State of Florida

Public Service Commission

-M-E-M-O-R-A-N-D-U-M-

DATE: March 10, 1995

TO: Blanco Bayó, Director, Records and Reporting

FROM: Joy Kelly, Chief, Bureau of Reporting

RE: UNDOCKETED WORKSHOP
HELD 2-24-95

IN RE: DISCUSSION ON THE RETURN ON EQUITY FOR NATURAL GAS

DOCUMENT NOS. 02555 3-8-95

The transcript for the above-described hearing has been completed and is forwarded for placement in the docket file.

Please note that Staff distribution of this transcript was made to:

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The following exhibits are being filed with this transcript:

NONE

The following exhibits have not been furnished to the Bureau of Reporting to date and do not accompany this transcript:

NONE

Acknowledged by: ______________

JK/pc

PSC/RAR 28 (Rev 7/94)

Public Service Commission

Docket #:

DOCKET NO. 950000-
~~HEARING~~ W.S. TRANSCRIPT DATED: 2-24-95
BEGINNING DOC. #02555-95 VOL. #
ENDING DOC. # VOL. #

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of	:	UNDOCKETED
Discussion on the Return on Equity for Natural Gas.	:	

PROCEEDINGS: WORKSHOP

BEFORE: CHAIRMAN SUSAN F. CLARK
COMMISSIONER J. TERRY DEASON
COMMISSIONER JULIA L. JOHNSON
COMMISSIONER DIANE K. KIESLING
COMMISSIONER JOE GARCIA

DATE: Friday, February 24, 1995

TIME: Commenced at 9:30 a.m.
Concluded at 11:15 a.m.

PLACE: Fletcher Building
FPSC Hearing Room 106
101 East Gaines Street
Tallahassee, Florida

REPORTED BY: ROWENA NASH HACKNEY
Official Commission Reporter

IN ATTENDANCE:

DONATO J. EASSEY, Merrill Lynch.

STEPHEN C. THOMPSON, Central Florida Gas Company.

J. E. McINTYRE, West Florida Natural Gas Company and Associated Gas Distributors of Florida

JACK E. UHL and E. ELLIOTT WHITE, Peoples Gas System, Inc.

DAVID ROGERS and ANNE VINCENT WOOD and WAYNE SCHIEFELBEIN, Chesapeake Utilities Corporation.

ROBERT F. LURIE, NUI Corporation.

JOHN STARK, City Gas of Florida.

RAND SMITH, City Gas Company

DARRYL TROY, Florida Public Utilities.

JOHN MELENDI, Sebring Gas Systems

JOHN McLELLAND, South Florida Natural Gas

PETER MARTIN, Florida Natural Gas

STUART SHOAF, St. Joe Natural Gas

LORNA WAGNER and MIKE PALECKI, Florida Public Service Commission, Division of Legal Services.

PETE LESTER, Florida Public Service Commission, Division of Auditing & Financial Analysis.

PROCEEDINGS

(Workshop convened at 9:45 a.m.)

CHAIRMAN CLARK: We'll go ahead and call the workshop to order. I apologize for the delay. We did have an oral argument we wanted to hear as quickly as possible.

Thank you for coming today to share your thoughts on the methodology for the return on equity for gas industries. Let me just stop right there.

Do I need to read a notice?

Okay. Would you please read the notice?

MS. WAGNER: Thank you. Pursuant to notice, this time and place has been set for the Return on Equity Workshop for the Gas Utilities. The purpose of this workshop is to discuss and evaluate appropriate methodologies for determining the rate of return for the natural gas industry. The purpose of this workshop is more fully set forth in the notice.

CHAIRMAN CLARK: Thank you. Is it appropriate to take appearances?

MR. PALECKI: (Nodding head)

CHAIRMAN CLARK: Okay.

MS. WAGNER: Beside me is Mike Palecki, and my name is Lorna Wagner. We are with the Florida Public Service Commission, 101 East Gaines Street, Tallahassee, Florida.

CHAIRMAN CLARK: Go ahead.

MR. ROGERS: David Rogers, Associated Gas Distributors of Florida.

MR. UHL: Jack Uhl, Peoples Gas System, Tampa, Florida.

MR. WHITE: Elliott White, Peoples Gas System, Tampa.

MR. McINTYRE: Jim McIntyre, Associated Gas Distributors of Florida and West Florida Natural Gas Company.

MR. EASSEY: Donato Eassey, Merrill Lynch, Houston, Texas.

MR. MELENDI: I'm Gary Melendi with Sebring Gas Systems in Sebring.

MR. SMITH: Rand Smith with City Gas Company, Hialeah.

MR. LURIE: Robert Lurie with NUI Corporation, parent of City Gas Company.

MS. WOOD: Anne Wood, Chesapeake Utilities Corporation.

MR. THOMPSON: Steve Thompson, Chesapeake Utilities.

MR. TROY: Darryl Troy, Florida Public Utilities Company.

MR. STARK: John Stark, City Gas of Florida.

MR. MARTIN: I'm Peter Martin with South Florida Natural Gas in New Smyrna Beach.

CHAIRMAN CLARK: Just a minute. Can you hear all those?

You need to come to a microphone, please, if you would, and repeat where you are from and who you are representing.

MR. TROY: Darrell Troy, Florida Public Utilities Company, West Palm Beach Florida.

MR. STARK: John Stark, City Gas of Florida.

MR. MARTIN: I'm Peter Martin with South Florida Natural Gas in New Smyrna Beach.

MR. McLELLAND: I'm John McLelland, South Florida Natural Gas, New Smyrna Beach.

MR. SHOAF: I'm Stuart Shoaf, St. Joe Natural Gas in Port St. Joe.

MR. SCHIEFELBEIN: Wayne Schiefelbein on behalf of Chesapeake Utilities.

CHAIRMAN CLARK: Thank you. Is there anyone else who would like to enter an appearance?

Okay. Any other preliminary matters? No?

MS. WAGNER: No, not at this time.

CHAIRMAN CLARK: Okay. It is my understanding that we were going to start off by presentation from

Mr. Eassey.

MR. EASSEY: Eassey.

CHAIRMAN CLARK: Eassey. And you are going to make the presentation on behalf of the Associated Gas Distributors of Florida?

MR. EASSEY: Not necessarily on behalf of the Associated Gas Distributors of Florida, but on behalf of the market in general and the stakeholders or the folks who put up the capital for these companies. I'm not representing any of the parties here, just giving Wall Street's view.

CHAIRMAN CLARK: Okay. Well, can you tell us who invited you to be here? I mean --

MR. EASSEY: Well, the Associated Gas Distributors invited me to be here.

CHAIRMAN CLARK: All right. Good. Then, as I understand it, after you make your presentation, other people and parties here may wish to make other presentations? Is that correct?

MR. PALECKI: We have some questions that the Staff has asked us, and we will make a presentation. And we've submitted those to Staff prior to this meeting.

CHAIRMAN CLARK: Okay.

MR. PALECKI: And they may have some

questions, and we'll be here to answer those and discuss those.

CHAIRMAN CLARK: All right.

Have we settled on any particular order, or can we just go down the table once the initial presentation is made?

MR. PALECKI: We can just go down the table.

CHAIRMAN CLARK: Okay. All right. Well, then it would be my intention to hear from Mr. Eassey first, and then have the parties respond to the questions that Staff has asked them to respond to. And then we'll have an opportunity to ask questions. And the Staff will have an opportunity to ask questions, as well as the Commissioners.

As you know, we held a similar workshop yesterday on the water and wastewater industry, and it's my understanding we will hold workshops relative to the telecommunications industry and to the electric industries. And then following the conclusions of all the workshops, we'll get a report back from our Staff describing the issues on this point and getting recommendations from them. Is that correct, Mr. Palecki?

MR. PALECKI: That's correct.

CHAIRMAN CLARK: All right. Mr. Eassey?

