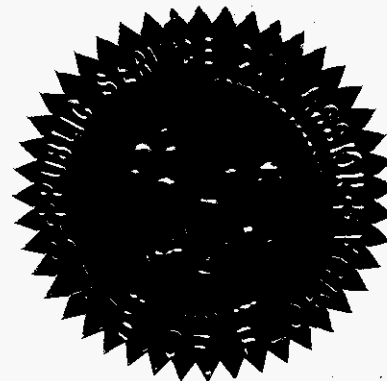


BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

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

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



VOLUME 33
Pages 4351 through 4577

ELECTRONIC VERSIONS OF THIS TRANSCRIPT ARE
A CONVENIENCE COPY ONLY AND ARE NOT
THE OFFICIAL TRANSCRIPT OF THE HEARING,
THE .PDF VERSION INCLUDES PREFILED TESTIMONY.

PROCEEDINGS: HEARING

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

DATE: Wednesday, September 16, 2009

TIME: Commenced at 9:38 a.m.

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

REPORTED BY: LINDA BOLES, RPR, CRR
Official FPSC Reporter
(850) 413-6734

APPEARANCES: (As heretofore noted.)

DOCUMENT NUMBER-DATE

09720-SEP218

FPSC-COMMISSION CLERK

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

I N D E X

WITNESSES

NAME:

PAGE NO.

WILLIAM E. AVERA

Direct Examination by Mr. Anderson	4366
Prefiled Direct Testimony Inserted	4370
Prefiled Rebuttal Testimony Inserted	4451
Cross Examination by Mr. Mendiola	4474
Cross Examination by Mr. McGlothlin	4558

CERTIFICATE OF REPORTER

4577

	EXHIBITS		
	NUMBER:	ID.	ADMTD.
1			
2			
3	130 WEA-1	4368	
4	131 WEA-2	4368	
5	132 WEA-3	4368	
6	133 WEA-4	4368	
7	134 WEA-5	4368	
8	135 WEA-6	4368	
9	136 WEA-7	4368	
10	137 WEA-8	4368	
11	138 WEA-9	4368	
12	139 WEA-10	4368	
13	140 WEA-11	4368	
14	141 WEA-12	4368	
15	142 WEA-13	4368	
16	143 WEA-14	4368	
17	144 WEA-15	4368	
18	145 WEA-16	4368	
19	146 WEA-17	4368	
20	363 WEA-18	4369	
21	492 CBOE Volatility Index	4496	
22	493 Steven G. Kim Article	4507	
23	494 Avista Testimony	4539	
24	495 Pepco Holdings, Inc.	4544	
25	496 Utility Proxy Group Analysis	4550	

P R O C E E D I N G S

1
2 (Transcript continues in sequence from Volume
3 32.)

4 **CHAIRMAN CARTER:** Good morning and welcome
5 again. Good to see everybody again. I mean that in a
6 generic sense. I know you guys are all ready to go and
7 so am I.

8 We, we are going to -- the word I used before
9 was fluidity with our court reporters, so they'll be
10 able to move in and move out without having to take
11 breaks or anything like that. And we're going to go --
12 I know that we've got a lot in front of us, but I want
13 everyone to understand that, like I said to you before,
14 people get a chance to present their case and we'll move
15 forward on that. So I don't want anybody to have any
16 brain cramps and forget what you're supposed to say or
17 anything like that, but we will proceed. All right?

18 Staff, any preliminary matters before we get
19 started?

20 **MS. BENNETT:** None from staff.

21 **CHAIRMAN CARTER:** Okay. From the parties, any
22 preliminary matters? Mr. Moyle, good morning.

23 **MR. MOYLE:** I have one that I'll just provide
24 maybe a heads up on. I don't know if now is the time to
25 bring it up, but we might do it before Mr. Pimentel

1 takes the stand. I mean, this witness, I don't believe,
2 has any, any knowledge. But in response to a request
3 from, I guess it was a Commission request last week,
4 Commissioner Skop had asked for the flight logs related
5 to the aviation issue. And those were produced late
6 yesterday. FIPUG had proffered an objection to those
7 because we hadn't seen what is there. I think -- I'll
8 consult with the Attorney General. I think we'll
9 probably be able to withdraw that.

10 But the thing that was, we found curious was
11 that a bunch of information was deleted off these logs.
12 There was a bunch of blackout stuff. And I don't
13 understand that they're confidential, if they're claimed
14 confidential, and I don't know, I think there's a
15 confidentiality order. To the extent it is
16 confidential, it's done that way. So I'm unsure as to,
17 you know, by what authority things are blacked out. I
18 know in discovery, you know, you're not able to send a
19 document and then black out things that you, you think
20 are not relevant. But that's an issue that I just
21 wanted to, you know, put out there as we, as we get
22 going.

23 **CHAIRMAN CARTER:** Okay. Not a problem.

24 Commissioner Skop.

25 **COMMISSIONER SKOP:** Thank you, Mr. Chair.

1 To Mr. Moyle's comments, I also received the
2 documents yesterday. I pored through them last night.
3 I have some concerns regarding the redactions. My
4 understanding in speaking to staff is that we do have
5 unredacted copies. I also have some additional
6 questions related to that that I'll get into with the
7 appropriate witness. But there's --

8 **CHAIRMAN CARTER:** Hang on a second,
9 Commissioner.

10 **COMMISSIONER SKOP:** I'm sorry.

11 **CHAIRMAN CARTER:** Chris, could you raise
12 Commissioner Skop's volume, please?

13 **MR. POTTS:** Yes, sir. Just one minute.

14 **CHAIRMAN CARTER:** Okay, Commissioner.

15 **COMMISSIONER SKOP:** Test. Okay.

16 But to Mr. Moyle's comments, again, I looked
17 through the data last night. The redactions,
18 particularly flights to Houston, you know, stuck out
19 like a sore thumb. So I talked to our staff. We
20 apparently have an unredacted copy of, of the data which
21 we're going to be taking a look at. But I have some
22 additional comments in terms of cost allocations that
23 I'll get to with the appropriate witness.

24 Thank you.

25 **CHAIRMAN CARTER:** Okay. And what we'll do

1 also for all the parties is that the copies that are
2 unredacted, all of the parties that have signed the
3 confidentiality agreement, assuming that is the case,
4 then you'll be able to see that. And before we do
5 anything in terms of admission or anything like that, I
6 want to make sure that all the parties have an
7 opportunity to see these documents. Okay?

8 **MR. MOYLE:** That's fine.

9 **CHAIRMAN CARTER:** Okay.

10 **MR. MOYLE:** The question I have though is I'm
11 not, I don't understand that FPL is claiming
12 confidentiality over it. I mean --

13 **CHAIRMAN CARTER:** You'll still be able to see
14 them, regardless of what they're --

15 **COMMISSIONER ARGENZIANO:** Mr. Chair, Mr.
16 Chair, I have that same concern. When was there any
17 kind of motion or request for confidentiality?

18 **MR. MOYLE:** They didn't ask for it.

19 **COMMISSIONER ARGENZIANO:** And I understand
20 that there are confidential pieces of information there,
21 but usually I thought you request confidentiality. I
22 think that's what Mr. Moyle is going to, and that would
23 be my first question. What -- how did that come up?

24 **CHAIRMAN CARTER:** Hang on a second. Staff.

25 **MR. WILLIS:** Chairman Carter --

1 **CHAIRMAN CARTER:** Yes, ma'am. Yes, sir.

2 **MR. WILLIS:** We thought we had an unredacted
3 version in the Clerk's Office. My staff went to check a
4 minute ago. We do not have an unredacted version, so.

5 **CHAIRMAN CARTER:** Commissioner Skop.

6 **COMMISSIONER SKOP:** Thank you, Mr. Chairman.
7 My understanding, again, I was looking at the
8 redactions. I did see a couple redacted sheets that had
9 "confidential" stamped on top of the page for those
10 particular flights.

11 Again, I think I would like to, unless the
12 company would take exception, see the unredacted version
13 of the documents. I'm also -- because what was
14 requested was only fixed wing aircraft, the flight log
15 numbers are not sequential. So it would be nice to have
16 a master list of not the documents but all the flight
17 log numbers along with the dates and the tail number,
18 and that way, you know, you can sort through what we
19 have versus what we don't have.

20 I also have a concern to the extent that one
21 of the company-owned airplanes appears to be used in
22 Part 135 operations, under FAA regulations, under New
23 World Air, and that's at the back of the document. And,
24 again, I have some concerns about that to the extent
25 that, you know, we need to take a look at some of the

1 issues that it brought up. So I'll get to those with
2 the appropriate witness.

3 **CHAIRMAN CARTER:** Okay. Let's do this.

4 Mr. Butler?

5 **MR. BUTLER:** It's probably going to be useful
6 for me to say what you do have and don't have just so
7 there isn't confusion going forward, and we can discuss
8 it now or later at your preference.

9 But we have provided all of the fixed wing
10 aircraft, you know, logs and, excuse me, all of the
11 logs. The gaps in the Bates number sequence that
12 Commissioner Skop is referring to is because originally
13 there had been a discovery production where it also
14 included the rotary aircraft, the helicopters. So when
15 those got pulled out, you ended up with gaps in the
16 Bates number sequence on it.

17 The reason for the redaction is not
18 confidential. One of the reasons it took us a while to
19 get these filed is we went through very carefully and
20 made a decision that we could file all of the
21 information on a nonconfidential basis. So we're not
22 requesting confidentiality on it, although we had
23 initially provided information on the logs and discovery
24 on a confidential basis. We have withdrawn that
25 confidentiality claim for it.

1 But the logs include information not only for
2 FPL and FPL Group, which, you know, FPL shares in
3 allocation of costs for FPL Group flights, but includes
4 flights that are purely for -- or seats occupied purely
5 for affiliate operations. What we've done is we've
6 redacted as not relevant the information on the
7 individual who flew, the specific business unit within
8 the affiliate and the purpose of the flight for those
9 affiliate flights. We've left the information that it
10 is an affiliate, the name of the affiliate so you can
11 see that it's an affiliate flight. We've left the to
12 and from, which allows anybody who wanted to calculate
13 what mileage was involved, if there's a question of
14 developing the allocations with respect to those flights
15 that were for affiliates.

16 But consistent with our practice on all of the
17 discovery that we have produced throughout the case, we
18 had not provided details on the business activities of
19 affiliates where none of that is charged to the utility.
20 And that's, that's the basis for the redactions that
21 appear in the logs that we had filed yesterday.

22 **CHAIRMAN CARTER:** Okay. The witness that will
23 come up for this matter would be Witness --

24 **MR. BUTLER:** The witness who will be -- of the
25 two remaining witnesses, the ones who have an ability to

1 speak to this, Mr. Pimentel is familiar generally with
2 the aviation policies. I don't think he's familiar
3 specifically with the logs. You know, our Witness
4 Barrett, who will be back on rebuttal, has some greater
5 familiarity, not with the logs per se, but with the
6 projections of the costs into the test year based on the
7 information that, you know, on historical flights, which
8 is obviously what is reflected on the, on the logs.

9 Mr. Bennett was of course the witness who was
10 most particularly familiar with them. But of the
11 witnesses we have on our, you know, remaining slate of
12 witnesses, those are the two with the greatest
13 familiarity.

14 **CHAIRMAN CARTER:** Commissioner Skop?

15 **COMMISSIONER SKOP:** Thank you, Mr. Chairman.

16 I guess when the witnesses come up, and perhaps --
17 again, I don't want to draw out the process. I think
18 from a cost accounting perspective our staff is trying
19 to get a better handle on making sure that the, the
20 costs are appropriately allocated and captured between
21 the functional unit and the regulated entity.

22 I have specific concerns about the Part 135
23 operation that appears to be some sort of timeshare for
24 executives under New World Jet, which is the same
25 aircraft tail number that FPL uses for regular flights.

1 And that tail number would be N1128 Bravo. So, again,
2 that has some ramifications and questions.

3 I also have questions with respect to FPL
4 lobbyists that are listed as guests on the flight, that
5 it -- the company activity charge appears to be Group,
6 which would be allocated, either Group or FPL allocated
7 to those particular things.

8 And the question is is the determining factor
9 for allocating costs the manifest and does that generate
10 the charge or is that subsequently reversed or accounted
11 for in proper cost accounting? But, again, I don't want
12 to be accusatory. I just want to try and have a better
13 understanding.

14 I also see noncompany attorneys on there as
15 guests periodically as well as a few other people. And,
16 again, I think that we need to take a look at that. One
17 particular flight had Eric Draper and Susan Glickman on
18 it for a press event and the billing entity was FPL.
19 So, again, I think those are some concerns, again,
20 trying to be fair to the company to take a look
21 critically at whether costs are properly allocated. But
22 if we can't get to the bottom of that, I think that the
23 company is potentially looking at disallowances.

24 So, again, I just want to get my questions
25 answered. I think it's a fair question in light of the

1 scrutiny that it deserves. And I guess we can, with the
2 appropriate witness, get to the answer to those
3 questions that I have.

4 **MR. BUTLER:** Thank you, Commissioner. We will
5 be sure -- we have, I think, the luxury of time in that
6 Mr. or Dr. Avera may be on the stand for a few minutes
7 here. But we will be sure that we have the appropriate
8 witness ready to answer your questions.

9 **COMMISSIONER SKOP:** Thank you.

10 **CHAIRMAN CARTER:** Okay. Does this -- this has
11 nothing to do the witness that's currently on the stand?

12 **MR. BUTLER:** It does not.

13 **CHAIRMAN CARTER:** Well, let's get going, guys
14 and dolls. Has this witness been sworn?

15 **COMMISSIONER EDGAR:** Mr. Chairman, excuse me.

16 **CHAIRMAN CARTER:** Yes. Commissioner Edgar,
17 you're recognized.

18 **COMMISSIONER EDGAR:** Could I ask so that I'm
19 also situated -- thank you. I apologize for
20 interrupting. Could we just briefly go over the order
21 of witnesses for this morning? I mean, just maybe the
22 first three.

23 **CHAIRMAN CARTER:** Ms. Bennett?

24 **MS. BENNETT:** Yes. Dr. Avera and then
25 Mr. Pimentel and then Mr. Reed.

1 **COMMISSIONER EDGAR:** Okay. Thank you.

2 **CHAIRMAN CARTER:** Mr. Wright.

3 **MR. WRIGHT:** Thank you, Mr. Chairman. I have
4 a relatively mundane preliminary matter. There's some,
5 some ambiguity as to what the correct procedure is for
6 obtaining the Commission's official recognition of its
7 own orders. I had thought from prior proceedings that
8 one need not file a formal request in writing for the
9 Commission to take official recognition of its own
10 orders.

