

State of Florida



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# Public Service Commission

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COMMISSION  
CLERK

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

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**DATE:** April 23, 2009  
**TO:** Ann Cole, Commission Clerk - PSC, Office of Commission Clerk  
**FROM:** Shari L. Cornelius, Staff Assistant, Division of Economic Regulation  
**RE:** Docket No. 080366-GU

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*SC* *CRAB* *MM*

The attached page 22 was inadvertently omitted from the above-referenced docket. However, it was included in the copies and in the electronic version. Please insert this page into the original document.

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FPSC-COMMISSION CLERK

**Issue 15:** What is the appropriate return on common equity for the projected test year?

**Recommendation:** The appropriate return on common equity for the projected test year is 11.00 percent with a range of plus or minus 100 basis points. (Livingston)

**Staff Analysis:** FPUC requested a return on common equity (ROE) of 11.75 percent. The Company's currently-allowed ROE of 11.25 percent was authorized in Order No. PSC-04-1110-PAA-GU.

This docket is being handled as a proposed agency action (PAA). The Commission has not held a hearing in this matter. To support its proposed ROE, FPUC proffered a witness that provided the results of four capital valuation methods applied to two groups of companies identified as comparable in risk to FPUC. These methods include the Capital Asset Pricing Model (CAPM), Discounted Cash Flow (DCF) analysis, Risk Premium (RP) model, and an assessment of realized market returns. No other parties filed testimony in this docket regarding ROE.

#### ROE Models

Based on the statutory principles for determining the appropriate rate of return for a regulated utility set forth by the U.S. Supreme Court in its Hope and Bluefield decisions, the Company developed two groups of comparable risk utilities to determine the ROE for FPUC.<sup>5</sup> The first group, "Sample 1," consisted of eight mid-sized natural gas distribution companies (LDCs). These companies were selected based on business line and financial performance. FPUC also analyzed each company based on the following criteria: equity participation in total capital, coefficient of variation in earnings per share over five and ten year periods, CAPM beta, and variation in market returns. This criteria was also applied to the second group, "Sample 2," which is comprised of 11 mid-sized electric utilities (IOUs). FPUC identified the companies in each group using data from Value Line Investment Survey (Value Line), Ibbotson Associates (Morningstar), and web-based services such as Yahoo Finance, UBS Financial Services, and Zacks Financial Services.

FPUC' witness used a single-stage DCF model in its analysis of each group. The DCF model defines the cost of capital as the sum of the adjusted dividend yield and expectations of future growth in cash flows to investors, including dividends and future appreciation in share prices. The results of this analysis ranged from 13.13 percent to 14.97 percent for the LDCs and from 9.57 percent to 13.17 percent for the IOUs. These results included an adjustment for flotation costs of 6 percent or approximately 25 to 33 basis points. Based on this analysis, FPUC concluded a DCF-based ROE of 12.84 percent.

FPUC' witness also employed the CAPM in its analysis. The CAPM is a risk premium model that uses as inputs a risk-free rate, an overall return for the market, and beta. Beta is a measure of systematic risk, which is risk that cannot be diversified away. FPUC applied the

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<sup>5</sup> Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679 (1923).

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