MR. EASSEY: First and foremost, good morning, and thank you for this opportunity to visit with the Commission and the Staff. This is a very, very important meeting for us on Wall Street. And at Merrill Lynch, in particular, we own $250 billion worth of equities in the market and -- on the electric side is out there, and Merrill Lynch owns about 10% of those. Or on average there's about $25 billion of capital invested on the equity side with respect to the gas companies; we own about 10% of those on average.

It's becoming increasingly difficult to attract capital to this industry. I think yesterday is a perfect example of what the gas industry lacks in attractiveness to the market. The market reached an all time high of over 4000 points which everyone in this room, I'm sure, is familiar with.

Since Order 636, which is a milestone in this industry, make no mistake about it, the market is up -- the S&P is up 21.3%. In contrast, the smaller midsize group, which is larger than any or all of these companies combined down in Florida, moved a whopping 8.7% relatively speaking. So therein lies the problem. It is very difficult to attract capital when the market in general has an opportunity this year to provide roughly 15% to 16% return on equity.

I brought, and you all have in front of you, some handouts from Merrill Lynch and how we present in a very basic format to our constituencies in the investment community. I'm not going to insult anybody's intelligence by going over the first couple of slides in there, but I think it's very important to take a look at Page 6. This is our universe of companies that we follow currently.

In there you can see that the large distributors have 11.76% on average return on equity allowed. The smaller group fairs slightly better at 11.86. That's the first column.

I would also like to point out on this page that we have the theoretical earnings power of the LDC upon an earnings per share basis of $1.59 for the large group. And as you look at the corporate level, however, which includes nonregulated activities, it's $1.98. And it is for these nonregulated activities where there is any hope at all right now in the market place for LDCs to attract capital and to grow the business on a competitive basis.

For the small LDC universe the average is $1.59. The corporate earnings consolidated goes up about .05 to a $1.54; not a big change there because they are not nearly as diversified, and they have the most difficulty in attracting capital, competitive cost of capital.

On the next slide you can see the historical spreads, if you will, between the allowed gas utilities return on equity, the S&P 500's actual return on equity, and then the actual average return on equity for all LDC gas companies, not just those that are in our universe. It looks fairly reasonable for the layman to look at this and say, "Well, jeez, the returns are not all that bad," but they are considerably below that of the S&P 500.

Between 1982 and 1988, it looks like the gas companies hit home runs, relatively speaking. But I think one needs to realize that the market in general was under a great deal of economic pressure. Oil and gas prices were at all time highs, and they were running the kind of returns from the gas price implications and from the market in general being depressed. But right now, the lines are diverging rather aggressively, and we see this as a negative red flag going forward.

Looking at the next slide, we're just comparing the S&P price earnings ratios relative to that of an LDC. And, again, you can see those lines are not going in the appropriate direction. In order to attract capital, I would like to remind everyone that you are competing for capital across the spectrum of investment opportunities. If you have a dollar to invest, you are going to go and look for the most attractive return on that dollar with the commensurate risks that your tolerances are aimed at.

The next slide on Page 9 shows our standard example of the S&P 500. It's current P/E, or price to earnings ratio, that which you track the price of a particular stock, is trading at 15.5 times earnings. The average LDC, as we speak, is trading at 11.5 to 12 times earnings. A full 300 basis points, in most cases, below that.

When you buy the S&P 500, which does include gas stocks by the way, both pipelines, LDCs, integrated electrics and a full spectrum of companies traded on the New York Stock Exchange, EPS growth is 12.2%. My best company is approximately 8% because, again, you can't grow if you can't attract capital.

The return on equity for the S&P 500 outlook right now is 17.3% for 1995. The capital structure is 46% dead on average and 54% equity. Again, a lot better than the best that we have right now is a 48% equity component. Some are approaching or heading toward 50%. The yields are only 2.73%.

The yields on the LDCs are hovering around anywhere between 5.3 and 7.5%, considerably higher. And of course the payout ratios on the S&P 500 are not nearly as aggressive at only 45%. The whole point here is that it's very difficult to attract capital if you don't have a competitive rate of return out there.

As we look forward as to what can be done about it, we advised -- and we have been discussing it for over two years with various forums, including various NARUC committee meetings. Last week I was down at the DOE, some of whom in here attended. And it's much appreciated that there's that much of attention.

But I think one can look at just the attendance list on that DOE NARUC joint conference and get a better appreciation for what Wall Street thinks about the gas industry right now.

It was a natural gas conference, nearly 1000 folks in attendance. There was one analyst there from Wall Street. That's the panel I was discussing with. And one of those guys is semiretired. And then we had Moody's there. But for the whole conference there was one analyst. And if that doesn't send a message, I don't know what does. It is difficult. So what can be done about it?

In our view, we have a simple approach. It goes in line, I think, with some of the goals that this commission has before itself. Regulatory determinations that are fair, just and reasonable; encourage efficiency in the utility operation; and encourage use of the cost beneficial new technology.

I can't help you on the Staff side. I think you have adequate Staff. But I would like to suggest to you that if you used a proxy of the S&P 500 returns over the past five years and keep that as a rolling average, as a target ROE with incentives which, in my view, is a natural extension of Order 636, you would have the best opportunity to balance the ratepayers' interest with that of the shareholder and/or the stakeholder's interest in totality.

To try to bring it into perspective a little bit, I think we have to look back at some of the decisions that were recently made. Some of which you all may be familiar with. I point to Washington Energy out in the state of Washington as the No. 1 candidate in this regard.

In September of 1993, the Washington Utilities and Transportation Commission came out with a 10.5% return on equity, and they set the equity component at 44%. Well below what the corporate structure actually was, but this is what they did.

If I may quote from the Commission's own order for a moment. Bear with me.

"The Commission adopts a capital structure which should allow the company to maintain its current bond rating." It's on Page 25 if anybody is curious.

"The authorized rate of return should assure investors' confidence in the financial integrity of the utility, enable the company to maintain and support its credit position and permit it to attract additional capital on a reasonable basis." They continued. "The Commission believes that the general result of this order is both predictable and reasonable." And finally, "The regulated gas company will remain healthy and strong under the rate and other decisions made within this order."

Well, what actually happened? The Commission did set a 10.5 ROE, the equity component was 44% and disaster struck. We call this a "Wall Street train wreck."

This order flunked competitive market realities on virtually every count. Washington Energy had to cut its dividend from $1.40 to $1. The credit rating was cut from a single A-minus to a triple B+. It's below that. It was just put on watch yesterday for negative connotations further.

Two days after the order came out, the bond rating was cut. One day -- actually one day after the order became public, nonregulated assets had to be --

CHAIRMAN CLARK: Let me ask a question about that. That seems awful quick for them to react to an order. Was there something else going on?

MR. EASSEY: When you say, "Was there something else going on?" No, there was some potentially extenuating circumstances as to why the Commission reacted the way they did. But, fortunately, there were some signals in the market well in advance, that the staff had posted their position, if you will, which myself reacted to it to try and get our clients away from the stock ahead of time. Again, all in a public forum.

The driving forces were not necessarily that some political implications that were going on between the Commission and the company. The driving forces were irrespective of market realities, and that's what I personally take issue with and have a passion that we try to get away from the political aspects of it and try to refocus on market realities.

When you say the market reacted quickly, when you see the opportunity for your equity to become eroded rather dramatically --

CHAIRMAN CLARK: No. What I'm talking about is two days after the order, the bond rating was changed. It seems to me that process takes a little more than two days.

MR. EASSEY: It's virtually instantaneous. Prior to my tenure with Merrill Lynch, I was with Duff & Phelps in the credit rating side. And you know immediately what kind of implication that has for your coverages immediately.

CHAIRMAN CLARK: Okay.

MR. EASSEY: And that's your job, is to go out and inform your investing client that, you know, things are changing here rather rapidly.

If I was at S&P or if I was at Duff & Phelps, I would have lowered it when I put -- if you look at the stock in the chart -- you don't have a copy of it, but I have it here -- you can look. The stock traded at $26 prior to the order. It's now hovering around 13, and it went there very, very quickly.