11 **CHAIRMAN CARTER:** You are correct. You are
12 correct.

13 **MR. WRIGHT:** And so I can cite orders -- my
14 understanding then is that I can cite orders for what
15 they are in my brief without having to ask for official
16 recognition?

17 **CHAIRMAN CARTER:** Absolutely.

18 **MR. WRIGHT:** Thank you. I apologize. There
19 was just some ambiguities between the parties. And
20 Mr. Butler and Mr. McGlothlin and I have discussed it.
21 We're all on the same page. I just wanted to make sure.

22 **CHAIRMAN CARTER:** Well, let's clear that up
23 then, because I mean obviously you would cite the order
24 number and staff would have that with the docket number
25 and all that, so.

1 **MR. WRIGHT:** Of course, Your Honor.

2 **CHAIRMAN CARTER:** Yeah. We don't -- obviously
3 we would recognize our own orders and all. So that's,
4 you're right, that's a mundane matter, but I certainly
5 would like to clear that up.

6 **MR. WRIGHT:** Thank you, Mr. Chairman.

7 **CHAIRMAN CARTER:** Mr. Moyle, ever so briefly.

8 **MR. MOYLE:** Just back on that issue.

9 **CHAIRMAN CARTER:** Which issue is that?

10 **MR. MOYLE:** I want to make sure that there's
11 no ambiguity with respect to the, to the flight logs and
12 the deletion of information. On the basis of relevancy
13 I'm going to make a motion at some point.

14 **CHAIRMAN CARTER:** You can do it at the point,
15 when we get to that point. We're not there right now.
16 Let's just --

17 **MR. MOYLE:** Okay. Because there's no rule
18 that I'm aware of that let's you --

19 (Simultaneous conversation.)

20 **CHAIRMAN CARTER:** We'll get started now, boys
21 and girls.

22 Okay. Has this witness been sworn?

23 **MR. ANDERSON:** Yes, sir, he has.

24 **CHAIRMAN CARTER:** Okay. Dr. Avera, are you
25 familiar with our time system?

1 **THE WITNESS:** I am, Mr. Chairman.

2 **CHAIRMAN CARTER:** Okay. All right. Let's,
3 let's go ahead before we do that. You're recognized,
4 Mr. Anderson.

5 **MR. ANDERSON:** Thank you, Chairman Carter.

6 **WILLIAM E. AVERA**

7 was called as a witness on behalf of Florida Power &
8 Light Company and, having been duly sworn, testified as
9 follows:

10 **DIRECT EXAMINATION**

11 **BY MR. ANDERSON:**

12 **Q.** Good morning, Dr. Avera.

13 **A.** Good morning, Mr. Anderson.

14 **Q.** Would you tell us your business name -- your
15 name and your business address?

16 **A.** I'm William E. Avera. I'm president of
17 FINCAP, Incorporated, 3907 Red River Street, Austin,
18 Texas 78751.

19 **Q.** Have you prepared and caused to be filed 88
20 pages of prefiled direct testimony in this proceeding?

21 **A.** I have.

22 **Q.** You've also caused to be filed errata to your
23 testimony?

24 **A.** Yes.

25 **Q.** Do you have any further changes or revisions

1 to your prefiled direct testimony?

2 **A.** I have one small change on Exhibit WEA-10,
3 Page 2 of 3 and 3 of 3.

4 **Q.** Could you tell us what that is?

5 **A.** If you go down to company Number 12, you will
6 see that Boeing is repeated. On other exhibits, Number
7 12 company is Brown-Forman 'B', the people who bring us
8 Jack Daniels and other products which I'm told some
9 consume. So 12 should be not Boeing but Brown-Forman
10 'B' on Page 2 of 3, and a similar change on Page 3 of 3.

11 **Q.** With those changes, if I asked you the same
12 questions contained in your prefiled direct testimony,
13 would your answers be the same?

14 **A.** Yes, sir.

15 **MR. ANDERSON:** Chairman Carter, FPL asks the
16 prefiled direct testimony of Dr. Avera be inserted into
17 the record as though read.

18 **CHAIRMAN CARTER:** The prefiled testimony of
19 the witness will be inserted into the record as though
20 read.

21 **BY MR. ANDERSON:**

22 **Q.** You're sponsoring exhibits to your direct
23 testimony?

24 **A.** Yes, sir.

25 **Q.** Thirty-three pages marked as WEA-1 to 17?

1 **A.** Yes.

2 **MR. ANDERSON:** Chairman Carter, these have
3 been previously marked by staff as Exhibits 130 to 146
4 on the Comprehensive Exhibit List.

5 **CHAIRMAN CARTER:** 130 to 146 for the record.

6 (Exhibits 130 through 146 marked for
7 identification.)

8 **BY MR. ANDERSON:**

9 **Q.** Have you prepared rebuttal testimony in this
10 proceeding?

11 **A.** Yes, sir.

12 **Q.** Does that consist of 20 pages of prefiled
13 rebuttal testimony?

14 **A.** Yes.

15 **Q.** Do you have any other changes, additions,
16 deletions to that rebuttal testimony?

17 **A.** No.

18 **Q.** If I asked you the same questions contained in
19 your prefiled rebuttal testimony, would your answers be
20 the same?

21 **A.** Yes.

22 **MR. ANDERSON:** Chairman Carter, we ask that
23 the prefiled rebuttal testimony be inserted into the
24 record as though read.

25 **CHAIRMAN CARTER:** The prefiled testimony of

1 the witness will be inserted into the record as though
2 read.

3 **BY MR. ANDERSON:**

4 Q. You're sponsoring one exhibit to your rebuttal
5 testimony?

6 A. Yes.

7 Q. That's 66 pages and it's marked as WEA-18;
8 right?

9 A. Yes.

10 **MR. ANDERSON:** Chairman Carter, that's been
11 previously marked as Exhibit 363 on the Comprehensive
12 Exhibit List.

13 **CHAIRMAN CARTER:** 363; is that correct? Let
14 me thumb to that page for a second.

15 It's found on Page 42, Commissioners.

16 (Exhibit 363 marked for identification.)

17 You may proceed.

18 **MR. ANDERSON:** Thank you. I would note that
19 Dr. Avera is sponsoring his direct and his rebuttal
20 testimony at this time. He's prepared to --

21 **CHAIRMAN CARTER:** Okay. Chris, the time for
22 direct and rebuttal. Okay.

1 **BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**
2 **FLORIDA POWER & LIGHT COMPANY**
3 **DIRECT TESTIMONY OF WILLIAM E. AVERA**
4 **DOCKET NO. 080677-EI**

5
6 **Q. Please state your name and business address.**

7 A. William E. Avera, 3907 Red River, Austin, Texas 78751.

8 **Q. By whom are you employed and in what capacity?**

9 A. I am a principal in Financial Concepts and Applications, Inc. ("FINCAP"), a firm
10 engaged in financial, economic, and policy consulting to business and
11 government.

12

13 **I. OVERVIEW**

14

15 **Q. What is the purpose of your testimony?**

16 A. The purpose of my testimony is to present to the Florida Public Service
17 Commission ("FPSC" or the "Commission") my assessment of the fair rate of
18 return on common equity ("ROE") for the jurisdictional electric utility operations
19 of Florida Power & Light Company ("FPL" or the "Company"). In addition, I
20 examine the reasonableness of FPL's capital structure.

21 **Q. Are you sponsoring any exhibits in this case?**

22 A. Yes. I am sponsoring Exhibits WEA-1 through WEA-17, which are attached to
23 my direct testimony.

- 1 • WEA-1 Qualifications of William E. Avera
- 2 • WEA-2 Yield Spreads – Corporate Bonds v. Treasuries
- 3 • WEA-3 CBOE VIX Index – One Month Moving Average
- 4 • WEA-4 Average Public Utility Bond Yield
- 5 • WEA-5 20-Year Treasury Bond Yields / Utility Bond Yield Spread
- 6 • WEA-6 Comparison of Proxy Group Risk Indicators
- 7 • WEA-7 DCF Model – Utility Proxy Group
- 8 • WEA-8 Sustainable Growth Rate – Utility Proxy Group
- 9 • WEA-9 DCF Model – Non-Utility Proxy Group
- 10 • WEA-10 Sustainable Growth Rate – Non-Utility Proxy Group
- 11 • WEA-11 Forward-looking CAPM – Utility Proxy Group
- 12 • WEA-12 Forward-looking CAPM – Non-Utility Proxy Group
- 13 • WEA-13 Expected Earnings Approach
- 14 • WEA-14 FPL Adjusted Capital Structure
- 15 • WEA-15 Capital Structure – Electric Utility Operating Cos.
- 16 • WEA-16 Capital Structure – Utility Proxy Group
- 17 • WEA-17 Endnotes to Direct Testimony of William E. Avera
- 18 **Q. Are you sponsoring or co-sponsoring any Minimum Filing Requirements**
- 19 **(“MFRs”)?**
- 20 A. No.
- 21 **Q. Please describe your educational background and professional experience.**
- 22 A. A description of my background and qualifications, including a resume containing
- 23 the details of my experience, is attached as Exhibit WEA-1.

1 **Q. Please summarize the information and materials you relied on to support the**
2 **opinions and conclusions contained in your testimony.**

3 A. I am familiar with the organization, finances, and operations of FPL from my
4 participation in prior proceedings before the FPSC. In connection with the
5 present filing, I considered and relied upon corporate disclosures, publicly
6 available financial reports and filings, and other published information relating to
7 FPL, including bond rating agency reports, financial filings, and prior regulatory
8 proceedings and orders. I also reviewed information relating generally to current
9 capital market conditions and specifically to current investor perceptions,
10 requirements, and expectations for FPL. These sources, coupled with my
11 experience in the fields of finance and utility regulation, have given me a working
12 knowledge of these issues relevant to investors' required return for FPL, and they
13 form the basis of my analyses and conclusions.

14 **Q. Please summarize your findings regarding a fair ROE for FPL.**

15 A. I determined that a fair ROE for FPL is currently in the range of 12.0 percent to
16 13.0 percent. This conclusion is based on several factors. I applied three
17 conventional methods of estimating ROE to a proxy group of nineteen other
18 utilities with comparable investment risks. Consistent with the fact that utilities
19 must compete for capital with firms outside their own industry, I also referenced a
20 proxy group of comparable risk companies in the non-utility sector of the
21 economy. In addition, my testimony explains that the fairness of an ROE within
22 the 12.0 percent to 13.0 percent range is supported by the need to maintain FPL's
23 strong financial position and provide a return on flotation costs. I also explain

1 how it is appropriate that the Commission recognize FPL's excellence in
2 management in establishing FPL's ROE within the recommended range. My
3 testimony demonstrates that FPL's capital structure is consistent with my fair
4 ROE range and necessary to meet the financial challenges FPL is now facing.

5 **Q. What are the financial challenges facing FPL?**

6 A. The nation is in the midst of a financial crisis that has made investors wary of
7 putting their money into anything other than the safest investments. FPL has
8 planned significant new capital investments to keep its system efficient and
9 reliable for the customers it serves. If FPL can raise private capital for these vital
10 infrastructure investments, both its customers and the economy of Florida will
11 benefit. In the past, FPL's financial strength, fostered by the support of this
12 Commission, has served customers well as the Company has been able to raise
13 capital on a reasonable basis to meet past challenges such as devastating storms.
14 To maintain its position of strength through the current financial crisis, FPL needs
15 the continued support of this Commission. FPL must be in a position of financial
16 strength to attract private capital on reasonable terms from investors whose first
17 instinct is to rush to the safety of U.S. Treasury securities. As illustrated on
18 Exhibit WEA-2, the spreads between the yields on U.S. Treasuries and corporate
19 bonds have recently risen to levels not seen since the Great Depression.

20 **Q. Given FPL's strong credit rating and investors' high regard for the quality of**
21 **this Commission, could FPL get by with a lower return during this period of**
22 **economic hardship?**

1 A. No. The challenging capital market environment highlights the benefits of FPL's
2 strong credit standing in attracting the capital needed to secure reliable service at
3 a lower cost for customers. Changing course from the path of financial strength
4 would be extremely short-sighted. Customers and the economy of Florida have
5 benefited from FPL's financial flexibility and ability to raise capital on reasonable
6 terms. If investors perceived that the Commission was withdrawing its support
7 for FPL's financial strength at this crucial juncture, then it would likely take a
8 long time to re-establish the well-deserved reputation that this Commission has
9 earned among investors. By helping sustain FPL's financial strength, the FPSC
10 will facilitate the flow of capital on reasonable terms that is required for the
11 Company to maintain and improve the electric infrastructure so vital to Florida's
12 economic recovery and future growth.

13 **Q. How can the FPSC be sure that an ROE in the 12.0 percent to 13.0 percent**
14 **range is necessary to maintain FPL's financial strength and ability to raise**
15 **capital in these challenging times?**

16 A. My testimony documents analyses using accepted methods that support the
17 reasonableness of a 12 percent to 13 percent ROE range for FPL. But beyond
18 these technical analyses, the Commission can confirm the reasonableness of the
19 ROE based on observable reality and common sense. Investors need to be paid to
20 put their money at risk. They always have the option of lending to the U.S.
21 government where interest and principal is assured by the power to tax and print
22 money. Investors can also buy utility bonds. Although more risky than U.S.
23 Treasury bonds, utility bonds offer investors the comfort of having interest and

1 principal payments that are specified by contract and have a senior claim on
2 earnings and assets. Common stock investors are the last in line to get paid, and
3 hence bear the greatest risk. The observable yields on utility bonds have soared
4 during the current crisis, with the average utility bond yield now over 100 basis
5 points higher since the FPSC approved the settlement in FPL's last base rate
6 proceeding. Because investors can now earn higher interest from the relative
7 safety of a utility bond, they require even higher compensation to put their money
8 at risk in a utility stock.

9 **Q. Is it possible that the current financial crisis is a temporary aberration that**
10 **will soon abate?**

11 A. No one knows the future of our complex global economy. We know that this
12 crisis has been building for a long time and few predicted that the economy would
13 fall as rapidly as it has, or that corporate bond yields would rise as rapidly as they
14 have. But it would be imprudent to gamble the interests of customers and the
15 economy of Florida in the hope that the harsh economic reality will pass quickly.
16 FPL must raise capital in the real world of financial markets. To ignore the
17 current reality would be unwise given the importance of reliable electric power
18 for customers and the economy.

