Ruth Nettles

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Sent: Friday, October 03, 2008 2:34 PM
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Cc: Charles Beck
Subject: E-Filing (Docket No. 080006-WS)
Attachments: 080006 Citizens' Prehearing Statement.pdf

Electronic Filing

a. Person responsible for this electronic filing:

Charlie Beck, Deputy Public Counsel
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b. Docket No. 080006-WS

In re: Water and Wastewater Industry Annual Reestablishment of Authorized Range of Return on Common Equity for Water and Wastewater Utilities pursuant to section 367.081(4)(f), F.S..

c. Document being filed on behalf of Office of Public Counsel

d. There are a total of 11 pages.

e. The document attached for electronic filing is OPC's Prehearing Statement.

Thank you for your attention and cooperation to this request.

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FPSC-COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Water and Wastewater Industry Annual Reestablishment of Authorized Range of Return on Common Equity for Water and Wastewater Utilities pursuant to section 367.081(4)(f), F.S.	))))))	**DOCKET NO. 080006-WS** **October 3, 2008**

CITIZENS' PREHEARING STATEMENT

Pursuant to order no. PSC-08-0430-PCO-WS issued July 1, 2008, the Citizens of Florida, through the Office of Public Counsel, hereby submit this Prehearing Statement.

Appearances:

Charlie Beck
Deputy Public Counsel
Office of Public Counsel
c/o The Florida Legislature
111 West Madison Street, Room 812
Tallahassee, Florida 32399-1400
On behalf of the Citizens of Florida.

1. WITNESSES:

Citizens prefiled direct and rebuttal by Mr. James A. Rothschild. Mr. Rothschild's direct testimony describes why the current leverage formula methodology should be updated. His surrebuttal responds to the testimony filed by Ms. Ahern of Utilities Inc. in support of the existing leverage formula methodology and the formula proposed by staff.

2. EXHIBITS:

The following exhibits were prefiled in connection with Mr. Rothschild's direct and surrebuttal testimony:

Direct Testimony

(JAR-1)	Resume of James A. Rothschild
(JAR-2)	Discounted Cash Flow (DCF) Indicated Cost of Equity
(JAR-3)	Capital Asset pricing Model
(JAR-4)	Recommended Leveraged Formula
(JAR-5)	Beta vs. DCF ROE for Companies used in Staff Analysis
(JAR-6)	Modigliani-Miller Theorem
(JAR-7)	Average Betas of 10 Groups of Companies from 1926-2007
(JAR-8)	Average Equity Ratio of Comparative Gas Companies
(JAR-9)	Selected Financial Data of Comparative Companies
(JAR-10)	Simplified Version of the DCF Method
(JAR-11)	External Financial Rate

Surrebuttal Testimony

(JAR-12)	Evaluation of Dr. Morin's Testimony
(JAR-13)	"Financial Advisers and Fuzzy Math"
(JAR-14)	"The Difference in Averaging"

3. STATEMENT OF BASIC POSITION

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

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

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

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

k=(OCC – D(1-ER))/ER

where k=cost of equity

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

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OCC=overall cost of capital

ER=Equity ratio

4. STATEMENT OF FACTUAL ISSUES AND POSITIONS

ISSUE 1: What is the most appropriate model or method to estimate a fair and reasonable return on a water and wastewater (WAW) utility's common equity capital?

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

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

OPC: Yes.

ISSUE 1b: Should the leverage formula methodology take into account the change to the cost of debt in response to changes in the level of common equity in a utility's capital structure?

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

ISSUE 1c: Should the determination of the leverage formula be based on a before-tax or after-tax cost of capital?

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

ISSUE 1d: Is it appropriate to make a Bond Yield Differential adjustment? If so, how should this adjustment be made?

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

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

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

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

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

ISSUE 2: Should the following leverage formula methodology be applied using updated financial data:

Return on Common Equity = 7.36% + 2.123/Equity Ratio

Where the Equity Ration = Common Equity/(Common Equity + Long Term Short-Term Debt)

Range: 9.48% @ 100% equity to 12.67% @ 40% equity

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

k=(OCC – D(1-ER))/ER

where k=cost of equity

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

OCC=overall cost of capital

ER=Equity ratio

ISSUE 3: What is the appropriate range of returns on common equity for water and wastewater (WAW) utilities pursuant to Section 367.081(4)(f), Florida Statutes?

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

ISSUE 4: Should this docket be closed?

OPC: Yes.

5. STIPULATED ISSUES:

None other than those recited in response to earlier issues.

6. PENDING MOTIONS:

On September 26, 2008, Citizens filed a motion for leave to file surrebuttal testimony. Utilities Inc. filed a motion to strike a portion of Mr. Rothschild's surrebuttal testimony and exhibits on October 1, 2008. Citizens are filing a response to the motion to strike, along with a separate motion to strike, today.

7. STATEMENT OF PARTY'S PENDING REQUESTS OR CLAIMS FOR CONFIDENTIALITY:

Citizens have no pending requests or claims for confidentiality;

8. OBJECTIONS TO QUALIFICATION OF WITNESSES AS AN EXPERT:

Citizens have no objection to the qualification of Utilities Inc.'s witness as an expert.

9. <u>STATEMENT OF COMPLIANCE WITH ORDER ESTABLISHING PROCEDURE</u>:

Citizens believe we have complied with the Order Establishing Procedure.

Dated this 3rd day of October, 2008.

Respectfully submitted,

Charlie Beck

Charlie Beck
Deputy Public Counsel

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111 West Madison Street
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Attorney for the Citizens
of the State of Florida

DOCKET NO. 080006-WS
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing Citizens' Prehearing Statement has been furnished by U.S. Mail and electronic mail to the following parties on this 3rd day of October, 2008.

Jean Hartman
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