There is a lot of connotations one can draw from it, but the most important of which is that it didn't pass a litmus test at all in the market. And it took a snapshot of the bonds, and this just happened to be at a point when bond and interest costs were almost at the bottom. And there is the regulatory lag exposure that you have to be saddled with going forward, is rather dramatic as well.

Under the methodology that we espouse, it would be an ongoing accountable test, if you will, each and every quarter, each and every six months, each and every year; however, the staff and the companies were able to agree upon. But it instills some discipline in the system. It is not a cost-plus contract. It is not a book blank check to the companies.

I would argue that the S&P 500 methodology with incentive rates -- mechanisms would, in fact, put a discipline that these companies have yet to deal with. It would allow the ratepayer to enjoy some rebates as the efficiencies are brought to the table and do away with the cost-plus mentality that this entire industry -- it's a national issue. It's not obviously just a Florida issue.

I would also suggest that if the pipelines were given incentive rates many moons ago, we wouldn't be sitting here today discussing this; and you would have more security of supply and deliverability and all those kinds of niceties that all these companies have enjoyed in the past. The shock absorbing ability of the pipelines and their aggregating prowess is a distant echo today than what it was just a few years back.

The LDCs are now responsible for the access of supply, the aggregation of supply, the balancing of all those issues and the deliverability of that to the well head, from the well head to the burner tip. I would suggest to you that the only thing consistent about natural gas today relative to 40 years ago is that when you strike a match in the air, it will ignite. Everything else is different from the prospecting for gas, from the gathering of it, to the processing, to the transmission of the gas and then the distributi n of it.

Compounding the problem, obviously, is bypass capacity brokering and release and marketers wanting to enter the LDC's traditional service territory. We welcome that from a Wall Street perspective. It's obviously good for competition, it's good for the ratepayer, but there's some drawbacks for the existing utility and stranded costs, similar to what you are facing with electrics.

By the way, I would not limit this discussion just to gas companies or S&P 500 methodology. I think it would be reasonable for any utility, as you go through this. And I think it would lighten up your workload considerably, but at the same time you would have more accountability to what the companies are doing.

By the benchmarks, and let me refer to the incentives that I've talked about a little bit because they are our key to the whole process. O&M per customer, new plant construction relative to a -- all these would be relative to a regional index; not the company next door or anything because there's too many idiosyncrasies that come into play.

But you would have your benchmarks that would include O&M per customer; plant per customer; customer complaints relative to other companies; and what you all hear from the ratepayers, gas acquisition. PGA would disappear as we know it today.

You would have predefined parameters. They would remove the handcuffs, if you will, that they are saddled with, that the marketer is not saddled with. They have no service obligation; they have no commitments; they have no invested capital. All they want is access to the pipe.

And I think it is a huge mistake not to recognize that the gross receipts tax, some of which was discussed earlier today -- and I'm sure that you all have had to be saddled with in recognizing the implications there -- but a transmission company doesn't pay any gross receipts tax in most jurisdictions.

Some folks are addressing that right now. But your state revenues will decline as those marketers penetrate each of these jurisdictions because it will be transportation gas and not sales gas. And Florida may not be unlike any other state where you will likely see some legislative changes to address that. But it is a real threat to the treasurer.

If I was a treasurer in most of these states, I would be getting a little excited right now because these marketers are about as aggressive as -- as well they should be because the opportunity is there.

But turning back to just removing the handcuffs of the LDCs, allowing them to deal with the realities of the market associated with gas procurement, hedging to protect the downside pressures and the upside pressures associated with gas prices, gas prices are not going up any time soon. Anyone who is counting on gas prices to revive this industry is making a huge mistake. And that's good for the consumer. It's also good for the LDCs because while they enjoy a very, very nice advantage on average in the nation over electricity for space heating and appliances and the like, that competitive advantage is actually going to improve, particularly under our S&P 500 methodology.

It's a methodology that the North Carolina Commission is looking at closely, even the Washington Commission is starting to look at it. Massachusetts has taken a hard and fast -- Ken Gordon and I have had lengthy discussions on it. And, of course, New Jersey is the most progressive right now.

One thing I would caution on is that the folks that go into this endeavor aggressively early will have a competitive advantage to attract industry and jobs because it is an efficient methodology. And as North Carolina moves forward, South Carolina, Tennessee, Virginia, Washington will all fall in step because they will not be able to compete on the traditional ratemaking methodology.

How do you protect the consumer? How do you protect Ma Jones' water heater bill from going up? It will not go up in my view, in the studies that I've done. The efficiencies that this kind of a system entails will drive costs further down, and I think that's where the win/win situation comes in from.

There is a lot more I could say about it, but what I would like to conclude with and then open it up for hopefully a great deal of discussion is that -- I've said this at the DOE meeting, and I think it hits home -- is that the very infrastructure of all these S&P 500 companies and each economy rests on the infrastructure of each community. That infrastructure is based on water, telephone, electricity and natural gas use.

If you allow that infrastructure to deteriorate or to decay, you are, in fact, allowing the community to decay right along with it. And those are paraphrased words from Commissioner Vincent Majkowski of Colorado who takes a very -- I apologize for butchering his name -- but he takes a very pragmatic approach. And I have a unique appreciation for his approach.

So the bottom line is, is that you can attract capital if you want to attract capital, but you've got to have competitive ROEs. It all starts there. Benchmark, decide, argue, flip a coin, whatever on what the parameters are going to be. Set them up high to give the company an opportunity to overearn and share that.

And pardon me, I left out the biggest, important part here, The scale on the overearning. For example, the S&P 500 right now would work out to be 13.5%, considerably above what the companies are earning right now. Now, that doesn't guaranty or give them a blank check. But what we're suggesting is, as these incentive attributes are met and/or attained or exceeded, then companies should be allowed to overearn. But you set the scale disproportionate to the ratepayers advantage.

In other words, let's say a company earned 14.5% in that first year. Well, that hundred basis points -- and you again set the scale to what you are comfortable with. But just for discussion purposes, the first 10 basis points would be split 90% for the ratepayer, 10% for the company. The next 10 basis points would be 80/20 and so on until you got to 50/50. Therein lies the incentive because the company will be -- its objective will be to overearn.

The ratepayer wins. How is he overearning? He grows the business, aggressively grows the business. The per unit cost on existing ratepayers must go down by definition. A lot of discussion about, "Well, shouldn't gas companies be part of electric companies as we go through this unbundling of the electric side?"

I feel that there could be, you know, very onerous and disastrous, almost, for gas use for the environment, et cetera, going forward. And the reasons are, is the combination of companies that we've seen that have split up, the gas company subsidizes the electric business. By definition, because of the electric cost is up here -- and we've done a great deal of studies, and I can show you everything we have on it -- and gas cost is down here. And you are a combination company, you must expand the electric business to drive that per unit cost and keep the ratepayers happy and ignore the gas business. Because if you grow this, the electric business is going to suffer.

So I take issue with the argument that gas companies and electric companies -- what will happen over time, in my view, is that you will see the power generators, the transmitters and the distributors being in one area and then a marketer being in another. And this is probably a 10 to 15 year process. But you are going to have aggregators of the power and distributors of power, and you'll be able to sit at home and switch to whatever you want to use for that given day. But that's down the road a piece.

In the meantime, you've got an industry that, you know, has a tremendous appetite for capital, and it's very difficult to attract capital in today's declining ROE environment. You all invest everyday. It's not just your future. In most cases it's your children's future, and you want the best return for that.

To encourage investment in utilities, which is the very infrastructure of the communities, is somewhat of a disappointment, I would think, and that you should be encouraging and not discouraging investment.

Industry employs about 2.6 million people. That's from the well head to the burner tip, and that is down about 25% over the past five years from where the number has been. And it's going to go down further. Because the only way companies can attract Capital today is subsidize their interest with a high dividend payout and cut costs. And a lot of times when you. Costs, you are sacrificing potentially safety, growth and other. That may present themselves.