1 While FPL enjoys the benefits of a strong credit rating, supportive regulation, and
2 excellent management, it also faces some unique circumstances that demand
3 financial resilience to protect its customers. For example, due to its location on
4 the Florida peninsula, FPL is exposed to fuel supply interruptions and
5 transmission disturbances that may require financial resources to seek alternative
6 sources of power and energy on a temporary or extended basis. FPL's use of
7 nuclear power, wisely supported by this Commission and state leaders, has many
8 economic and environmental benefits. But the exposure to outages due to
9 circumstances beyond the control of the company (e.g., Nuclear Regulatory
10 Commission actions) means that FPL must have the financial resilience required
11 to purchase or generate replacement power with little notice. FPL's customers are
12 predominantly home and small business owners with few alternatives when power
13 is interrupted and therefore are particularly dependent on FPL's reliability. This
14 exposure is exacerbated by the potential for tropical storms in FPL's service area,
15 which create a particular need for financial resilience by FPL. Similarly, if
16 Florida is to grow, reliable electric service is paramount.

17 **Q. In addition to considering the specific conditions and exposures that affect**
18 **FPL, what quantitative estimation methods did you use to evaluate an ROE**
19 **for FPL?**

20 A. I applied three recognized methods to estimate investors' required rate of return:
21 • *Discounted Cash Flow ("DCF") model that uses the current stock price,*
22 *dividend, and expected growth rate to estimate investors' required return;*

- 1 ● *Capital Asset Pricing Model ("CAPM") that uses the expected stock*
- 2 *market risk premium, the risk-free Treasury yield, and the beta to estimate*
- 3 *investors' return requirements; and,*
- 4 ● *Expected Earnings Approach, which I apply using forward-looking*
- 5 *information to assess what investors expect comparable companies to*
- 6 *actually earn.*

7 **Q. Why did you rely on more than one method to estimate the cost of equity for**
8 **FPL?**

9 A. Each method relies on different inputs and assumptions. Investors do not limit
10 themselves to any one method of evaluating stocks competing for their money. If
11 the cost of equity estimation is limited to a single approach, the resulting estimate
12 may be unreasonable and unreliable.

13 **Q. Does the fact that there are different accepted methods to estimate the cost of**
14 **equity, each based on certain assumptions, imply that determining the ROE**
15 **is subjective?**

16 A. Absolutely not. The alternative approaches that I have applied to estimate the
17 cost of equity have considerable theoretical and practical support, and the body of
18 knowledge on the topic of cost of capital attests to the significance of developing
19 cost of capital estimates that work in the real world of financial markets. For
20 example, the reality that investors require compensation for bearing the risk of
21 putting their money in common stock is a fundamental tenet of the theory and
22 practice of finance. While assumptions and judgment underlie these methods to

1 estimate the cost of equity, this does not imply that they are subjective or that the
2 cost of equity is unknowable.

3
4 Each method of estimating the cost of equity is based on empirical evidence and
5 accepted applications. While experts may disagree on particular nuances and
6 details of their application, the reliability of these methods is confirmed by their
7 use throughout the regulatory arena as well as in the worlds of investment
8 management and corporate finance.

9
10 The fact that alternative methods may give somewhat different results, or that
11 different experts may come to different estimates using these methods, does not
12 mean the methods are subjective or unreliable. It means simply that interpreting
13 the results of these methods requires care and practical judgment.

14 **Q. What is the practical test of the reasonableness of the ROE used in setting a**
15 **utility's rates?**

16 A. The ROE compensates common equity investors for the use of their capital to
17 finance the plant and equipment necessary to provide utility service. Investors
18 commit capital only if they expect to earn a return on their investment
19 commensurate with returns available from alternative investments with
20 comparable risks. To be consistent with sound regulatory economics and the
21 standards set forth by the Supreme Court in the *Bluefield*¹ and *Hope*² cases, a
22 utility's allowed ROE should be sufficient to: (1) fairly compensate investors for
23 capital invested in the utility, (2) enable the utility to offer a return adequate to

1 attract new capital on reasonable terms, and (3) maintain the utility's financial
2 integrity.

3 **Q. Should the Commission's determination of FPL's ROE be based on a review**
4 **of historical returns authorized by other regulatory commissions?**

5 A. No. Reference to historical rates of return authorized by other regulatory
6 commissions does not provide a meaningful basis to establish FPL's ROE for
7 several reasons. First, because of the inherent lag in regulatory proceedings, the
8 test periods and financial data considered in historical cases is unlikely to reflect
9 the dramatic increase in capital costs associated with the financial market turmoil
10 that began in the third quarter of 2008. As a result, recent historical authorized
11 rates of return fail to reflect the returns that investors require in today's capital
12 markets. Moreover, these historical returns are not predicated on the
13 circumstances and financial exposures facing FPL. As I have explained, the
14 Commission should evaluate FPL's cost of equity based upon the return investors
15 require for companies with comparable risk and taking into account the current
16 financial market environment. The Commission's determination should also
17 specifically account for the risks and exposures unique to FPL. I believe that it
18 would be neither good policy or consistent with the regulatory standards
19 established in *Bluefield* and *Hope* decisions for the FPSC to base its ROE for FPL
20 on conclusions reached by other regulatory commissions for non-jurisdictional
21 utilities with different risk profiles, and which are based on data that fail to
22 capture the ongoing upheaval in the economic and capital market environment.

1 **Q. Is it appropriate to recognize and encourage exemplary management in**
2 **evaluating the fair ROE for FPL from within your recommended range?**

3 A. Yes. Recognition and encouragement for exemplary performance, such as that
4 documented in the testimony of FPL's witnesses, is an appropriate consideration
5 in establishing a fair rate of return from within the 12.0 percent to 13.0 percent
6 range. Consumers in FPL's service area have benefited from efficient and cost-
7 effective operations, excellent customer service, reliable electric service, and
8 prices that have declined in real terms. Considering exemplary performance in
9 establishing a point estimate from within my ROE range offers an appropriate
10 incentive for FPL to continue to innovate and take risks in pursuit of superior
11 results.

12 **Q. What is your conclusion as to the reasonableness of FPL's recommended**
13 **capital structure for regulatory purposes?**

14 A. Based on my evaluation, I concluded that the 55.8 percent adjusted common
15 equity ratio requested by FPL and supported in the testimony of FPL witness
16 Pimentel represents a reasonable mix of capital sources from which to calculate
17 FPL's overall rate of return. This conclusion was based on the following findings:

- 18 • *While FPL's adjusted common equity ratio falls somewhat above the*
19 *average maintained by the electric utilities in the proxy group, it is well*
20 *within the range of individual results for these firms and in-line with the*
21 *lower leverage expected for the industry going forward;*
- 22 • *Absent its relatively conservative capital structure, FPL's debt rating*
23 *would undoubtedly be lower than present levels and the resulting greater*

1 *investment risk would imply an increase in investors' required rate of*
2 *return for FPL's securities; and,*

- 3 • *For an electric utility with an obligation to provide reliable service,*
4 *uncertainties associated with FPL's resource mix and service area*
5 *highlight the necessity of preserving financial flexibility, especially during*
6 *periods of adverse capital market conditions.*

7
8 Since the 1930s, there has not been a time when the domestic and global financial
9 markets have experienced as much turmoil and uncertainty as they are now
10 undergoing. For a utility with an obligation to provide reliable service, investors'
11 increased reticence to supply additional capital during times of crisis highlights
12 the necessity of preserving the flexibility necessary to overcome periods of
13 adverse capital market conditions. The investment risks faced by utilities and
14 their investors have only been exacerbated in this uncertain environment. In turn,
15 the need for supportive regulation and an adequate ROE may never have been
16 greater.

17

18 **II. CAPITAL MARKET CONDITIONS**

19

20 **Q. What is the purpose of this section?**

21 A. This section evaluates the impact of recent capital market trends on FPL's ROE
22 and discusses why it is critical to consider investors' current requirements in order
23 to support FPL's finances on an ongoing basis.

1 **Q. What are the implications of recent capital market conditions?**

2 A. Recent volatility in the debt and equity markets linked to the ongoing financial
3 crisis and the economic downturn evidences investors' trepidation to commit
4 capital. Because price volatility implies greater risk for investors, it also marks a
5 significant upward revision in their required returns. The Chicago Board Options
6 Exchange ("CBOE") Volatility Index, commonly known as the "VIX", is a key
7 measure of expectations of near-term volatility and market sentiment based on
8 options prices for the S&P 500 Stock Index ("S&P 500"). The unprecedented
9 price fluctuations and uncertainty that investors have endured since the third-
10 quarter of 2008 is mirrored in the sharp and sustained increase in the VIX, which
11 is plotted on Exhibit WEA-3. Bloomberg reported in October 2008 that the VIX
12 had surged 26 percentage points, to almost triple its average during the past year.³

13
14 With respect to utilities specifically, as of year-end 2008, the Dow Jones Utility
15 Average stock index had declined over 28 percent since June 2008, while yields
16 on utility bonds have experienced significant volatility and increased
17 precipitously. Exhibit WEA-4 plots the monthly average yield on public utility
18 bonds reported by Moody's Investors Service ("Moody's") from August 2005,
19 when the settlement in FPL's last base rate proceeding was approved by the
20 FPSC, through January 2009. As shown there, in August 2005, the average yield
21 on public utility bonds was 5.5 percent. As illustrated on Exhibit WEA-4,
22 average public utility bond yields generally increased through 2007. This upward
23 trajectory increased significantly in 2008, with the average yield on public utility

1 bonds reaching a peak of 7.8 percent in November 2008 before moderating to
2 approximately 6.8 percent in January 2009. In other words, since the settlement
3 in 2005 establishing an 11.75 percent ROE "for all other regulatory purposes"
4 was approved, the average yield on public utility bonds has increased
5 approximately 130 basis points.

6 **Q. What does this evidence indicate with respect to establishing a fair ROE for**
7 **FPL?**

8 A. The sell-off in common stocks and the increase in utility bond yields are
9 indicative of higher costs for long-term capital, reflecting the fact that the ongoing
10 financial and economic crisis has spilled over into the utility industry. For
11 example, utilities have been forced to draw on short-term credit lines to meet debt
12 retirement obligations because of uncertainties regarding the availability of long-
13 term capital.⁴ As the Edison Electric Institute ("EEI") noted in a letter to
14 congressional representatives, the financial crisis has serious implications for
15 utilities and their customers:

16 In the wake of the continuing upheaval on Wall Street, capital
17 markets are all but immobilized, and short-term borrowing costs to
18 utilities have already increased substantially. If the financial crisis
19 is not resolved quickly, financial pressures on utilities will
20 intensify sharply, resulting in higher costs to our customers and,
21 ultimately, could compromise service reliability.⁵

1 Similarly, an October 1, 2008, *Wall Street Journal* report confirmed that
2 dislocations in credit markets were also impacting the utility sector:

3 Disruptions in credit markets are jolting the capital-hungry utility
4 sector, forcing companies to delay new borrowing or come up with
5 different—often more costly—ways of raising cash.⁶

6
7 An October 2008 report on the implications of credit market upheaval for utilities
8 noted that, while high-quality companies can still issue debt, “they now have to
9 pay an unusually high risk premium over Treasuries.”⁷ Similarly, S&P recently
10 concluded:

11 Regulated electric issuers continued to access debt markets during
12 the fourth quarter of 2008 at rates in line with the 10-year average
13 of about 8% for five-year notes, not the abnormally low interest
14 rate environment of the 2000’s which is a distant memory.⁸

15
16 Meanwhile, a Managing Director with Fitch Ratings, Ltd. (“Fitch”) observed that
17 with debt costs at present levels, “significantly higher regulated returns will be
18 required to attract equity capital.”⁹ More recently, Fitch confirmed “sharp
19 repricing of and aversion to risk in the investment community,” and noted that the
20 disruptions in financial markets and the fundamental shift in investors’ risk
21 perceptions has increased the cost of capital for utilities such as FPL:

22 The broad credit markets are in shambles and access to credit is
23 restrictive, particularly at lower credit ratings. While credit is

1 available to investment-grade issuers in the utilities, power and gas
2 sectors, it is more expensive, particularly when viewed against the
3 easy money environment which prevailed for most of this
4 decade.¹⁰

5
6 Fitch concluded, "The sharp increase in the cost of equity capital is a negative
7 credit development."¹¹ All of these statements represent information currently
8 being provided to and reviewed by investors, and constitute real evidence of the
9 investment and economic environment faced by FPL.

10 **Q. Do trends in the yields on Treasury notes and bonds accurately reflect the**
11 **expectations and requirements of FPL's equity investors?**

12 A. No. The graph at the top of Exhibit WEA-5, plots the monthly average yields on
13 20-year Treasury bonds from August 2005 through January 2009. As shown
14 there, beginning in the third quarter of 2007, the yields on 20-year Treasury bonds
15 began a general decline. In response to accelerating concerns over economic
16 uncertainties and the Federal Reserve's actions to increase liquidity in the face of
17 a profound crisis in credit markets, the fall in Treasury bond yields became
18 increasingly pronounced, with the yield on 20-year notes falling below 3 percent
19 in December 2008. Meanwhile, the price of 3-month Treasury bills rose high
20 enough to push yields into the negative for the first time in history.¹²

21
22 While the yields on Treasury securities have fallen significantly, the required
23 returns for common stocks and public utility bonds have moved sharply higher to

1 compensate for increased perceptions of risk. This “flight to quality” has caused
2 the spread between the observable yields on public utility bonds and 20-year
3 Treasury bonds to spike dramatically. The graph at the bottom of Exhibit
4 WEA-5, plots the monthly spread between average public utility bond yields and
5 20-year Treasury bond yields since August 2005. As illustrated there, the gap
6 between the yields on 20-year government bonds and public utility bonds
7 widened significantly, reflecting the extent of the uncertainties facing investors.
8 During 2007, this yield spread averaged 121 basis points, versus 228 basis points
9 in 2008 and 338 basis points during January 2009. As Standard & Poor’s recently
10 observed:

11 The Standard & Poor’s composite spreads widened to new five-
12 year highs yesterday, leaving the investment-grade spread at 554
13 basis points (bps) and the speculative grade spread at 1,598 bps,
14 both well more than triple their five-year moving averages. ...
15 With speculative-grade defaults on the rise, a higher
16 preponderance of credit downgrades, and a general malaise about
17 the future of the economy, we expect spreads to remain at their
18 elevated levels for some time until confidence is restored to the
19 market.¹³

20 **Q. What does this imply with respect to the ROE for a utility such as FPL?**

21 **A.**Because of the significant increase in the spread between utility and government
22 bond yields, trends in Treasury bond yields have virtually no relevance in
23 evaluating long-term capital costs for FPL in the current capital market climate.

