longer than a year. In this context, the argument for geometric average premiums becomes stronger.

C. The Error in Measuring Equity Risk Premiums with Historic Data

Measuring the equity risk premium using historical stock and bond returns is subject to a substantial forecasting error. For example, the arithmetic mean long-term equity risk premium of approximately 6.5% has a standard deviation of over 20.0%. This may be interpreted in the following way with respect to the historical distribution of the long-term equity risk premium using a standard normal distribution and a 95%, +/- 2 standard deviation confidence interval: We can say, with a 95% degree of confidence, that the true equity risk premium is between -34.7% and +47.7%. As such, the historical equity risk premium is measured with a substantial amount of error.

D. Unattainable and Biased Historic Stock Returns

Returns developed using Ibbotson's methodology are computed on stock indexes and therefore: (1) cannot be reflective of expectations because these returns are unattainable to investors and (2) produce biased results. This methodology assumes: (1) monthly portfolio rebalancing and (2) reinvestment of interest and dividends. Monthly portfolio rebalancing presumes that investors rebalance their portfolios at the end of each month in order to have an equal dollar amount invested in each security at the beginning of each month. The assumption generates high transaction costs and thereby renders these returns unattainable to investors. In addition, an academic study

demonstrates that the monthly portfolio rebalancing assumption produces biased estimates of stock returns.[4]

Transaction costs themselves provide another bias in historic versus expected returns. In the past, the observed stock returns were not the realized returns of investors, due to the much higher transaction costs of previous decades. These higher transaction costs are reflected through the higher commissions on stock trades and the lack of low cost mutual funds like index funds.

E. Company Survivorship Bias

Using historic data to estimate an equity risk premium suffers from company survivorship bias. Company survivorship bias results when using returns from indexes like the S&P 500. The S&P 500 includes only companies that have survived. The fact that returns of firms that did not perform well were dropped from these indexes is not reflected. Therefore, these stock returns are upwardly biased because they only reflect the returns from more successful companies.

F. The "Peso Problem" - U.S. Stock Market Survivorship Bias

The use of historic return data also suffers from the so-called "Peso Problem," which is also known as U.S. stock market survivorship bias. The "peso problem" issue was first

[4] See Richard Roll, "On Computing Mean Returns and the Small Firm Premium," *Journal of Financial Economics*, Vol. 12, pp. 371-86 (1983).

highlighted by the Nobel laureate, Milton Friedman, and gets its name from conditions related to the Mexican peso market in the early 1970s. This issue involves the fact that past stock market returns were higher than were expected at the time because despite war, depression and other social, political, and economic events, the U.S. economy survived and did not suffer hyperinflation, invasion and/or the calamities of other countries. As such, highly improbable events, which may or may not occur in the future, are factored into stock prices, leading to seemingly low valuations. Higher than expected stock returns are then earned when these events do not subsequently occur. Therefore, the "peso problem" indicates that historic stock returns are overstated as measures of expected returns because the U.S. markets have not experienced the disruptions of other major markets around the world.

G. One of the Biggest Mistakes in Teaching Finance

Jay Ritter, a Professor of Finance at the University of Florida, identified the use of historical stock and bond return data to estimate a forward-looking equity risk premium as one of the "Biggest Mistakes" taught by the finance profession.[5] His argument is based on the theory behind the equity risk premium, the excessive results produced by historical returns, and the previously-discussed errors such as survivorship bias in historical data.

[5] Jay Ritter, "The Biggest Mistakes We Teach," *Journal of Financial Research*, pp. 1-10(Summer 2002).