I think that covers just about everything I wanted to say about it, except that I really appreciate the opportunity to be here; and I'm encouraged that this Commission has taken the initiative to at least hear Wall Street's view. Again, it's a very important view.

I am one of 16 or so gas analysts. I'm probably the most versed on the LDCs. I follow pipelines and integrated gas companies as well. In my area of responsibility, there is probably $18 billion invested.

CHAIRMAN CLARK: Commissioners, do you have any questions while this presentation is fresh in your mind?

COMMISSIONER DEASON: I have a few. I can ask them now or later; it doesn't matter.

CHAIRMAN CLARK: Okay. Why don't you go

ahead.

COMMISSIONER DEASON: Okay. You've covered a lot of ground, and I just have a few questions about some of the things that you did cover.

I take it that your recommendation, going to some type of S&P indexing, is also to go hand-in-hand with your idea that there should be some type of incentives --

MR. EASSEY: Absolutely.

COMMISSIONER DEASON: -- given to companie basically to overearn and share those benefits with the customers.

I guess I need to understand a little bit more exactly what type of incentives you think are appropriate. I know that incentives really weren't the main focus of this workshop today, it was ROE. But the way you are presenting your ROE arguments, you think they go hand-in-hand.

MR. EASSEY: Absolutely. And the incentives are really measurements. They are not -- if you've got a regional index for the average operation and maintenance expense for a similar situated company, if you will, If you've got a half-a-million customers, there's other similarly situated customers that have the same kind of cost structure, if you will, that you should be striving for.

My best measure on companies right now is O&M per customer, to some extent cost of capital per customer. If you want to, look at how aggressive the company was in managing its finances across the board, that and equity as a combination. You know, if the average cost of gas in the southeast part of the United States was $1.40 and a company charged $2 for whatever reason, that is a failed benchmark, in my view. Ar . that's something, you know, that would have to be addressed as to why that happened.

The incentives are really, as I said earlier, just measurements. And the incentive is to meet those bogies that are agreed upon by the staff and the Commission or exceed them. Because that's where it's a win/win situation.

Right now you are out spending money and spending money and hoping to get some reasonable rate of return on that. Most people would argue that you are spending money for growth. I would suggest to you that if you look at the load factor issue, which I recently issued back in January, on a year-round basis, the LDCs facilities on average, those in our universe, which represents about 22% of the gas consumed on an annual basis, only use 57% of their capacity year round. On the winter, obviously, that's the period you need your capacity, it climbs up to 86%.

But if you were to drop out specific enterprises or So. Cal Gas, it would go down precipitously in the winter. So that means we've got a little excess capacity throughout the nation. We may not have it down here in Florida, but we do have it.

So the point is, is that maybe some growth materialized or came to fruition that really didn't need to. Under this scenario, you would only go after hose products and growth opportunities that provide real return and pass the mustard test, if you will.

COMMISSIONER DEASON: Well, you are talking about indexing. For example, one of the key factors you've identified is O&M per customer. And I think you are recommending that that be indexed or compared to some type of a regional average.

Are you familiar with the O&M benchmark this Commission already utilizes in ratemaking?

MR. EASSEY: Partially.

COMMISSIONER DEASON: And there are a number of differences. One, it's strictly for one company, and it's basically done on a historic versus a current basis. And there is a percentage growth factor applied to historic O&Ms. And there's basically a burden of proof or a threshold wherein a company that exceeds that benchmark, well, then they have a heightened burden to show that their expenditures which exceed that benchmark are justified.

And another main difference I would see is if a company is below the benchmark, there's no basically sharing in the sense that if it's just below the benchmark, they've met the burden.

And I think what you are saying is if they do better than a benchmark, if their costs are lower than a benchmark, they should be able to keep some of that benefit and share some of that benefit. Is that the main difference that you --

MR. EASSEY: That's right. But it wouldn't be just that one. There would be a cadre of attributes, if you will, that you would be shooting for.

And, again, you might have weather, for example, which is 20% warmer than normal. That's beyond the company's control. You should not allow that to detract the ability for the company to raise capital.

And what happens if weather is -- in most jurisdictions, if weather is warmer than normal? Then they take a big hit on earnings and stuff. But that, again, would only be -- you'd have to weight these things as to their relevance to the earnings ability of the company. And it's that earnings ability and payout and dividend growth and all the things that you are used to calculating the returns on and driving those returns that are going to drive the story going forward.

Wall Street knows that the world has changed in the gas industry. And that is evident by what I started out with; the market is up 20-some-odd percent and the LD -- since Order 636 -- and the LDCs are up 8%. You know, I don't know how to give a more compelli·· , description.

I would also say --

COMMISSIONER DEASON: Well, let me ask you a question on that point because that is interesting. The market has been expanding; it's been going up. It's at an all time high. It's got to have been going up. So, basically, times are good. And times are good for the LDCs, too. They are up 8%. They are not as good.

MR. EASSEY: 8% since April --

COMMISSIONER DEASON: Just let me ask my question, and then you can expand all you want.

MR. EASSEY: Okay.

COMMISSIONER DEASON: My question is, is that, in the bad times -- let's hope we don't have any, but we know they are going to come -- the markets go up and down. In the bad times when the S&P 500 doesn't show a

20% gain, it shows a 20% loss over a given period of time, would you likewise say that gas should be a 20% loss, or should there be less fluctuation so that in the bad times there's maybe is -- if there was an 8% gain when the whole market went up 20, when the whole market goes down 20, should the gas companies realistically only go down 8%?

Because some would argue that LDCs are less risky than the market generally, which is a good surrogate in the market, generally is the S&P 500. Now, you can answer my question.

MR. EASSEY: Okay. Thank you.

First of all, the reason for the five-year average is to try and smooth out some of the peaks and valleys of the market. Now, if we've got a five-year decline, so be it. That's the market.

I think you have to -- if you go down this road, you have to recognize that you have to take the good with the bad. And that's why, while I'll continue to recognize -- Wall Street appreciates what's happened in the market and how each of the different companies make up that market mix. They also have an appreciation that, you know, while people say that LDCs are not as risky, I would take issue with that today. I would say they are one of the most riskiest investments one could have right now. Again, I would have to suggest that the five-year rolling average is appropriate.

Now, if you go into this methodology and you find that it doesn't work, that the ratepayer doesn't benefit, there's nothing to preclude you from going back to something that works better. I would just suggest to you that if you are going to encourage development of natural gas in this state, or in the nation, that you've got to attract capital.

China, with O'Leary over there yesterday with some of the corporations, they are looking for $6 billion in capital. Those are mostly U.S. dollars in capital. I would suggest to my clients to buy Hong Kong Gas before I would suggest to them to buy a Florida utility. Because the opportunity for returns are there. And that's the competitive market forces that you are dealing with.

CHAIRMAN CLARK: For an equity investment?

MR. EASSEY: Absolutely. 35% return at Hong Kong Gas opportunity over the past year.

CHAIRMAN CLARK: It's a big risk though, isn't it?

MR. EASSEY: It doesn't come without its risk. And when you look forward down the time line with respect to LDCs, you have a fair share of risk. Last year they were down 16 -- over 16% as a group. The market was down four-tenths of a percent or something like that in general. So, I mean, they more than -- far exceeded the loss.

CHAIRMAN CLARK: Let me ask. You would recommend that investment for every one of your investors?

MR. EASSEY: No. I'm using that as an example.

CHAIRMAN CLARK: You would recommend that for your more aggressive investors, wouldn't you?

MR. EASSEY: Absolutely. We have the less risk averse.

CHAIRMAN CLARK: That's right.

MR. EASSEY: And we have those that have risk tolerances that are higher.

But I think what's important, and the point is, that we are heading down this competitive market reality, if you will, for utilities in general, and the LDCs are not immune to that. But what this methodology would do, would more closely tie the corporate Americas' growth with that of the utility. It would also smooth out those peaks and valleys that we were just discussing. And then it would be a clean break from the interest rate cycle that we've been following for setting equity.