1 As a result of the turmoil and uncertainty spreading through financial markets,
2 investors have sought a safe haven in government-backed securities, such as
3 Treasury bonds. While the required returns for other asset classes, such as
4 common stocks and public utility bonds, have moved higher to compensate for
5 increased perceptions of risk, the yields on Treasury securities have fallen
6 significantly. As evidenced above, the spread between the observable yields on
7 utility bonds and Treasury securities has spiked dramatically as a result.

8
9 In other words, focusing solely on the decrease in Treasury bond yields
10 experienced since 2007 might suggest that investors' required returns have fallen,
11 but the exact opposite is true. Treasury bond yields have declined because of a
12 "flight to quality" as investors' risk perceptions have mounted in the face of the
13 ongoing financial crisis. As the Wall Street Journal noted, "Real-world
14 borrowing costs are in a different universe from Treasury yields and Fed rates."¹⁴
15 The fact that prices of Treasury bonds have been driven sharply higher is the
16 mirror image of higher, not lower returns for more risky asset classes, such as the
17 common stock of utilities like FPL.

18 **Q. Would expectations of an economic recession lead to lower capital costs?**

19 A. No. Investors' required rates of return for FPL and other financial assets are a
20 function of risk, with greater exposure to uncertainty requiring higher – not lower
21 – rates of return to induce long-term investment. This has been vividly
22 demonstrated in numerous segments of the debt markets where heightened

1 uncertainties regarding risk exposure have resulted in the almost complete
2 inability of borrowers to access credit at reasonable rates.

3

4 It is important not to confuse investors' expectations for future growth and cash
5 flows, which is one consideration in estimating the cost of equity, with their
6 required rate of return. In fact, trends in growth rates say nothing at all about
7 investors' overall risk perceptions. The fact that investors' required rates of
8 return for long-term capital can rise in tandem with expectations of declining
9 growth that would accompany an economic slowdown is demonstrated in the
10 bond markets, where perceptions of greater risks have pushed yields on long-term
11 utility bonds sharply higher.

12

13 Similarly, the uncertainty over future trends in corporate earnings and stock prices
14 has led investors to sharply reevaluate what they are willing to pay for common
15 stocks. While the precipitous decline in utility stock prices may in part be
16 attributed to somewhat diminished expectations of future cash flows, there is also
17 every indication that investors' discount rate, or cost of equity, has moved
18 significantly higher to accommodate the greater risks they now associate with
19 equity investments.

20

21 The idea that the current recession would lead the rate of return demanded by
22 equity investors to decline is also contrary to economic logic. As documented
23 above, the required yield on long-term utility bonds has increased substantially in

1 response to investors' heightened risk perceptions. A drop in the cost of common
2 equity would imply that the risk premium between common stocks and bonds has
3 declined. The notion that equity risk premiums would be declining at a time of
4 unprecedented capital market turmoil runs counter to common sense. Investors
5 require a higher rate of return to assume more risk and common stocks have the
6 lowest priority claim on a company's cash flows. Given the significant increase
7 in utility bond yields documented earlier, the dramatic widening of the yield
8 spreads between risk-free Treasury bonds and corporate debt instruments, and
9 investors heightened sensitivity to risk, there is no evidence to suggest that the
10 return demanded by equity investors has declined.

11 **Q. Would it be reasonable to disregard current capital market conditions in**
12 **establishing a fair ROE for FPL?**

13 A. Absolutely not. They reflect the reality of the situation in which FPL and other
14 businesses must attract and retain capital. As noted earlier, the standards
15 underlying a fair rate of return require that FPL's authorized ROE reflect a return
16 competitive with other investments of comparable risk and preserve the
17 Company's ability to maintain access to capital on reasonable terms. This
18 standard can only be met by considering the requirements of investors in today's
19 capital markets.

20
21 While the events of the last several months undoubtedly mark a significant
22 transition in investors' expectations, there is very little indication that the dire
23 conditions confronting the economy and financial markets will be resolved

1 quickly. As Fitch recently concluded, “higher corporate interest rates are likely to
2 prevail through 2009 and into the foreseeable future.”¹⁵ Moreover, the fact that
3 market volatility may complicate the evaluation of the cost of equity provides no
4 basis to ignore the dramatic upward shift in investors’ risk perceptions and
5 required rates of return for long-term capital. Capital markets are continuously
6 responding to current information and investors are incessantly revising their
7 forward-looking expectations accordingly. It is for this very reason that it
8 becomes even more critical to focus on current expectations, rather than
9 backward-looking or “normalized” data.

10 **Q. What are the implications of disregarding actual capital market conditions in**
11 **setting the allowed ROE?**

12 A. If the increase in investors’ required rate of return on long-term capital is not
13 incorporated in the allowed rate of return on equity, the results will fail to meet
14 the comparable earnings standard that is fundamental in determining the cost of
15 capital. From a more practical perspective, failing to provide investors with the
16 opportunity to earn a rate of return commensurate with FPL’s risks will only serve
17 to weaken its financial integrity, while hampering the Company’s ability to attract
18 the capital needed to meet the economic and reliability needs of its service area.

1 **III. RISKS AND FINANCIAL REQUIREMENTS OF FPL**

2

3 **Q. What is the purpose of this section of your testimony?**

4 A. As a predicate to my capital market analyses, this section briefly reviews FPL's
5 operations and finances. In addition, it examines the risks that investors take into
6 account in evaluating their required rate of return for FPL and the unique financial
7 requirements that should be considered in establishing a fair ROE for FPL.

8

9 **A. Operations and Finances**

10

11 **Q. Please briefly describe FPL and its parent, FPL Group, Inc.**

12 A. Headquartered in Juno Beach, Florida, FPL is engaged in the generation,
13 transmission, and distribution of electric power throughout 35 counties located
14 principally along the east and lower west coasts of Florida. FPL's service territory
15 includes a population of more than 8.7 million, with service being provided to
16 approximately 4.5 million customers. FPL is the principal subsidiary of FPL
17 Group, Inc. ("FPL Group"). FPL Group is a leading energy company with
18 approximately 39,000 megawatts ("MW") of generating capacity, and more than
19 15,000 employees in 27 states and Canada. In addition to the electric utility
20 operations of FPL, FPL Group's principal subsidiaries include NextEra Energy
21 Resources, LLC, which is the largest generator in North America of renewable
22 energy from the wind and sun. At year-end 2008, FPL Group had total assets of

1 approximately \$44.8 billion, with consolidated revenues totaling approximately
2 \$16.4 billion.

3 **Q. Please describe FPL's electric utility operations.**

4 A. During 2008, approximately 51 percent of electric sales were attributable to
5 residential customers, with 43 percent from commercial and 6 percent from
6 industrial and other users. With a combined capacity of approximately 22,087
7 MW, FPL's generating facilities include four nuclear units at the St. Lucie and
8 Turkey Point generating stations, with a total capacity of 2,939 MW. In 2008,
9 nuclear generation accounted for 22 percent of the electric energy provided by
10 FPL, with natural gas at 53 percent, oil at 5 percent, and coal at 6 percent.

11

12 The remaining 14 percent of FPL's 2008 energy requirements were obtained
13 through purchased power contracts. Take-or-pay purchased power contracts with
14 the Jacksonville Electric Authority and with subsidiaries of The Southern
15 Company provide approximately 1,300 MW of power through mid-2015 and 375
16 MW thereafter through 2021. FPL also has various firm contracts to purchase
17 approximately 740 MW of capacity and energy from certain cogenerators and
18 qualifying facilities. In addition, FPL has various agreements with several other
19 electricity suppliers to purchase an aggregate of up to approximately 920 MW of
20 power with expiration dates ranging from 2009 through 2012. FPL estimates that
21 capacity and minimum payments under these agreements will average
22 approximately \$500 million annually through 2013.

1 FPL's transmission and distribution facilities consist of over 570 substations and
2 include over 48,000 miles of overhead lines and approximately 25,000 miles of
3 underground and submarine cables. At December 31, 2008, FPL's investment in
4 utility assets was approximately \$26.2 billion. FPL's retail electric operations are
5 subject to the jurisdiction of the FPSC, with the interstate jurisdiction regulated by
6 the Federal Energy Regulatory Commission ("FERC"). Additionally, FPL's
7 nuclear facilities are subject to licensing and oversight by the Nuclear Regulatory
8 Commission. FPL's latest decommissioning studies indicate that FPL's portion of
9 the cost of decommissioning its four nuclear units, including costs associated with
10 spent fuel storage, to be \$10.9 billion. At December 31, 2008, the accumulated
11 provision for nuclear decommissioning totaled approximately \$2.3 billion.

12 **Q. What credit ratings have been assigned to FPL?**

13 A. FPL has been assigned a corporate credit rating of "A" by Standard & Poor's
14 Corporation ("S&P") and an issuer rating of "A1" by Moody's Investors Service
15 ("Moody's"). Similarly, Fitch Ratings Ltd. ("Fitch") has assigned an issuer
16 default rating of "A" to FPL.

17

18 **B. Risks and Financial Requirements**

19

20 **Q. How have investors' risk perceptions for the utility industry evolved?**

21 A. Implementation of structural change and related events caused investors to rethink
22 their assessment of the relative risks associated with the utility industry. The past
23 decade witnessed steady erosion in credit quality throughout the utility industry,

1 both as a result of revised perceptions of the risks in the industry and the
2 weakened finances of the utilities themselves. Fitch recently reported that the
3 short- and long-term outlook for investor-owned electric utilities is negative.¹⁶
4 Similarly, Moody's observed, "Material negative bias appears to be developing
5 over the intermediate and longer term due to rapidly rising business and operating
6 risks."¹⁷

7 **Q. Does FPL anticipate the need to access the capital markets going forward?**

8 A. Yes. FPL will require capital investment to meet customer growth, provide for
9 necessary maintenance and replacements, and fund new investment in the
10 facilities needed to generate, transmit and distribute electricity. As discussed in
11 greater detail by FPL witness Pimentel, planned capital expenditures for the next
12 five years total approximately \$16 billion.

13
14 Continued support for FPL's financial integrity and flexibility will be
15 instrumental in attracting the long-term capital necessary to fund these projects in
16 an effective manner. In addition, FPL must meet short-term liquidity needs
17 arising from seasonal cash flows and ongoing construction programs. FPL's
18 exposure to storm restoration activities and the substantial liquidity requirements
19 necessary to support its fuel hedging program magnify the importance of
20 maintaining financial flexibility, which is essential to guarantee access to the cash
21 resources and interim financing required to cover operating cash flows and fund
22 required investments in the utility system.

1 **Q. Is the potential for energy market volatility an ongoing concern for investors**
2 **and does it affect FPL's financial requirements?**

3 A. Yes on both counts. In recent years utilities and their customers have had to
4 contend with dramatic fluctuations in gas costs due to ongoing price volatility in
5 the spot markets. S&P concluded that "natural gas prices have proven to be very
6 volatile" and warned of a "turbulent journey" due to the uncertainty associated
7 with future fluctuations in energy costs,¹⁸ with Moody's warning investors of
8 ongoing exposure to "extremely volatile" energy commodity costs, including
9 purchased power prices, which are heavily influenced by fuel costs.¹⁹ Fitch has
10 also highlighted the challenges that fluctuations in commodity prices can have for
11 utilities and recently noted that:

12 From their September 2007 low of \$5.29, spot natural gas prices as
13 reported at Henry Hub rose 150% to \$13.31 in early July 2008 and
14 declined 57% to \$5.68 per million British thermal unit (mmBtu) on
15 Dec. 10, 2008. The sharp run-up and subsequent collapse of
16 natural gas prices in 2008 is emblematic of the extreme price
17 volatility that characterizes the commodity and is likely to persist
18 in the future.²⁰

19 **Q. Are volatile natural gas prices relevant to FPL's financial requirements?**

20 A. Yes. In order to meet rising demand for electricity across its service territory, FPL
21 has sought to acquire additional power resources to ensure its ability to maintain
22 adequate reserve margins and provide reliable service. The expansion of gas-fired
23 generation has resulted in this fuel representing over 50 percent of FPL's fuel mix.

1 As a result, exposure to fluctuations in natural gas prices or supply interruption is
2 a significant concern, with S&P noting that “a large and growing reliance on
3 natural gas to fuel utility generation could over time turn from an advantage
4 (because of its environmental status) to a weakness if gas prices continue to
5 fluctuate and trend up.”²¹ FPL’s significant exposure to natural gas detracts from
6 the Company’s credit quality and should be considered in evaluating a fair ROE.
7 While FPL has stated that it continues to explore alternative fuel sources and
8 technologies, the potential for a continuation of the extreme price volatility
9 experienced in the market for natural gas means that FPL must be able to fund
10 fuel under-recoveries and have the financial strength to effectively hedge price
11 risks.

12 **Q. Don’t the Commission’s adjustment mechanisms protect FPL from exposure**
13 **to fluctuations in power supply costs?**

14 A. To a limited extent, yes. The investment community views FPL’s ability to
15 periodically adjust retail rates to accommodate fluctuations in fuel and purchased
16 power as an important source of support for FPL’s financial integrity.
17 Nevertheless, they also recognize that there can be a lag between the time FPL
18 actually incurs the expenditure and when it is recovered from ratepayers. As a
19 result, FPL is not insulated from the need to finance deferred power production
20 and supply costs and support the substantial liquidity requirements related to its
21 fuel hedging program. Indeed, despite the significant investment of resources to
22 manage fuel procurement, investors are aware that the best that FPL can do is to

1 recover its actual costs. In other words, FPL earns no return on fuel costs and is
2 exposed to disallowances for imprudence in its fuel procurement.

3 **Q. What other financial pressures impact investors' risk assessment of FPL and**
4 **its financial requirements?**

5 A. Investors are aware of the financial and regulatory pressures faced by utilities
6 associated with rising costs and the need to undertake significant capital
7 investments. As Moody's observed:

8 [P]ressures are building. Utilities are facing rising operating costs
9 and infrastructure investment needs that are prompting them to
10 seek more-frequent requests for rate relief. Meanwhile, as energy
11 (and other commodity) costs rise, so does the risk of a consumer
12 backlash over electric rates that could prompt legislative
13 intervention or a more contentious atmosphere between utilities
14 and their regulators.²²

15
16 Similarly, S&P noted that "heavy construction programs," along with rising
17 operating and maintenance costs and volatile fuel costs, were a significant
18 challenge to the utility industry.²³ Fitch recently echoed this assessment,
19 concluding:

20 Continued access to capital at reasonable rates in 2009 remains
21 uncertain at a time when many utility holding groups have
22 historically high capital investment programs and will require

1 ongoing access to reasonably priced capital in order to fund new
2 investment and refinance maturing debt.²⁴

3
4 As noted earlier, FPL's plans include electric utility capital expenditures of
5 approximately \$16 billion over the next five years. While providing the
6 infrastructure necessary to meet the energy needs of customers is certainly
7 desirable, it imposes additional financial responsibilities on FPL that are
8 heightened during times of capital market turmoil.