In the Washington decision, it was just an interest rate driven decision for the most part. And as one knows, clearly, that it failed on market realities test for equity. Equity is equity, and debt is debt. If you want to bond -- if an investor wants a bond, he'll buy a bond or she'll buy a bond. If they want equity with the upside potential associated with it, they'll go that route.

I think that going down this method would enhance what heretofore has been the very best delivery system in the world. It is the most efficient in the world. It helps industry grow, and it attracts jobs. There's not a delivery system out there more efficient than a natural gas delivery system. And as I said earlier, with gas prices where they are at today, it's even more efficient.

The marketers are going to try and come in and take advantage of it. But what, in my view, is, in order to protect the stranded ratepayer, if you will, the captive ratepayer, you are going to have to take the handcuffs off of the LDC management in order to allow them to raise prices in industrial load where it will take it, lower prices where they need to compete with fuel or coal and protect the captive ratepayer in the meantime. It's a difficult balance to do, but it can be done. I've done it for 21 companies, and I know that it works mechanically, anyway, or from a quantitative basis.

But with the current regulation, you can't attract efficient capital as you otherwise would. The investor will quickly recognize the upside opportunities associated with this methodology.

Finally, there's the sharing. It's not just let's get in there and get this rate case done. We'll ask for 13 -- or we'll ask for 9 or 10 and 11, and we'll settle for 12, and then go back and cut costs and try to get a better return for Wall Street to, you know, welcome their initiatives. It's no way to run an efficient operation.

Every other company out there runs its activities based on what the market opportunities present themselves and what kind of risk/reward versus return. And the LDC has been insulated from that for over 40 years. But the market forces that are now coming down, since Order 636, this industry has been turned inside out.

As I said earlier, the shock absorbing and the aggregation prowess and all of that stuff, it's all gone. If we had the December of '89 winter weather in

January of '93, the January 17th time frame, i.e. the production area froze off. 636 would be overturned by now because supplies wouldn't be there, and everybody would blame 636 irrespective of the mechanics that are going on out there.

We had a very small test on the deliverability of this nation's energy supply. The world couldn't move because the rivers were froze. The standby fuel that a lot of interruptible customers were required by most statutes to have if they use interruptible load of natural gas, the facilities were there, but the oil tanks were rusted and weren't full with oil or whatever, so --

There was some bit of a test, but it was only four or five days. And the front that came through from Chicago over to the northeast didn't have a lot of teeth in it down in the production area.

So you have to still contract for gas. You have to have long-term supply, security. You have service obligation to deal with and all those kinds of things. Yet you still want to give them the flexibility, or I would think you would want to give them the flexibility to compete heads up with those other marketers who do not have capital invested or a service obligation or any of the other niceties the LDC is saddled with.

COMMISSIONER DEASON: Giving a company the ability to compete is one thing, but -- and maybe you can expand on this. I'm fearful of what you are saying is that the companies need the ability, basically no limits on their upward earnings. I say that because I know you are talking about sharing. But still there would be a tremendous incentive on the upside, and hopefully they would do well. And they would earn well, and they would be sharing, and everybody would be a win/win situation.

But what I'm fearful of is the other side. If you are going to have almost unlimited on the upside -- and I know it is limited -- but this would be a tremendous change from what it is now.

MR. EASSEY: Absolutely.

COMMISSIONER DEASON: What about for a company that hit some hard times, made some wrong decisions or just had some bad luck or something, I don't know, and their earnings start really going down. And we get to a situation where in a truly competitive market, that company may just have to file bankruptcy or liquidate its assets or whatever.

You are talking about a local distribution company with captive customers who need to stay warm in the winter, and you know that this Commission is not going to let a company like that just say, "Well, we quit. You know, we made some bad decisions, and we are just going to cut our losses." That's not going to happen.

How do you balance that with the incentives that you want to recognize on the upside of earnings?

MR. EASSEY: That disproportionate scale would work on the upside and downside. And first of all, you would cap it out. I mean, once a company -- you'd max it out at 50/50 once they've earned 200 basis points over their allowed. And then you'd say that's it, Everything beyond that, 100%. 100% goes back to the ratepayer on it. So you would cap it out. I mean, it would be ridiculous not to.

On the down side, if you've done everything correctly, you would still share those shortfalls with that of the ratepayers. In other words, you would have to charge them more for those shortfalls. If you've met those attributes. If you've done everything in your power correctly, you've stayed within the regional indexes that were preconceived and agreed upon, et cetera, but it would again be disproportionate. Of course, it would be the other way. The first 10 basis points.

You might not even have a sharing for the first 100 basis points, let's say. But beyond that when you fell down to 10%, let's say, from that 13.5, well, you've got 200 basis points, 2.5 that you want to make up somehow. And you've done everything correctly. You fell short. And you'd have to go out, on the next billing cycle, and up the rates to make up for that shortfall. I mean, you'd have to -- it would be --

COMMISSIONER DEASON: Well, now that's -- financial aspects of this business, that's going to dictate the rates. But we all know that we've got to work in a legal world.

MR. EASSEY: Absolutely.

COMMISSIONER DEASON: And before this changes the rates, you've got to give notice to customers and due process and all that sort of thing. And if you start talking about this sharing on the downside -- are you talking about just automatic rate increases that somehow were to be approved in advance and that customers really never know what the rates are going to be until we get the latest financial results for the quarter or the year and we start calculating sharings?

It's got to be meshed with the legal world in which we all operate and the due process and the notice to customers and customer participation and all those things. And how do you plan on meshing those things in with your proposal?

MR. EASSEY: Well, that's probably the most difficult aspect of the whole process, but it's not an impossible attribute to meet. I would suggest to you that when you go back to the Bloomfield Water Works decision of many eons ago, you find that we have been doing little to keep pace with that decision from a national perspective. The FERC is even suggesting that they need to take even more aggressive posture with incentive rates and those kinds of things.

If I can indulge for a moment to quote both Santa and Hoecker from the FERC, and this was just a couple of weeks back. "A system of regulation that sends a signal that the best way to make money is to add new capacity is somewhat out of step with the market and the current cycle for the industry." This is Donald Santa.

And then James Hoecker said, "The cost of service ratemaking tends to encourage pipeline management to bloat the rate base and to reward inefficient behavior by rewarding a company's increase in risk by giving a higher rate of return." So I think it's time to look at alternatives. It's time for open-mindedness, and new ways to achieve efficiency.

If the FERC moves down that road, it's going to become increasingly difficult. There's going to be an educational process for the ratepayers to understand that they've enjoyed 10 years of declining rates. I don't know if that's true for Florida, but it is true for the price of natural gas throughout the nation. And some of that is just now starting to hit the ratepayers in a positive way, that there's going to be an educational process; there may be some legislative changes that are needed from the current laws that are on the books, et cetera, but it's not an impossibl process. And it would instill accountability and efficiencies that have been long lacking in this industry.

I don't have a straightforward answer beyond that, but I think there would be a great deal of public discussion about it and a great deal of trial and error. But it would be better than what we have today. And, again, this is Wall Street's view. There is a lot of other stakeholders that have probably a different view.

I would also suggest to you that the only people that aren't on the meter when you all are going through your process, due process, is the ratepayer; but he's picking up the tab for all the litigation that goes on, the reams and reams and reams of paperwork that has to be gone through and the consultants and attorneys and all that stuff. They are making a killing at this process. And those folks will fight this kind of approach vehemently against it. I guarantee it. That's the approach.

I will also go on to suggest to you that if we continue down the road we are at right now, people will lose jobs. Everybody says to me that these stocks ought to be trading at book value. Book value is a measure of a point in time on a historical accounting basis adjusted for income minus the dividends, et cetera.

The S&P 500 is trading at 2.87 times book on average. The LDCs are trading at 1.45 times book. Relatively speaking, they are very inexpensive. But people think they should be trading at book from, again, a regulatory mind-set that is different than the market realities today.