9 **Q. Are environmental considerations also affecting investors' evaluation of**
10 **electric utilities, including FPL?**

11 A. Although FPL's exposure is moderated through the environmental compliance
12 cost recovery clause established by the FPSC, utilities are confronting increased
13 environmental pressures that could impose significant uncertainties. In 2007 S&P
14 cited environmental mandates, including emissions, conservation, and renewable
15 resources as one of the top ten credit issues facing U.S. utilities.²⁵ Similarly,
16 Moody's noted that "the prospect for new environmental emission legislation, via
17 federal or state carbon emission rules, represents the single-biggest emerging
18 issue on the horizon,"²⁶ while Fitch recently observed that "the structure, timing
19 and implementation is still uncertain."²⁷

20 **Q. What exposures should be considered in evaluating FPL's financial**
21 **requirements?**

22 A. Approximately 22 percent of FPL's total energy requirements are provided by its
23 four nuclear units located at the St. Lucie and Turkey Point generating stations.

1 Moreover, in light of political opposition to the construction of new coal-fired
2 generation in Florida, expanding FPL's nuclear generating capacity will likely be
3 required in order to diversify fuel mix while meeting customer load.

4
5 As discussed in the testimony of FPL's witnesses, consumers have realized
6 considerable savings in energy costs as a result of FPL's effective management of
7 its nuclear generating facilities. While nuclear power confers advantages in terms
8 of fuel cost savings and diversity, investors also associate nuclear facilities with
9 risks that are not encountered with other sources of generation. S&P has long
10 recognized the additional risks posed by nuclear facilities, as reflected in a 1994
11 article:

12 Operating and maintaining [nuclear plants] is more complex
13 compared with fossil plants because of safety considerations and
14 the additional safety equipment and operational controls required.²⁸

15
16 More recently, Moody's confirmed that "ownership of nuclear generating
17 facilities brings a higher level of complexity associated with operating and
18 maintaining the units."²⁹

19
20 As Moody's noted, "[O]ne of the biggest risks associated with nuclear generation
21 is an unanticipated extended outage," concluding that "an extended outage can
22 significantly stress an owner's liquidity and over-all financial profile."³⁰ In
23 addition, longer-term uncertainties regarding the disposal of spent fuel and the

1 ultimate costs of decommissioning continue to accompany any investment in
2 nuclear generating facilities. In order to mitigate against these potential
3 exposures, Moody's cited the importance of a constructive regulatory relationship
4 and "a need to establish financial policies over the near-term aimed at producing
5 very strong financial credit ratios in order to maintain a given rating."³¹

6
7 Nuclear power represents a significant portion of the Company's generating
8 capability, and this concentration increases FPL's exposure to significant financial
9 threats. Considering these potential uncertainties in establishing FPL's ROE will
10 preserve the Company's financial wherewithal and ensure that consumers
11 continue to benefit from FPL's ongoing investment in nuclear facilities.

12 **Q. What other operational factors increase FPL's need for financial strength?**

13 A. Because of the geographical location of FPL's service territory, the potential
14 exposures associated with a prolonged outage at key generating facilities or
15 disruptions in fuel supply are heightened. As Fitch noted:

16 Given the location of the company's service territory at the
17 extreme southern end of the Florida peninsula, there are limits on
18 the ability to import power.³²

19
20 Apart from its relative isolation, FPL's service territory has extreme exposure to
21 the catastrophic damage of tropical storms. While the investment community
22 recognizes that the FPSC has been generally supportive in permitting recovery of
23 the costs of storm damage, FPL nonetheless must maintain the financial strength

1 and liquidity necessary to effect a rapid and far-reaching response in the likely
2 event of a future hurricane strike.

3 **Q. How does the nature of the economy in FPL's service territory impact its**
4 **relative risks and financial requirements?**

5 A. Past experience indicates that the economy in FPL's service territory can be
6 highly vulnerable, especially to conditions that cause a decline in tourism. And
7 while the Florida economy has achieved a degree of diversification that was not
8 present during the tourism-led slump of the 1970s, Floridians are aware that the
9 combined effect of a general business slowdown and a plunge in tourism can
10 result in a particularly severe economic double-whammy, which heightens the
11 risks of an economic downturn for FPL's investors and customers. More recently,
12 the economy of FPL's service territory has been the epicenter for the monumental
13 collapse in real estate values that precipitated a global financial crisis. Coupled
14 with the deepening world-wide recession, continued turmoil in the housing
15 market and the sharp decline in Florida's economic growth has implications for
16 FPL's finances, as S&P recently recognized:

17 A prolonged downturn in the Florida economy, particularly the real
18 estate market, could affect the cash flows of regulated unit Florida
19 Power & Light.³³

20
21 While the long-term outlook for Florida's economy may remain positive,
22 investors nonetheless recognize the exposure to additional volatility introduced by
23 current uncertainties.

1 **IV. CAPITAL MARKET ESTIMATES**

2

3 **Q. What is the purpose of this section?**

4 A. In this section, I develop capital market estimates of the cost of equity. First, I
5 address the concept of the cost of equity, along with the risk-return tradeoff
6 principle fundamental to capital markets. Next, I describe DCF and CAPM
7 analyses conducted to estimate the cost of equity for benchmark groups of
8 comparable risk firms and evaluate expected earned rates of return for utilities.
9 Finally, I examine flotation costs, which are properly considered in evaluating a
10 fair rate of return on equity.

11

12 **A. Economic Standards**

13

14 **Q. What role does the return on common equity play in a utility's rates?**

15 A. The return on common equity is the cost of inducing and retaining investment in
16 the utility's physical plant and assets. This investment is necessary to finance the
17 asset base needed to provide utility service. Competition for investor funds is
18 intense and investors are free to invest their funds wherever they choose.
19 Investors will commit money to a particular investment only if they expect it to
20 produce a return commensurate with those from other investments with
21 comparable risks.

1 **Q. What fundamental economic principle underlies the cost of equity concept?**

2 A. The fundamental economic principle underlying the cost of equity concept is the
3 notion that investors are risk averse. In capital markets where relatively risk-free
4 assets are available (e.g., U.S. Treasury securities), investors can be induced to
5 hold riskier assets only if they are offered a premium, or additional return, above
6 the rate of return on a risk-free asset. Because all assets compete with each other
7 for investor funds, riskier assets must yield a higher expected rate of return than
8 safer assets to induce investors to invest and hold them.

9
10 Given this risk-return tradeoff, the required rate of return (k) from an asset (i) can
11 generally be expressed as:

$$12 \quad k_i = R_f + RP_i$$

13 where: R_f = Risk-free rate of return, and

14 RP_i = Risk premium required to hold riskier asset i .

15 Thus, the required rate of return for a particular asset at any time is a function of:
16 (1) the yield on risk-free assets, and (2) the asset's relative risk, with investors
17 demanding correspondingly larger risk premiums for bearing greater risk.

18 **Q. Is there evidence that the risk-return tradeoff principle actually operates in**
19 **the capital markets?**

20 A. Yes. The risk-return tradeoff can be readily documented in segments of the
21 capital markets where required rates of return can be directly inferred from market
22 data and where generally accepted measures of risk exist. Bond yields, for
23 example, reflect investors' expected rates of return, and bond ratings measure the
24 risk of individual bond issues. The observed yields on government securities,

1 which are considered free of default risk, and bonds of various rating categories
2 demonstrate that the risk-return tradeoff does, in fact, exist in the capital markets.

3 **Q. Does the risk-return tradeoff observed with fixed income securities extend to**
4 **common stocks and other assets?**

5 A. It is generally accepted that the risk-return tradeoff evidenced with long-term debt
6 extends to all assets. Documenting the risk-return tradeoff for assets other than
7 fixed income securities, however, is complicated by two factors. First, there is no
8 standard measure of risk applicable to all assets. Second, for most assets –
9 including common stock – required rates of return cannot be directly observed.
10 Yet there is every reason to believe that investors exhibit risk aversion in deciding
11 whether or not to hold common stocks and other assets, just as when choosing
12 among fixed-income securities.

13 **Q. Is this risk-return tradeoff limited to differences between firms?**

14 A. No. The risk-return tradeoff principle applies not only to investments in different
15 firms, but also to different securities issued by the same firm. The securities
16 issued by a utility vary considerably in risk because they have different
17 characteristics and priorities. Long-term debt is senior among all capital in its
18 claim on a utility's net revenues and is, therefore, the least risky. The last
19 investors in line are common shareholders. They receive only the net revenues, if
20 any, remaining after all other claimants have been paid. As a result, the rate of
21 return that investors require from a utility's common stock, the most junior and
22 riskiest of its securities, must be considerably higher than the yield offered by the
23 utility's senior, long-term debt.

1 **Q. What does the above discussion imply with respect to estimating the cost of**
2 **equity for a utility?**

3 A. Although the cost of equity cannot be observed directly, it is a function of the
4 returns available from other investment alternatives and the risks to which the
5 equity capital is exposed. Because it is not readily observable, the cost of equity
6 for a particular utility must be estimated by analyzing information about capital
7 market conditions generally, assessing the relative risks of the company
8 specifically, and employing various quantitative methods that focus on investors'
9 required rates of return. These various quantitative methods typically attempt to
10 infer investors' required rates of return from stock prices, interest rates, or other
11 capital market data.

12 **Q. Did you rely on a single method to estimate the cost of equity for FPL?**

13 A. No. In my opinion, no single method or model should be relied on by itself to
14 determine a utility's cost of equity because no single approach can be regarded as
15 definitive. For example, a publication of the Society of Utility and Financial
16 Analysts (formerly the National Society of Rate of Return Analysts), concluded
17 that:

18 Each model requires the exercise of judgment as to the
19 reasonableness of the underlying assumptions of the methodology
20 and on the reasonableness of the proxies used to validate the
21 theory. Each model has its own way of examining investor
22 behavior, its own premises, and its own set of simplifications of
23 reality. Each method proceeds from different fundamental

1 premises, most of which cannot be validated empirically.
2 Investors clearly do not subscribe to any singular method, nor does
3 the stock price reflect the application of any one single method by
4 investors.³⁴
5

6 Therefore, I used both the DCF and CAPM methods to estimate the cost of equity.
7 In addition, I also evaluated a fair ROE using an earnings approach based on
8 investors' current expectations in the capital markets. In my opinion, comparing
9 estimates produced by one method with those produced by other approaches
10 ensures that the estimates of the cost of equity pass fundamental tests of
11 reasonableness and economic logic.
12

13 **B. Comparable Risk Proxy Groups**

14

15 **Q. How did you implement these quantitative methods to estimate the cost of**
16 **common equity for FPL?**

17 **A.** Application of the DCF model and other quantitative methods to estimate the cost
18 of equity requires observable capital market data, such as stock prices. Moreover,
19 even for a firm with publicly traded stock, the cost of equity can only be
20 estimated. As a result, applying quantitative models using observable market data
21 only produces an estimate that inherently includes some degree of observation
22 error. Thus, the accepted approach to increase confidence in the results is to apply

1 the DCF model and other quantitative methods to a proxy group of publicly
2 traded companies that investors regard as risk comparable.

3 **Q. What specific proxy group of utilities did you rely on for your analysis?**

4 A. In order to reflect the risks and prospects associated with FPL's jurisdictional
5 utility operations, my DCF analyses focused on a reference group of other utilities
6 composed of those companies classified by The Value Line Investment Survey
7 ("Value Line") as electric utilities with: (1) a minimum S&P corporate credit
8 rating of "BBB+" [as discussed subsequently, the average bond rating for the
9 Utility Proxy Group is single-A], (2) a Value Line Safety Rank of "1" or "2", (3) a
10 Value Line Financial Strength Rating of "B++" or better, and (4) at least two
11 published earnings per share ("EPS") growth projections from Value Line,
12 Thomson I/B/E/S ("IBES"), First Call Corporation ("First Call"), and Zacks
13 Investment Research ("Zacks").³⁵ These criteria resulted in a proxy group
14 composed of nineteen companies. I refer to this group as the "Utility Proxy
15 Group."

16 **Q. What other proxy group did you consider in evaluating a fair ROE for FPL?**

17 A. Under the regulatory standards established by *Hope* and *Bluefield*, the salient
18 criteria in establishing a meaningful benchmark to evaluate a fair rate of return is
19 relative risk, not the particular business activity or degree of regulation. As noted
20 in *Regulatory Finance: Utilities' Cost of Capital*, "It should be emphasized that
21 the definition of a comparable risk class of companies does not entail similarity of
22 operation, product lines, or environmental conditions, but rather similarity of
23 experienced business risk and financial risk."³⁶ Utilities must compete for capital,

1 not just against firms in their own industry, but with other investment
2 opportunities of comparable risk. With regulation taking the place of competitive
3 market forces, required returns for utilities should be in line with those of non-
4 utility firms of comparable risk operating under the constraints of free
5 competition. Consistent with this accepted regulatory standard, I also applied the
6 DCF model to a reference group of comparable risk companies in the non-utility
7 sectors of the economy. I refer to this group as the "Non-Utility Proxy Group".

8 **Q. What criteria did you apply to develop the Non-Utility Proxy Group?**

9 A. My comparable risk proxy group was composed of those U.S. companies
10 followed by Value Line that: 1) pay common dividends; 2) have a Safety Rank of
11 "1"; 3) have a Financial Strength Rating of "A" or above, and 4) have investment
12 grade credit ratings from S&P. In addition, consistent with the criteria used to
13 develop the Utility Proxy Group discussed earlier, I also included only those firms
14 with at least two published growth estimates from Value Line, IBES, First Call, or
15 Zacks.

16 **Q. Do these criteria provide objective evidence to evaluate investors' risk
17 perceptions?**

18 A. Yes. Credit ratings are assigned by independent rating agencies for the purpose of
19 providing investors with a broad assessment of the creditworthiness of a firm.
20 Ratings generally extend from triple-A (the highest) to D (in default). Other
21 symbols (*e.g.*, "A+") are used to show relative standing within a category.
22 Because the rating agencies' evaluation includes virtually all of the factors
23 normally considered important in assessing a firm's relative credit standing,

1 corporate credit ratings provide a broad, objective measure of overall investment
2 risk that is readily available to investors. Widely cited in the investment
3 community and referenced by investors, credit ratings are also frequently used as
4 a primary risk indicator in establishing proxy groups to estimate the cost of equity.

5
6 While credit ratings provide the most widely referenced benchmark for
7 investment risks, other quality rankings published by investment advisory services
8 also provide relative assessments of risk that are considered by investors in
9 forming their expectations. Value Line's primary risk indicator is its Safety Rank,
10 which ranges from "1" (Safest) to "5" (Riskiest). This overall risk measure is
11 intended to capture the total risk of a stock, and incorporates elements of stock
12 price stability and financial strength.

13
14 The Financial Strength Rating is designed as a guide to overall financial strength
15 and creditworthiness, with the key inputs including financial leverage, business
16 volatility measures, and company size. Value Line's Financial Strength Ratings
17 range from "A++" (strongest) down to "C" (weakest) in nine steps. Given that
18 Value Line is perhaps the most widely available source of investment advisory
19 information, its Safety Rank and Financial Strength Rating provide useful
20 guidance regarding the risk perceptions of investors. These objective, published
21 indicators incorporate consideration of a broad spectrum of risks, including
22 financial and business position, relative size, and exposure to company-specific
23 factors.

1 **Q. How do the overall risks of your proxy groups compare with FPL?**

2 A. Exhibit WEA-6 compares the Non-Utility Proxy Group with the Utility Proxy
3 Group and FPL across four key indicators of investment risk. Because FPL has no
4 publicly traded common stock, the Value Line risk measures shown reflect those
5 published for its parent, FPL Group.

6 **Q. Does this comparison indicate that investors would view the firms in your
7 proxy groups as risk-comparable to FPL?**

8 A. Yes. As shown on Exhibit WEA-6, the average corporate credit rating for the
9 Utility Proxy Group is "A-", with ratings for the individual firms ranging from
10 "BBB+" to "A+", while the Non-Utility Proxy Group's average credit rating is
11 slightly higher at "A+". Considering that the "+" and "-" designations tend to
12 reflect very modest gradations in risk, these average single-A ratings for the
13 Utility and Non-Utility Proxy Groups are essentially identical to FPL's corporate
14 credit rating.

15
16 Meanwhile, the average Value Line Safety Rank and Financial Strength Rating
17 for the Utility Proxy Group is one notch lower than for FPL, while the average
18 beta value of 0.73 indicates less risk than for FPL. With respect to the Non-
19 Utility Proxy Group, its average Safety Rank and Financial Strength Rating is
20 identical to FPL, with its 0.84 average beta suggesting somewhat greater risk.
21 Considered together, a comparison of these objective measures, which consider of
22 a broad spectrum of risks, including financial and business position, relative size,
23 and exposure to company specific factors, indicates that investors would likely

1 conclude that the overall investment risks for FPL are comparable to those of the
2 firms in the Utility and Non-Utility Proxy Groups.

3

4

C. Discounted Cash Flow Analyses

5

6 **Q. How is the DCF model used to estimate the cost of equity?**

7 A. DCF models attempt to replicate the market valuation process that sets the price
8 investors are willing to pay for a share of a company's stock. The model rests on
9 the assumption that investors evaluate the risks and expected rates of return from
10 all securities in the capital markets. Given these expectations, the price of each
11 stock is adjusted by the market until investors are adequately compensated for the
12 risks they bear. Therefore, we can look to the market to determine what investors
13 believe a share of common stock is worth. By estimating the cash flows investors
14 expect to receive from the stock in the way of future dividends and capital gains,
15 we can calculate their required rate of return. In other words, the cash flows that
16 investors expect from a stock are estimated, and given its current market price, we
17 can "back-into" the discount rate, or cost of equity, that investors implicitly used
18 in bidding the stock to that price. Notationally, the general form of the DCF
19 model is as follows:

$$P_0 = \frac{D_1}{(1+k_e)^1} + \frac{D_2}{(1+k_e)^2} + \dots + \frac{D_t}{(1+k_e)^t} + \frac{P_t}{(1+k_e)^t}$$

where: P_0 = Current price per share;

P_t = Expected future price per share in period t ;

D_t = Expected dividend per share in period t ;

k_e = Cost of equity.

That is, the cost of equity is the discount rate that will equate the current price of a share of stock with the present value of all expected cash flows from the stock.

Q. What form of the DCF model is customarily used to estimate the cost of equity in rate cases?

A. Rather than developing annual estimates of cash flows into perpetuity, the DCF model can be simplified to a "constant growth" form:³⁷

$$P_0 = \frac{D_1}{k_e - g}$$

where: g = Investors' long-term growth expectations.

The cost of equity (k_e) can be isolated by rearranging terms within the equation:

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

This constant growth form of the DCF model recognizes that the rate of return to stockholders consists of two parts: 1) dividend yield (D_1/P_0); and 2) growth (g). In other words, investors expect to receive a portion of their total return in the form of current dividends and the remainder through price appreciation.

1 **Q. What form of the DCF model did you use?**

2 A. I applied the constant growth DCF model to estimate the cost of equity for FPL,
3 which is the form of the model most commonly relied on to establish the cost of
4 equity for traditional regulated utilities and the method most often referenced by
5 regulators.

6 **Q. How is the constant growth form of the DCF model typically used to estimate
7 the cost of equity?**

8 A. The first step in implementing the constant growth DCF model is to determine the
9 expected dividend yield (D_1/P_0) for the firm in question. This is usually
10 calculated based on an estimate of dividends to be paid in the coming year divided
11 by the current price of the stock. The second, and more controversial, step is to
12 estimate investors' long-term growth expectations (g) for the firm. The final step
13 is to sum the firm's dividend yield and estimated growth rate to arrive at an
14 estimate of its cost of equity.

15 **Q. How was the dividend yield for the Utility Proxy Group determined?**

16 A. Estimates of dividends to be paid by each of these utilities over the next twelve
17 months, obtained from Value Line, served as D_1 . This annual dividend was then
18 divided by the corresponding stock price for each utility to arrive at the expected
19 dividend yield. The expected dividends, stock prices, and resulting dividend
20 yields for the firms in the utility proxy group are presented on Exhibit WEA-7.
21 As shown there, dividend yields for the firms in the Utility Proxy Group ranged
22 from 2.8 percent to 6.4 percent.

1 **Q. What is the next step in applying the constant growth DCF model?**

2 A. The next step is to evaluate long-term growth expectations, or “g”, for the firm in
3 question. In constant growth DCF theory, earnings, dividends, book value, and
4 market price are all assumed to grow in lockstep, and the growth horizon of the
5 DCF model is infinite. But implementation of the DCF model is more than just a
6 theoretical exercise; it is an attempt to replicate the mechanism investors used to
7 arrive at observable stock prices. A wide variety of techniques can be used to
8 derive growth rates, but the only “g” that matters in applying the DCF model is
9 the value that investors expect.

10 **Q. Are historical growth rates likely to be representative of investors’**
11 **expectations for utilities?**

12 A. No. If past trends in earnings, dividends, and book value are to be representative
13 of investors’ expectations for the future, then the historical conditions giving rise
14 to these growth rates should be expected to continue. That is clearly not the case
15 for utilities, where structural and industry changes have led to declining
16 dividends, earnings pressure, and, in many cases, significant write-offs. While
17 these conditions serve to depress historical growth measures, they are not
18 representative of long-term expectations for the utility industry.

19 **Q. What are investors most likely to consider in developing their long-term**
20 **growth expectations?**

21 A. While the DCF model is technically concerned with growth in dividend cash
22 flows, implementation of this DCF model is solely concerned with replicating the
23 forward-looking evaluation of real-world investors. In the case of utilities,

1 dividend growth rates are not likely to provide a meaningful guide to investors'
2 current growth expectations. This is because utilities have significantly altered
3 their dividend policies in response to more accentuated business risks in the
4 industry, with the payout ratio for electric utilities falling from approximately 80
5 percent historically to on the order of 60 percent.³⁸ As a result of this trend
6 towards a more conservative payout ratio, dividend growth in the utility industry
7 has remained largely stagnant as utilities conserve financial resources to provide a
8 hedge against heightened uncertainties.

9
10 As payout ratios for firms in the utility industry trended downward, investors'
11 focus has increasingly shifted from dividends to earnings as a measure of long-
12 term growth. Future trends in earnings, which provide the source for future
13 dividends and ultimately support share prices, play a pivotal role in determining
14 investors' long-term growth expectations. The importance of earnings in
15 evaluating investors' expectations and requirements is well accepted in the
16 investment community. As noted in *Finding Reality in Reported Earnings*
17 published by the Association for Investment Management and Research:

18 [E]arnings, presumably, are the basis for the investment benefits that
19 we all seek. "Healthy earnings equal healthy investment benefits"
20 seems a logical equation, but earnings are also a scorecard by which
21 we compare companies, a filter through which we assess
22 management, and a crystal ball in which we try to foretell future
23 performance.³⁹

1 Value Line's near-term projections and its Timeliness Rank, which is the principal
2 investment rating assigned to each individual stock, are also based primarily on
3 various quantitative analyses of earnings. As Value Line explained:

4 The future earnings rank accounts for 65% in the determination of
5 relative price change in the future; the other two variables (current
6 earnings rank and current price rank) explain 35%.⁴⁰

7
8 The fact that investment advisory services focus primarily on growth in earnings
9 indicates that the investment community regards this as a superior indicator of
10 future long-term growth. Indeed, "A Study of Financial Analysts: Practice and
11 Theory," published in the *Financial Analysts Journal*, reported the results of a
12 survey conducted to determine what analytical techniques investment analysts
13 actually use.⁴¹ Respondents were asked to rank the relative importance of
14 earnings, dividends, cash flow, and book value in analyzing securities. Of the 297
15 analysts that responded, only 3 ranked dividends first while 276 ranked it last.
16 The article concluded:

17 Earnings and cash flow are considered far more important than book
18 value and dividends.⁴²

19
20 More recently, the *Financial Analysts Journal* reported the results of a study of
21 the relationship between valuations based on alternative multiples and actual
22 market prices, which concluded, "In all cases studied, earnings dominated
23 operating cash flows and dividends."⁴³

1 **Q. Do the growth rate projections of security analysts consider historical**
2 **trends?**

3 A. Yes. Professional security analysts study historical trends extensively in
4 developing their projections of future earnings. Hence, to the extent there is any
5 useful information in historical patterns, that information is incorporated into
6 analysts' growth forecasts.

7 **Q. What are security analysts currently projecting in the way of growth for the**
8 **firms in the utility proxy group?**

9 A. The earnings growth projections for each of the firms in the Utility Proxy Group
10 reported by Value Line, IBES, First Call, and Zacks are displayed on Exhibit
11 WEA-7.

12 **Q. Some argue that analysts' assessments of growth rates are biased. Is there**
13 **any reason to believe these projections are inappropriate for estimating**
14 **investors' required return using the DCF model?**

15 A. No. In applying the DCF model to estimate the cost of equity, the only relevant
16 growth rate is the forward-looking expectations of investors that are captured in
17 current stock prices. Investors, just like securities analysts and others in the
18 investment community, do not know how the future will actually turn out. They
19 can only make investment decisions based on their best estimate of what the
20 future holds in the way of long-term growth for a particular stock, and securities
21 prices are constantly adjusting to reflect their assessment of available information.

1 Any claims that analysts' estimates are not relied upon by investors are illogical
2 given the reality of a competitive market for investment advice. If financial
3 analysts' forecasts do not add value to investors' decision-making, it would be
4 irrational for investors to pay for these estimates. Similarly, those financial
5 analysts who fail to provide reliable forecasts will lose out in competitive markets
6 relative to those analysts whose forecasts investors find more credible. The
7 reality that analyst estimates are routinely referenced in the financial media and in
8 investment advisory publications (e.g., Value Line) implies that investors use
9 them as a basis for their expectations.

10
11 The continued success of investment services such as Thompson Reuters and
12 Value Line, and the fact that projected growth rates from such sources are widely
13 referenced, provides strong evidence that investors give considerable weight to
14 analysts' earnings projections in forming their expectations for future growth.
15 While the projections of securities analysts may be proven optimistic or
16 pessimistic in hindsight, this is irrelevant in assessing the expected growth that
17 investors have incorporated into current stock prices, and any bias in analysts'
18 forecasts – whether pessimistic or optimistic – is irrelevant if investors share
19 analysts' views. Earnings growth projections of security analysts provide the
20 most frequently referenced guide to investors' views and are widely accepted in
21 applying the DCF model. As explained in *Regulatory Finance: Utilities' Cost of*
22 *Capital:*

1 Because of the dominance of institutional investors and their
2 influence on individual investors, analysts' forecasts of long-run
3 growth rates provide a sound basis for estimating required returns.
4 Financial analysts also exert a strong influence on the expectations
5 of many investors who do not possess the resources to make their
6 own forecasts, that is, they are a cause of g [growth]. ...
7 Published studies in the academic literature demonstrate that
8 growth forecasts made by securities analysts represent an
9 appropriate source of DCF growth rates, are reasonable indicators
10 of investor expectations and are more accurate than forecasts based
11 on historical growth. ... Cragg and Malkiel (1982) presented
12 detailed empirical evidence that the average analyst's expectation
13 is more similar to expectations being reflected in the marketplace
14 than are historical growth rates, and that they represent the best
15 possible source of DCF growth rates.⁴⁴

16 **Q. How else are investors' expectations of future long-term growth prospects**
17 **often estimated when applying the constant growth DCF model?**

18 A. In constant growth theory, growth in book equity will be equal to the product of
19 the earnings retention ratio (one minus the dividend payout ratio) and the earned
20 rate of return on book equity. Furthermore, if the earned rate of return and the
21 payout ratio are constant over time, growth in earnings and dividends will be
22 equal to growth in book value. Despite the fact that these conditions are seldom,
23 if ever, met in practice, this "sustainable growth" approach may provide a rough

1 guide for evaluating a firm's growth prospects and is frequently proposed in
2 regulatory proceedings.

3

4 Accordingly, while I believe that analysts' forecasts provide a superior and more
5 direct guide to investors' growth expectations, I have included the "sustainable
6 growth" approach for completeness. The sustainable growth rate is calculated by
7 the formula, $g = br + sv$, where "b" is the expected retention ratio, "r" is the
8 expected earned return on equity, "s" is the percent of common equity expected to
9 be issued annually as new common stock, and "v" is the equity accretion rate.