I can only urge you to have a sense of open-mindedness about it, to take a look at it and say, "Who is a looser in this kind of environment? Is it the ratepayer, or is it the bureaucratic morass that the system has encouraged and paid for over these past many years?" So I would argue that the ratepayer will be better off in the long run over this. Again, going back to your own goals, I think it meets with the litmus test, if you will, as to what you are striving for.

COMMISSIONER DEASON: One last question. I think in your presentation I caught that you said that consistent with your ideas, the way the industry is changing and the incentives and things of that nature, that you would recommend abolishment of the purchased gas adjustment clause. I guess I can understand some reasons for that. It seems to me, though, that there are some benefits from such a clause. I'd just like for you to expand some more on that.

MR. EASSEY: Sure.

COMMISSIONER DEASON: As to why you think it would be more beneficial to eliminate it.

MR. EASSEY: I'm speaking sort of nationally in the context there. For various parts of this nation it -- we are not going to be able to have a cookie-cutter approach to how this process moves forward.

The PGA is a good benchmark and a good mechanism for traditional approaches to the industry. The direction the industry is heading for would suggest to you that you and I as the ratepayer will be co-opting with other users to contract for our own gas. So I would venture to suggest to you that within the next five years, in the state of New Jersey, for example, they are already unbundling, very similar to what the pipelines did, the merchant function from the LDC.

So there will be nc buying and selling of gas in the state of New Jersey by the a utility. When I say that, there might be a marketer that does the aggregation and what not, but You'll be buying and paying the LDC to transport that gas to you. That's all they make money on now. Most jurisdictions, save California, are not allowed to make money on buying and selling a commodity anyway. So that further cos savings, if you will, will come down to the individual holder. So -- in the national context.

In the State of Florida where you may have to protect the ratepayer on the rate shocks associated with gas, and sign the longer term contracts, because, now, let's face it, this is not the most gas-attractive market in the United States; it's up east. So the PGA may be warranted strictly for the residential captive customer for the interim. But eventually it's going to go down this road as technology advances and the availability of more gas apply in this state.

COMMISSIONER DEASON: But you are saying as customers develop a greater opportunity to basically purchase their own gas, either through some type of marketing approach or through some type of cooperative group of customers get together or whatever, when customers have that option, then. But as long as they are captive customers, it's going to need --

MR. EASSEY: PGA may be appropriate, particularly here in Florida.

CHAIRMAN CLARK: Thank you, Mr. Eassey.

I think it's appropriate now to go through the parties who are present today and allow you to make any further presentation you would like to do, and to direct them to the questions asked in the notice. Was that also put in the notice? Were the questions in the notice in the same way --

MS. WAGNER: Yes, they were.

CHAIRMAN CLARK: I don't have it with me.

MS. WAGNER: Yes, they were.

CHAIRMAN CLARK: Okay. All right. We'll start at this end of the table. Would you identify yourself again?

MR. ROGERS: I'll defer to Mr. McIntyre. He's going to make a presentation, I think, on the questions for AGDF.

CHAIRMAN CLARK: Thank you. Go ahead.

MR. McINTYRE: I've put together an executive summary of the questions that we've -- the answers to the questions. And as a group, we've tried to answer those to the best of our ability.

The only thing is that the authorized rate of returns for equity, Florida natural gas distribution systems are not adequate to maintain financial viability and attract capital. They are well below the returns investors can realize from investing in corporate America, as we've just heard. To maintain financial viability and attract capital at reasonable rates on an ongoing basis, a regulated firm's authorized rate of return on equity must be commensurate with the business and financial risk to which the firm is exposed.

The authorized returns on equity for Florida's natural gas distribution companies do not compensate the firms for risk, factors specific to individual firms such as demand risk, supply risk, small size, financial risk, and changes in federal regulatory and regulatory risk.

The current authorized returns on equity for Florida's local distribution companies do not reflect the material increases in capital costs that have occurred recently, including those occurring over the last several months.

As you are aware, the Federal Reserve has increased interest rates eight times since embarking on a course of tighter monetary policy. Long-term bond yields have increased over 24% in 1994, and short-term rates, as measured by T-bills, have increared over 100% since January 1, 1994.

Adding to this, most natural gas LDCs are small. Although small firms can sometimes be more efficient and respond to customer needs, they are subject to higher risks, such as environmental, property and liability increases and medical insurance.

The LDCs in Florida have varying degrees of business and financial risk. However, all LDCs in Florida have essentially the same authorized rate of return on equity, and in most cases are lower than our competing large electric neighbors.

Investors and lenders carefully consider a company's authorized and achieved rate of return on equity when deciding whether to lend funds and at what terms.

The ROE that is expected to be achieved is a function of the authorized rate of return on equity, The company's rate design, its operations, the depreciation and a competitive position. The ROE anticipated is closely linked to other debt-rating criteria such as: Funds from operation to total debt; funds from operation; interest coverage; pretax interest coverage, and net cash flow to capital spending.

By analyzing historical and current achieved ROE, investors and lenders can gain an insight to be used to project earnings. Also investors and lenders carefully analyze regulatory policies and practices and their impacts. Items investors include are allowed rates of return, use of project test years, use and treatment of the PGA, weather normalization, acceptance of alternative forms of regulation, including incentive regulations and other PSC incentives.

Another important factor is the deregulation and unbundling, FERC Order 636, which we've discussed earlier. The order fundamentally changed the role of LDCs. As you are aware, the merchant function and the related associated risks historically borne by the pipelines shifted to the LDCs. The risks associated with supply, transportation, contract uncertainties and storage are all new risks for LDCs.

Furthermore, the FERC policy has a tendency to encourage bypass. When bypass occurs, LDCs are left with stranded investment and idle capacities; and there are currently about 12 issues of bypass before the FERC.

Also, LDCs are required to make 20-year commitments. We have to sign contracts for capacity which we may not have 20 years down the road. Companies also must sign up for contracts to serve the coldest day. We must sign up and commit to take gas or pay the demand charges for our coldest day. And also the straight, fixed variable rate design also increases a utility's fixed cost, gas supplies because it covers all the fixed cost of the pipeline.

The most significant fallout from 636 was that it brought to Florida a floating nonregulated LDC, commonly called a marketer. A marketer who has no investment in facilities, no obligation to serve the public and no state or federal price or safety regulations to contend with. A marketer brings only a package of gas, pays no taxes, collects no taxes and competes with a local distribution company, which is hamstrung with traditional regulation.

Florida LDCs are more risky than other LDCs for two other reasons. First, they are served by only one pipeline. Of course, it is known monopoly suppliers are able to extract higher prices for their products and services. And secondly, LDCs are a greater risk than comparable northern companies due to their low throughput per customer, per residential customer.

The cost of equity methodologies that may be appropriate for gas companies in Florida are the discounted cash flow model, the risk premium approach, the arbitrage pricing theory, and the comparable earnings approach. We feel that the double leverage approach to determining an LDC's cost of equity is not an acceptable methodology. And a brief description of each methodology includes pros and cons and was submitted to Staff.

The leverage formula is not feasible for LDCs in Florida. The basic assumption of the leverage formula is that the business risk is similar for all LDC -- all gas LDCs in Florida. The assumption is incorrect. Furthermore, traditional capital structure theory holds that as leverage increases past a reasonable range, the cost of distress outweighs the tax benefits of additional debt. Therefore, the overall cost of capital can vary as leverage varies. For a given level risk, too much or too little equity can prove inefficient with regard to minimizing the cost of capital or maximizing shareholder wealth. The cost of equity is a nonlinear function of many variables and is not solely a function of leverage.

Finally, the assumption that an investment grade bond rating is representative of the cost of debt for firms that cannot access, many times, the bond market, due in a large part to their size, is questionable.

The Florida natural gas companies are at a pivotal point in its relatively brief history. The natural gas industry can provide the opportunity to solve some of the environmental, economic development and energy issues facing this great state. Traditional regulation does not fit the reality of today's natural gas business climate.

The gas-to-gas competition for the customer is not regulated. Customers have choices, and LDCs must be able to attract capital to be able to provide the services customers want and effectively compete for a capital market share.