10 **Q. What is the purpose of the "sv" term?**

11 A. Under DCF theory, the "sv" factor is a component of the growth rate designed to
12 capture the impact of issuing new common stock at a price above, or below, book
13 value. When a company's stock price is greater than its book value per share, the
14 per-share contribution in excess of book value associated with new stock issues
15 will accrue to the current shareholders. This increase to the book value of existing
16 shareholders leads to higher expected earnings and dividends, with the "sv" factor
17 incorporating this additional growth component.

18 **Q. What growth rate does the earnings retention method suggest for the Utility
19 Proxy Group?**

20 A. The sustainable, "br+sv" growth rates for each firm in the Utility Proxy Group are
21 summarized on Exhibit WEA-7, with the underlying details being presented on
22 Exhibit WEA-8. For each firm, the expected retention ratio (b) was calculated
23 based on Value Line's projected dividends and earnings per share. Likewise, each

1 firm's expected earned rate of return (r) was computed by dividing projected
2 earnings per share by projected net book value. Because Value Line reports end-
3 of-year book values, an adjustment was incorporated to compute an average rate
4 of return over the year, consistent with the theory underlying this approach to
5 estimating investors' growth expectations. Meanwhile, the percent of common
6 equity expected to be issued annually as new common stock (s) was equal to the
7 product of the projected market-to-book ratio and growth in common shares
8 outstanding, while the equity accretion rate (v) was computed as 1 minus the
9 inverse of the projected market-to-book ratio.

10 **Q. What cost of equity estimates were implied for the Utility Proxy Group using**
11 **the DCF model?**

12 A. After combining the dividend yields and respective growth projections for each
13 utility, the resulting cost of equity estimates are shown on Exhibit WEA-7.

14 **Q. In evaluating the results of the constant growth DCF model, is it appropriate**
15 **to eliminate cost of equity estimates that are implausibly low?**

16 A. Yes. It is a basic economic principle that investors can be induced to hold more
17 risky assets only if they expect to earn a return to compensate them for their risk
18 bearing. As a result, the rate of return that investors require from a utility's
19 common stock, the most junior and riskiest of its securities, must be considerably
20 higher than the yield offered by senior, long-term debt. Consistent with this
21 principle, the DCF results for the Utility Proxy Group must be adjusted to
22 eliminate cost of equity estimates that are determined to be extreme outliers.

1 **Q. Have similar tests been applied by regulators?**

2 A. Yes. FERC has noted that adjustments are justified where applications of the
3 DCF approach produce illogical results. FERC evaluates DCF results against
4 observable yields on long-term public utility debt and has recognized that it is
5 appropriate to eliminate cost of equity estimates that do not sufficiently exceed
6 this threshold. In a 2002 opinion establishing its current precedent for
7 determining ROEs for electric utilities, for example, FERC concluded:

8 An adjustment to this data is appropriate in the case of PG&E's low-
9 end return of 8.42 percent, which is comparable to the average
10 Moody's "A" grade public utility bond yield of 8.06 percent, for
11 October 1999. Because investors cannot be expected to purchase
12 stock if debt, which has less risk than stock, yields essentially the
13 same return, this low-end return cannot be considered reliable in this
14 case.⁴⁵

15

16 More recently, in its October 2006 decision in *Kern River Gas Transmission*
17 *Company*, FERC noted that:

18 [T]he 7.31 and 7.32 percent costs of equity for El Paso and Williams
19 found by the ALJ are only 110 and 122 basis points above that
20 average yield for public utility debt.⁴⁶

1 FERC upheld the opinion of Staff and the Administrative Law Judge that cost of
2 equity estimates for these two proxy group companies “were too low to be
3 credible.”⁴⁷

4 **Q. What does this test of logic imply with respect to the DCF results for the**
5 **Utility Proxy Group?**

6 A. The average corporate credit rating associated with the firms in the Utility Proxy
7 Group is “A-”. Companies rated “A-”, “A”, and “A+” are all considered part of
8 the single-A rating category, with Moody’s monthly yields on single-A bonds
9 averaging approximately 6.4 percent in January 2009.⁴⁸ As highlighted on
10 Exhibit WEA-7, one of the individual equity estimates for the firms in the Utility
11 Proxy Group exceeded this threshold by 50 basis points, with another falling
12 below the yield available on single-A utility bonds.⁴⁹ In light of the risk-return
13 tradeoff principle and the test applied in *Kern River Gas Transmission Company*,
14 it is inconceivable that investors are not requiring a substantially higher rate of
15 return for holding common stock, which is the riskiest of a utility’s securities. As
16 a result, consistent with the test of economic logic applied by FERC, these values
17 provide little guidance as to the returns investors require from utility common
18 stocks and should be excluded.

19 **Q. Do you also recommend excluding cost of equity estimates at the high end of**
20 **the range of DCF results?**

21 A. Yes. The upper end of the cost of equity range produced by the DCF analysis
22 presented on Exhibit WEA-7 was set by cost of equity estimates of 17.5 percent
23 for Integrys Energy Group, with one other DCF estimate at 17.0 percent.

1 Compared with the balance of the remaining estimates, these results are extreme
2 outliers and should also be excluded in evaluating the results of the DCF model
3 for the Utility Proxy Group. This is also consistent with the threshold adopted by
4 FERC, which established that a 17.7 percent DCF estimate was "an extreme
5 outlier" and should be disregarded.⁵⁰

6 **Q. What cost of equity estimates are implied by your DCF results for the Utility
7 Proxy Group?**

8 A. As shown on Exhibit WEA-7, after eliminating illogical low- and high-end
9 values, application of the constant growth DCF model resulted in cost of equity
10 estimates generally exceeding 11 percent [DCF estimates for FPL Group ranged
11 between 12.1 percent and 13.9 percent].

12 **Q. What were the results of your DCF analysis for the Non-Utility Proxy
13 Group?**

14 A. I applied the DCF model to the Non-Utility Proxy Group in exactly the same
15 manner described earlier for the Utility Proxy Group. As shown on Exhibit
16 WEA-9, after eliminating illogical low- and high-end values, application of the
17 constant growth DCF model resulted in cost of equity estimates generally
18 exceeding 13 percent. As discussed earlier, reference to the Non-Utility Proxy
19 Group is consistent with established regulatory principles and required returns for
20 utilities should be in line with those of non-utility firms of comparable risk
21 operating under the constraints of free competition.

D. Capital Asset Pricing Model

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22

Q. Please describe the CAPM.

A. The CAPM is a theory of market equilibrium that measures risk using the beta coefficient. Because investors are assumed to be fully diversified, the relevant risk of an individual asset (*e.g.*, common stock) is its volatility relative to the market as a whole, with beta reflecting the tendency of a stock's price to follow changes in the market. The CAPM is mathematically expressed as:

$$R_j = R_f + \beta_j(R_m - R_f)$$

where: R_j = required rate of return for stock j ;

R_f = risk-free rate;

R_m = expected return on the market portfolio; and,

β_j = beta, or systematic risk, for stock j .

Like the DCF model, the CAPM is an *ex-ante*, or forward-looking model based on expectations of the future. As a result, in order to produce a meaningful estimate of investors' required rate of return, the CAPM must be applied using estimates that reflect the expectations of actual investors in the market, not with backward-looking, historical data.

Q. How did you apply the CAPM to estimate the cost of equity?

A. Application of the CAPM to the Utility Proxy Group based on a forward-looking estimate for investors' required rate of return from common stocks is presented on Exhibit WEA-11. In order to capture the expectations of today's investors in

1 current capital markets, the expected market rate of return was estimated by
2 conducting a DCF analysis on the dividend paying firms in the S&P 500.

3
4 The dividend yield for each firm was obtained from Value Line, with the growth
5 rate being equal to the average of the earnings growth projections for each firm
6 published by Value Line, IBES, First Call, and Zacks, with each firm's dividend
7 yield and growth rate being weighted by its proportionate share of total market
8 value. Based on the weighted average of the projections for the 346 individual
9 firms, current estimates imply an average growth rate over the next five years of
10 9.6 percent. Combining this average growth rate with a dividend yield of 3.6
11 percent results in a current cost of equity estimate for the market as a whole of
12 approximately 13.2 percent. Subtracting a 3.2 percent risk-free rate based on the
13 average yield on 20-year Treasury bonds for December 2008 produced a market
14 equity risk premium of 10.0 percent.

15 **Q. What was the source of the beta values you used to apply the CAPM?**

16 A. I relied on the beta values reported by Value Line, which in my experience is the
17 most widely referenced source for beta in regulatory proceedings. As noted in
18 *Regulatory Finance: Utilities' Cost of Capital:*

19 Value Line betas are computed on a theoretically sound basis using
20 a broadly-based market index, and they are adjusted for the
21 regression tendency of betas to converge to 1.00. . . . Value Line is
22 the largest and most widely circulated independent investment
23 advisory service, and exerts influence on a large number of

1 institutional and individual investors and on the expectations of
2 these investors.⁵¹

3
4 As shown on Exhibit WEA-11, multiplying the 10.0 percent market risk premium
5 by the respective Value Line betas for the firms in the Utility Proxy Group, and
6 then adding the resulting risk premiums to the average long-term Treasury bond
7 yield, results in an average indicated cost of equity of 10.5 percent, with the
8 implied ROE for FPL Group being 11.2 percent.

9 **Q. What cost of equity was indicated for the Non-Utility Proxy Group based on
10 this forward-looking application of the CAPM?**

11 A. As shown on Exhibit WEA-12, applying the forward-looking CAPM approach to
12 the firms in the Non-Utility Proxy Group results in an average implied cost of
13 equity of 11.5 percent.

14 **Q. Do you have any observations regarding these CAPM results?**

15 A. Yes. Applying the CAPM is complicated by the impact of the unprecedented
16 financial crisis on investors' risk perceptions and required returns. The CAPM
17 cost of equity estimate is calibrated from investors' required risk premium
18 between Treasury bonds and common stocks. As discussed earlier, investors have
19 sought a safe haven in Treasury bonds and this "flight to safety" has caused the
20 yield spreads for corporate debt to spike to levels not seen since the Great
21 Depression. Economic logic would suggest that investors' required risk premium
22 for common stocks over Treasury bonds has also increased dramatically. Thus,
23 the recent financial turmoil may cause CAPM cost of equity estimates to

1 understate investors' required returns for common stocks, particularly when
2 historical data are used to calculate the market risk premium. While my
3 application of the CAPM makes every effort to incorporate investors' forward-
4 looking expectations, the full effect of the "flight to safety" may not be captured
5 in my market risk premium estimate. One other obvious limitation of CAPM cost
6 of equity estimates is that beta values are customarily calculated based solely on
7 historical data and may not accurately reflect investor's forward-looking rate of
8 return requirements, particularly during periods of financial turmoil.

9 **Q. Did your CAPM analysis rely on geometric or arithmetic means in arriving**
10 **at an equity risk premium?**

11 A. No. Reference to arithmetic or geometric mean risk premiums is associated with
12 applications of the CAPM that depend on historical data. In order to derive an
13 estimate of the market equity risk premium under this approach, historical average
14 returns on Treasury bonds are typically subtracted from those for common stocks.
15 These average rates of return based on backward-looking data for historical time
16 periods can be derived using both arithmetic and geometric means.

17
18 As discussed above, however, my application of the CAPM was a purely forward-
19 looking approach, which is consistent with the underlying assumptions of this
20 method and the standards underlying a determination of a fair rate of return.
21 Because I looked directly at investors' current expectations in the capital markets
22 – and not at historical rates of return – my CAPM analysis did not need to
23 reference either the arithmetic or geometric mean of historical rates of return.⁵²

1 **Q. Are there selected academic studies or other sources that might measure an**
2 **equity risk premium that is less than what is indicated based on investors'**
3 **current expectations for the stocks in the S&P 500?**

4 A. There are a plethora of studies that examine what investors have actually realized
5 in terms of equity returns versus stocks. Similarly, there are articles suggesting
6 what investors should expect based on "building blocks" or other techniques.
7 Further, there are surveys of corporate executives and others about what they
8 expect the return differential to be over various horizons. Finally, there are
9 projections that the managers of utility pensions funds use for actuarial purposes.

10

11 None of these values are comparable to the risk premium as I have applied it in
12 my forward-looking CAPM analyses, which is based not on some generic notion
13 of the equity risk premium but is derived from contemporaneous projections for
14 individual stocks in the S&P 500. Average realized risk premiums computed over
15 some selected time period may be an accurate representation of what was actually
16 earned in the past, but they don't answer the question as to what risk premium
17 investors were actually expecting to earn on a forward-looking basis during these
18 same time periods. Similarly, calculations of the equity risk premium developed
19 at a point in history – whether based on actual returns in prior periods or
20 contemporaneous projections – are not the same as the forward-looking
21 expectations of today's investors, which are premised on an entirely different set
22 of capital market and economic expectations.

1 The purpose of my analysis was to determine an allowed return that would meet
2 the regulatory requirement of allowing FPL to attract capital and maintain its
3 financial integrity. The most appropriate benchmark for a meaningful forward-
4 looking estimate of the return investors require from FPL, is what investors are
5 currently requiring for other investments with which FPL must compete for
6 capital. The risk premium used in my CAPM is derived from current market data
7 and is forward-looking in the sense of using the projected earnings estimates used
8 by investors. It does not depend on analysis of past historical data on risk
9 premiums nor does it purport to identify what investors will actually realize in the
10 future, or what they should reasonably expect over the long-term. Rather it is an
11 estimate of what investors currently require when they allocate their capital to
12 competing investments. These current forward-looking required returns are the
13 touchstone of whether an authorized ROE can meet the FPSC's standard of
14 capital attraction and maintaining financial integrity.

15

16 **E. Expected Earnings Approach**

17

18 **Q. What other analyses did you conduct to estimate the cost of equity?**

19 A. As I noted earlier, I also evaluated the cost of equity using the expected earnings
20 method. Reference to rates of return available from alternative investments of
21 comparable risk can provide an important benchmark in assessing the return
22 necessary to assure confidence in the financial integrity of a firm and its ability to
23 attract capital. This expected earnings approach is consistent with the economic

1 underpinnings for a fair rate of return established by the U.S. Supreme Court.
2 Moreover, it avoids the complexities and limitations of capital market methods
3 and instead focuses on the returns earned on book equity, which are readily
4 available to investors.