I'd like to thank Donato for his presentation. He came down here at his own expense to speak before the Commission, and I appreciate him doing that.

We have the discussion of the return on equity for natural gas questions. We can go through those one by one; or if the Staff has some questions, they've been provided with this prior to this meeting. We'll go ahead and answer those.

CHAIRMAN CLARK: Have we completed the presentations, or nobody else wants to make presentations?

Okay.

Commissioners, do you have any questions?

COMMISSIONER DEASON: Well, I have one for

Mr. McIntyre.

You've indicated that you don't think that the leverage formula is appropriate for the gas companies, and you've identified some shortcomings in the approach. And I don't necessarily disagree with the shortcomings that you've identified.

The benefit, of course, of the leverage formula is simple, and you can look at it. And as economic conditions change, as market conditions change you can put those inputs into the formula, and you can derive -- you may not agree with the output; at least you know what it is, and it's simple.

Do you have something in mind that you think would mitigate or eliminate the shortcomings with the leverage formula, but would still give the benefits of having a simple approach that everyone knows what the inputs are, knows what the formula is, and can readily determine what would be considered a reasonable return on equity without going through the time and expense of a case where we have to have the cost of capital experts and we go through the whole nine yards? Do you have some other method in mind that would achieve that?

MR. McINTYRE: I think one that -- Mr. Eassey brought up a good alternative to that method, and it helps unbundle some of the services and allows us to be a little more competitive than we normally would.

You know, you can make the formula whatever you want, and you can make the formula come out the way you want most of the time, but it's difficult to come in here and change that. And I think that --

COMMISSIONER DEASON: Let me ask one further question, and I'll give you an opportunity follow-up. Mr. Eassey's approach is he wants it tied to S&P 500, but that goes hand-in-hand with his concepts of added incentives and freeing up management to manage the company more and share in benefits if they are achieved and sharing in the downside if downside is achieved. Do you agree with all of that, and what is your view on elimination of the PGA?

MR. McINTYRE: Well, first of all, I agree with the incentives. I think we should go to an incentive ratemaking. You know, we'd have to look at specifically at what those incentives are and whether they are fair and equitable. I think you need to have a downside. I think eventually the PGA right now is a burden because of the fact that you can't stream gas to customers. In Ocala, for example, we have Golden Flake Data Chip Company, is called on continuously by marketers to buy gas, but they want to buy from a local supplier. We can't compete because we have to collect the taxes, the franchise taxes. So I think that eventually we should be unburdened with the PGA.

COMMISSIONER DEASON: Now, that raises a very interesting question, and I do agree with you that to the extent there is a tax structure which basically prevents you from competing, that seems to be patently unfair and is probably inconsistent with getting the true benefits of competition to customers, but that's something we don't have control over. Have you gone to the legislature to seek a remedy to that particular problem? Because that is a taxing matter. You know, we don't have taxing authority.

MR. McINTYRE: Right. We're in the process of working with the legislature.

COMMISSIONER DEASON: Okay.

MR. McINTYRE: And there are some laws coming up before the legislature on gross receipts tax. But on the other hand, customers want to deal with somebody local. You know, they don't want to deal with the telephone which is an office in Houston.

When this cold day comes along and the rivers do freeze up, they want someone who can be there to take care of them, and they can get a lot better service if they had a local distribution company. We have to justify that and give them good service and be able to compete with the people on a long distance basis. But I think we can do that if we are unbundled.

COMMISSIONER DEASON: I think this other gentleman wanted to say something.

MR. UHL: Jack Uhl, Peoples Gas System.

I'd like to respond to your question, Commissioner Deason, on the leverage formula.

I think that we see it as sort of failing -- it fails the market test, I think, is our primary concern because it's no better than the input that you put into it. And it's not responsive to market forces. So I think we are concerned with it from that aspect.

With respect to your question to Mr. Eassey -- to Jim in terms of Mr. Eassey's theory of dealing with the S&P 500 with some checks, balances, incentives and one thing or another, it would seem to me that we might be well advised here in Florida to -- in the natural gas industry, begin to look at something different than what we've been doing in terms of trying to maybe be more sensitive to the market forces and maybe moving to some ranges or whatever. So you might use a benchmark such as he has suggested but build around that some very tight parameters so that you allow the utility to operate within these parameters.

I'm not really familiar too much with what you've done in the telecommunications industry, but I do believe you have done some -- this Commission, I think, has done some fairly innovative things there in the recent years.

And so I think -- I would suggest that we ought to collectively see what might make sense in terms of the things that have been discussed here and maybe move a little different path than what we've been moving on and try to accomplish a win/win situation.

I think Peoples, frankly, believes that in a competitive environment that we're in, that we do have some difficulties in competing with marketers, for example, that are not burdened with regulation, one thing or other. But we are not troubled with dealing in the competitive environment so long as the playing field is, you know, somewhat even. And I think in that environment there's some win/win possibilities here for the stakeholders.

I think that certainly the ratepayers can fair much better and the utilities can fair better maybe than we have. And I think it will take perhaps some burden, heavy burden, from the Staff and the Commission.

So I would like to see us maybe move sort of in that direction. And I can't be very definitive because we've covered a lot of territory here this morning. But I think we've heard -- in my view, I think we've heard some very interesting ideas and concepts which, I think, are worthy of exploring.

MR. EASSEY: If I may, Commissioner Deason, the one thing about the gross receipts tax and the tax issues, by the time you get legislation passed, it's very likely that a great deal of bypass will have already occurred, and the damage will have already been done. When I looked at the bypass situation with Arcadian and Atlanta Gas Light, for example, I paraphrased Winston Churchill in one of my writeoffs by saying, "Never have so few gained so much at the expense of so many." The "so many" was the captive ratepayers. Atlanta Gas Light, for example, rate base didn't change, or its cost of service changed $.01.

For example, to make it simple, they were collecting, let's say, $25 million a year from Arcadian. And they were passing on all but $5 million, if you will, to SONAT. But now SONAT is collecting only $10 million from Arcadian because of the cost of the rate structures, et cetera. But they still have to cover that $15 million shortfall that Atlanta Gas Light was paying through them. So the ratepayers', that remained on Atlanta Gas Systems, cost just went up exponentially.

And how is that serving the public? It

certainly served the competetive market forces for Arcadian, and their product costs went down. But that's one customer. It's not in the public interest. And I would argue that -- or at least present for consideration that the Commission address the tax issue to the realm of its responsibility to encourage the legislature to move. Maybe you can't. I don't know.

CHAIRMAN CLARK: We can't. And it seems to me this is the first it's been brought to me in terms of a problem with the discrepancy between the gross receipts --

MR. EASSEY: I mean, a marketer, this is what we call a string of pearls down here.

CHAIRMAN CLARK: A what?

MR. EASSEY: A string of pearls, if you will, for cherry picking the industrial and large commercial users. I mean, you can go to every McDonald's and Burger King and Pizza Hut that burns gas, or every large industrial potato chip maker or someone who is paper and pulp and pick them off and say, "Hey, we can save you two-point-whatever percent, to 2.5% of taxes."

CHAIRMAN CLARK: What I am suggesting to you is while it is probably obvious to somebody who deals with it on a daily basis, I can tell you when we had the same problem in the telecommunications market where the

CPE was, in effect, broken away from the monopoly and it was no longer subject to regulation, there was a huge amount of revenues no longer available to be taxed.

And my recollection is we didn't recognize that on the front end, but when it became apparent, when the Department of Revenue saw their tax base being eroded, they set up a task force to deal with it. And has it been brought up before and I haven't been paying attention?

MR. McINTYRE: David, why don't you address that. David works with the legislature.

CHAIRMAN CLARK: No. What I'm saying is has it been brought to us in effect to say this is the problem, and it has an adverse effect on your availability to compete and your ability to keep the large customers. And when you lose the large customers, cost of service doesn't change, but the units you can spread it over changes.

MR. McINTYRE: No, it has not been brought to you before. It's just become a problem in the last -- and the state legislature, as David will point out to you, tried to address the issue last year and did not.

CHAIRMAN CLARK: To some extent if you have the Commission saying, "Yeah, this is a problem," it helps to have someone who doesn't have a stake in it being a source of advice.

MR. ROGERS: David Rogers, Associated Gas Distributors.

It has been brought up by the Department of Revenue, although I don't think they fully realize the impact of it. It was brought to the finance and tax committee in the legislature, and I expect it's going to be brought up again in this session. But so far, I don't think they realize the magnitude of the tax base we are talking about here. But I don't know that it's been brought to your attention.

CHAIRMAN CLARK: Well, you know, I guess what I would suggest is maybe we need to -- I don't know if it's appropriate to put it on internal affairs. It strikes me that it is because it would be a legislative matter that we should look at and provide some advice on. Because I don't look forward to the LDC losing a large customer and having to deal with that loss of revenue. Because 2% was enough to make somebody change.

COMMISSIONER DEASON: Madam Chairman, it may be appropriate for the gas industry to maybe communicate with Mr. Vandiver. I guess he's our chief lobbyist, and advise him of the situation. And he may want to make a briefing at internal affairs or whatever.

Obviously, the legislative session is right around the corner. There's going to be many things up there that we are interested in. This may be one thing that we feel like we could give some meaningful input into the legislative process, and maybe it just explores a little bit further look.

CHAIRMAN CLARK: Okay. I think that's good advice.

Is it fair to sum up what you are telling us with respect to a change in the way we look at ROE that you are a hybrid company. You not only provide a monopoly service, you provide a competitive service, and you have no choice. You have to be the provider of a last resort, in effect. And we need to recognize the fact that you serve partly in a competetive market, the purchased gas, and that you need to be able to earn competitive rates of return. So we need to come up with some hybrid in the same way that you are a hybrid.

MR. McINTYRE: That's correct, and it's more obvious in the industrial and the large commercial side. I don't think the residential -- can deregulate that. But I think large commercial and industrial should be looked at.

CHAIRMAN CLARK: But if we ever get to the point that a residential customer could purchase his own gas and have you all deliver it, then we just break that part of the business off. We recognize that the only monopoly part is the distribution.

MR. McINTYRE: Right.

CHAIRMAN CLARK: But we aren't there yet.

MR. McINTYRE: Right.

MR. UHL: Could I just make one quick comment? I've said this many times over the years, and it's just dawned on me that it needs to be said again because I tend to forget it. And that is the monopoly situation is a little bit different in the gas industry.

And I hope you don't mind if I indulge everybody, Madam Chairman. But every chance I get, I want to remind all of us that we need to differentiate the LDCs in this state from the electric industry, from the telephone industry, and I don't know about water and wastewater, Perhaps. They are, too. I just am not knowledgeable enough.

But we are in a situation where no one has to have our product. In other words, you can live in the state of Florida without natural gas. You don't have to have it. Particularly in the residential sector. So what we are, as I see it, is an industry that is a highly competitive industry with regulated rates and regulated safety, etcetera. So we live in a highly competetive environment even in the residential area, but we still have this obligation to protect that particular part of our core business.

So anyway, thank you.

CHAIRMAN CLARK: Does Staff have any questions?

MS. WAGNER: Yes, we do. They would like to address the gas industries.

CHAIRMAN CLARK: Okay.

MR. LESTER: I wanted to discuss the issue of privately placed debt. And I understand that most gas companies in Florida issue privately placed debt, and they don't have rated debt. And I wonder if you can discuss the benefits and the drawbacks of privately placed debt and how much the interest rate is and cost.

MR. McINTYRE: I can only speak from my own experience with it. It's much more difficult because it's smaller. Most of the people that you've talked to, like Travelers who we placed our last bond issue with, they won't do anything less than $25 million. Our total capitalization is just over $20 million, so it would be impractical for us to go to that type of market, so it is much more difficult for a small LDC.

I'd like some of the other people to give some examples, but we're bigger than a bank would particularly want to handle, but we are smaller than what a normal bond company would want to handle.

Does anybody else want to address that?

MR. EASSEY: I can give you Wall Street's two-cents worth here, if I may.

The average cost of debt of privately placed is generally higher than it would be in the public market.

COMMISSIONER DEASON: What would that premium be in your opinion?

MR. EASSEY: Anywhere between 100 and 25 basis points potentially. You know, depending on the type of business at risk and why you can't get capital elsewhere.

As Jim described, you talk to any financier, it's difficult to go out and raise capital below a certain figure. And most of the banks, commercial banks and Wall Street want a 25 -- at least a $25 million deal to spend their time on. We've got to deal with $6 billion deals.

COMMISSIONER DEASON: Would it be possible for several gas companies to come together and --

MR. EASSEY: Absolutely. I would suggest to you, Commissioner, that you will see that. I think the competetive forces will drive some consolidation, not only from a cooperative standpoint, but from a hostile standpoint.

We've seen it in Massachusetts. There's already a policy statement issued by a Commission up there, and it says, "We will allow a premium acquisition to be passed on to the ratepayer if you can show that the ratepayers' cost are going down. And the same thing, I'm afraid -- this is one of the things that these gentlemen probably don't want to hear, but it's the facts of life, is that there will be consolidation in this state. And it will be to the benefit of the ratepayer. It will not necessarily be the benefit of the management. But at least give them an opportunity to get a fair value for it, is the way I look at it.

COMMISSIONER DEASON: And you are speaking of consolidation as actually forming and taking two separate entities and making one entity. I guess my question was could two separate entities come together, still maintain their separate identities legally in an operating sense but just come together to issue debt on a joint basis. Is that something that's possible?

MR. EASSEY: Well, just before Jim takes over I would suggest to you that it's very difficult to have the same kind of timing of -- the needs for capital may not be in concert, if you will, and your debt coverages might be a little different than his or vice versa, all kinds of things.

MR. McINTYRE: Well, most of the time you have to pledge assets and give corporate guarantees, and it would be difficult.

And the other thing is even though we are small, we are a very diverse group, and some of the companies have large amounts of residentials; others have very small amounts and large industrials, so that the credit rating of the different companies would be different. And I guess you'd have to figure out how you were going to pledge the repayment schedule, too.

But I don't know. It's an interesting question. I've never tried that.

COMMISSIONER DEASON: I agree that all of those things would be difficult. I just wondered, if the premium is 250 basis points -- and that may be extreme, it may be worth it to address some of those problems if the difference is, say, 50 basis points, which we had some testimony here yesterday in the water industry that if the premium is about 50 basis points, it may not be worth it.

CHAIRMAN CLARK: Further questions? Any questions from the parties?

Thank you very much for coming.

Thank you, Mr. Eassey.

MR. EASSEY: Eassey.

CHAIRMAN CLARK: I'll probably never get it right now.

As I said, we'll be looking at return of equity for other industries and then expecting a recommendation and discussion of the issues from our Staff. Thank you very much.

(Thereupon, the hearing concluded at 11:15 a.m.)

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STATE OF FLORIDA)
:
COUNTY OF LEON)

CERTIFICATE OF REPORTER

I, ROWENA NASH HACKNEY, Commission Reporter,

DO HEREBY CERTIFY that the Workshop was heard by the Florida Public Service Commission at the time and place herein stated; it is further

CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript, consisting of 67 pages, constitutes a true transcription of my notes of said proceedings.

DATED this 7th day of March, 1995.

Rowena Nash Hackney

ROWENA NASH HACKNEY
Official Commission Reporter
(904) 488-5981

STATE OF FLORIDA)
:
COUNTY OF LEON)

The foregoing certificate was acknowledged before me this 7th day of March, 1995, by Rowena Nash Hackney, who is personally known to me.

Patricia A. Church

PATRICIA A. CHURCH
Notary Public - State of Florida
My Commission No. CC-90785

Notary Public, State of Florida
My Commission Expires April 20, 1995
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