5 **Q. What rates of return on equity are indicated for utilities based on the**
6 **expected earnings approach?**

7 A. Value Line reports that its analysts anticipate an average rate of return on common
8 equity for the electric utility industry of 11.5 percent in 2009 and over its 2011-
9 2013 forecast horizon.⁵³ Meanwhile, Value Line expects that natural gas
10 distribution utilities will earn an average rate of return on common equity of 11.5
11 percent in 2009 and 12.0 percent over its three-to-five year forecast horizon.⁵⁴

12
13 For the firms in the Utility Proxy Group specifically, the returns on common
14 equity projected by Value Line over its three-to-five year forecast horizon are
15 shown on Exhibit WEA-13. Consistent with the rationale underlying the
16 development of the br+sv growth rates, these year-end values were converted to
17 average returns using the same adjustment factor discussed earlier. As shown on
18 Exhibit WEA-13, Value Line's projections for the Utility Proxy Group suggested
19 an average ROE of 11.7 percent. As shown on Exhibit WEA-13, the expected
20 earnings approach implied an ROE for FPL Group of 14.0 percent.

F. Flotation Costs

1

2

3 **Q. What other considerations are relevant in setting the return on equity for**
4 **FPL?**

5 A. The common equity used to finance the investment in utility assets is provided
6 from either the sale of stock in the capital markets or from retained earnings not
7 paid out as dividends. When equity is raised through the sale of common stock,
8 there are costs associated with "floating" the new equity securities. These
9 flotation costs include services such as legal, accounting, and printing, as well as
10 the fees and discounts paid to compensate brokers for selling the stock to the
11 public. Also, some argue that the "market pressure" from the additional supply of
12 common stock and other market factors may further reduce the amount of funds a
13 utility nets when it issues common equity.

14 **Q. Is there an established mechanism for a utility to recognize equity issuance**
15 **costs?**

16 A. No. While debt flotation costs are recorded on the books of the utility, amortized
17 over the life of the issue, and thus increase the effective cost of debt capital, there
18 is no similar accounting treatment to ensure that equity flotation costs are
19 recorded and ultimately recognized. Alternatively, no rate of return is authorized
20 on flotation costs necessarily incurred to obtain a portion of the equity capital used
21 to finance plant. In other words, equity flotation costs are not included in a utility's
22 rate base because neither that portion of the gross proceeds from the sale of
23 common stock used to pay flotation costs is available to invest in plant and

1 equipment, nor are flotation costs capitalized as an intangible asset. Unless some
2 provision is made to recognize these issuance costs, a utility's revenue requirements
3 will not fully reflect all of the costs incurred for the use of investors' funds.
4 Because there is no accounting convention to accumulate the flotation costs
5 associated with equity issues, they must be accounted for indirectly, with an
6 upward adjustment to the cost of equity being the most logical mechanism.

7 **Q. What is the magnitude of the adjustment to the "bare bones" cost of equity to**
8 **account for issuance costs?**

9 A. While there are a number of ways in which a flotation cost adjustment can be
10 calculated, one of the most common methods used to account for flotation costs in
11 regulatory proceedings is to apply an average flotation-cost percentage to a
12 utility's dividend yield. Based on a review of the finance literature, *Regulatory*
13 *Finance: Utilities' Cost of Capital* concluded:

14 The flotation cost allowance requires an estimated adjustment to the
15 return on equity of approximately 5% to 10%, depending on the size
16 and risk of the issue.⁵⁵

17

18 Alternatively, a study of data from Morgan Stanley regarding issuance costs
19 associated with utility common stock issuances suggests an average flotation cost
20 percentage of 3.6%.⁵⁶

21

22 Applying these expense percentages to a representative dividend yield for a utility
23 of 4.9 percent implies a flotation cost adjustment on the order of 18 to 49 basis

1 points. Issuance costs are a legitimate consideration in setting the return on equity
2 for a utility, and I recommend incorporating a 25 basis-point adjustment in
3 determining a reasonable ROE range for FPL.⁵⁷

4 5 **V. RETURN ON EQUITY RANGE FOR FPL**

6 7 **Q. What is the purpose of this section?**

8 A. This section addresses the economic requirements for FPL's rate of return on
9 equity. It discusses the regulatory policy reasons for avoiding a return on equity
10 that is not sufficient to maintain FPL's financial integrity and ability to attract
11 capital, and examines other factors properly considered in determining a fair rate
12 of return, including specific exposures faced by FPL. Finally, this section
13 presents my conclusions regarding a fair ROE range and discusses the merits of
14 an ROE reward to recognize FPL's exemplary results.

15 16 **A. Implications for Financial Integrity**

17 18 **Q. Why is it important to allow FPL an adequate return on equity?**

19 A. Given the importance of the utility industry to the economy and society, it is
20 essential to maintain reliable and economical service to all consumers. While
21 FPL remains committed to provide reliable electric service, a utility's ability to
22 fulfill its mandate can be compromised if it lacks the necessary financial
23 wherewithal or is unable to earn a return sufficient to attract capital. Coupled

1 with the ongoing potential for energy market volatility, FPL's plans for significant
2 infrastructure investment and its exposure to other potential challenges might
3 require the relatively swift commitment of significant capital resources in order to
4 maintain the high level of service that customers have come to expect.

5 As documented earlier, the major rating agencies have warned of exposure to
6 uncertainties associated with political and regulatory developments, especially in
7 view of the pressures associated with large capital expenditure programs and the
8 potential for high and volatile commodity costs in wholesale energy markets.

9 Investors understand just how swiftly unforeseen circumstances can lead to
10 deterioration in a utility's financial condition, and stakeholders have discovered
11 first hand how difficult and complex it can be to remedy the situation after the
12 fact. While providing the infrastructure necessary to enhance the power system
13 and meet the energy needs of customers is certainly desirable, it imposes
14 additional financial responsibilities on FPL. For a utility with an obligation to
15 provide reliable service, investors' increased reticence to supply additional capital
16 during times of crisis highlights the necessity of preserving the flexibility
17 necessary to overcome periods of adverse capital market conditions. These
18 considerations heighten the importance of allowing FPL an adequate ROE.

19 **Q. What role does regulation play in ensuring that FPL has access to capital**
20 **under reasonable terms and on a sustainable basis?**

21 A. Considering investors' heightened awareness of the risks associated with the
22 utility industry and the damage that results when a utility's financial flexibility is
23 compromised, the continuation of supportive regulation remains crucial to FPL's

1 access to capital. Investors recognize that regulation has its own risks, and that
2 constructive regulation is a key ingredient in supporting utility credit ratings and
3 financial integrity, particularly during times of adverse conditions. Fitch noted
4 that:

5 Regulatory risk remains a recurring theme for this year's outlook,
6 as the pressure of a weak economic backdrop could result in
7 political push-back to rate increase requests.⁵⁸

8
9 The report went on to conclude, "Fitch is concerned that the recent rapid
10 escalation in the cost of capital will not be reflected on a timely basis in utility
11 rates."⁵⁹ Similarly, with respect to FPL specifically, Fitch concluded:

12 Maintaining a supportive political and regulatory environment in
13 Florida that permits full and timely recovery of utility capital
14 investments, commodity costs and storm recovery is important to
15 the maintenance of the current ratings.⁶⁰

16
17 Moody's has also emphasized the need for regulatory support "in an era of
18 broadly rising costs," noting that as cost pressures have escalated for electric
19 utilities, so too has the importance of timely recovery through the regulatory
20 process and the risks associated with regulatory lag.⁶¹ S&P concluded "the
21 quality of regulation is at the forefront of our analysis of utility
22 creditworthiness."⁶²

1 **Q. Does the fact that FPL operates under various cost adjustment mechanisms**
2 **warrant any adjustment in your evaluation of a fair ROE?**

3 A. No. Investors recognize that FPL is exposed to significant risks associated with
4 energy price volatility and rising costs and concerns over these risks have become
5 increasingly pronounced in the industry. The FPSC's cost adjustment
6 mechanisms are a valuable means of mitigating those risks, but they do not
7 eliminate them. As noted above, of particular concern to investors is the impact
8 of regulatory lag and cost-recovery on the utility's ability to earn its authorized
9 return. While the adjustment mechanisms approved for FPL partially attenuate
10 exposure to attrition in an era of rising costs, this leveling of the playing field only
11 serves to preserve FPL's opportunity to earn its authorized return, as required by
12 established regulatory standards.

13
14 Moreover, adjustment mechanisms and contractual arrangements that enable
15 utilities to implement rate changes to pass-through fluctuations in fuel costs have
16 been widely prevalent in the industry and utilities increasingly benefit from a
17 wide variety of mechanisms designed to mitigate against the risks associated with
18 fluctuations in costs and regulatory lag. While not always directly analogous to
19 the specific mechanisms in effect for FPL, the objective is similar; namely, to
20 allow the utility an opportunity to earn a fair rate of return and partially attenuate
21 exposure to attrition in an era of rising costs. Reflective of this industry trend, the
22 companies in the Utility Proxy Group operate under a variety of cost adjustment
23 mechanisms, which range from riders to recover bad debt expense and post-

1 retirement employee benefit costs to adjustment clauses designed to address the
2 rising costs of environmental compliance measures.

3
4 For example, Pacific Gas and Electric Company benefits from a number of
5 balancing account mechanisms that cover a significant portion of its revenue
6 requirements. Similarly, Xcel Energy, Inc. also benefits from a transmission cost
7 recovery adjustment that allows the utility to recover incremental transmission
8 investments between rate cases, as well as an adjustment clause to account for the
9 impact of demand side management programs. Moreover, in response to the
10 heightened risk associated with utilities' exposure to substantial costs for
11 environmental remediation, adjustment mechanisms designed to allow for
12 recovery of these costs outside a general rate case have become increasingly
13 prevalent. As a result, the mitigation in risks associated with utilities' ability to
14 attenuate the impact of fluctuations in costs is already reflected in the cost of
15 equity estimates developed earlier. Similarly, the firms in the Non-Utility Proxy
16 Group also have the ability to alter prices in response to rising production costs,
17 with the added flexibility to withdraw from the market altogether.

18 **Q. Do the exposures peculiar to FPL highlight the need for ongoing support of**
19 **the company's financial strength and ability to attract capital?**

20 A. Most definitely. As discussed earlier, FPL faces a number of potential challenges
21 that might require the relatively swift commitment of considerable capital
22 resources in order to maintain the high level of service to which its customers
23 have become accustomed. For example, mandated shutdowns in response to

1 security threats or a catastrophic event elsewhere in the U.S. would impose
2 significant reliance on wholesale power markets to meet energy shortfalls. FPL's
3 reliance on purchased power for a significant portion of its power requirements
4 also imposes increased vulnerability to supply disruptions, especially in light of
5 its relative geographic isolation on the Florida peninsula. Similarly, any
6 interruption of gas supplies due to deliverability constraints imposed on FPL's
7 suppliers could also result in the need for a considerable financial commitment for
8 an alternative fuel source or replacement power. Given the potential for
9 significant volatility in wholesale energy markets and FPL's lack of control over
10 the timing of such events, FPL must have the wherewithal to meet these
11 challenges even when capital and energy market conditions are unfavorable. In
12 addition, it is crucial that FPL maintain its ability to meet the significant liquidity
13 requirements necessary for storm restoration and its fuel hedging program.

14
15 Apart from this exposure to the vagaries of capital and energy market conditions,
16 FPL must simultaneously meet the long-term energy needs of its service area. To
17 continue to meet these challenges successfully and economically, it is crucial that
18 FPL receive adequate support for its credit standing. While providing an ROE
19 that is sufficient to maintain FPL's ability to attract capital, even under duress, is
20 consistent with the economic requirements embodied in the Supreme Court's
21 *Hope* and *Bluefield* decisions, it is also in customers' best interests. Ultimately, it
22 is customers and the service area economy that enjoy the benefits that come from
23 ensuring that the utility has the financial wherewithal to invest in infrastructure

1 and take whatever actions are required to ensure a reliable energy supply. By the
2 same token, customers and the service area economy also bear a significant
3 burden when the ability of the utility to attract necessary capital is impaired and
4 service quality is compromised.

5 **Q. What evidence illustrates the benefits of maintaining FPL's ability to attract**
6 **capital?**

7 A. FPL's consistent ability to keep pace with the growing needs of its customers
8 demonstrates the advantage that accrues to all stakeholders when the utility is able
9 to maintain a strong financial position. In recent years, FPL has spent billions of
10 dollars to add the new generation and transmission capacity dictated by the
11 demands of a vibrant service area and repair the devastation wrought by tropical
12 storms, while simultaneously increasing efficiency and lowering emissions.
13 Despite the associated complexities, including volatile conditions in energy and
14 capital markets, FPL has effectively and economically responded to these
15 challenges, in part due to its strong financial position.

16

17 As discussed in the testimony of FPL's witnesses, FPL has done an outstanding
18 job of meeting customers' power requirements reliably, efficiently, and at rates
19 that compare favorably with other utilities. While FPL's conservative posture has
20 benefited customers and provided a strong platform for continued success, actions
21 that serve to erode financial strength or impair financial flexibility could have
22 swift and damaging consequences. The cost of providing FPL an adequate return

1 is small relative to the potential benefits that a strong utility can have in providing
2 reliable service and fostering growth.

3
4 **B. Return on Equity Recommendation**

5
6 **Q. What then is your conclusion as to a fair ROE range for FPL applicable to**
7 **the 2010 test year?**

8 A. Taken together, and considering their relative strengths and weaknesses, the
9 results of my alternative analyses generally indicate a cost of equity in the 11.0
10 percent to 13.0 percent range. Apart from the results of these quantitative
11 methods, it is crucial to recognize the importance of maintaining a strong
12 financial position so that FPL remains prepared to respond to unforeseen events
13 that may materialize in the future. While this imperative is reinforced by current
14 capital market conditions, it extends well beyond the financial markets and
15 includes the Company's ability to absorb potential shocks associated with
16 devastating hurricanes, volatile fuel pricing, and disruptions in energy supply.

17
18 The challenging capital market environment highlights the benefits of FPL's
19 strong credit rating in attracting the capital needed to secure reliable service at a
20 lower cost for customers. Changing course from the path of financial strength
21 would be extremely short-sighted, especially considering that a combination of
22 events could adversely impact FPL's ability to serve customers if its current
23 financial strength were not maintained. After considering the potential exposures

1 faced by FPL and the economic requirements necessary to maintain access to
2 capital even under adverse circumstances, it is my opinion that a reasonable ROE
3 for FPL is in the range of 12.0 percent to 13.0 percent. This conclusion is
4 supported by the implications of ongoing turmoil in the capital markets and my
5 recommended 25 basis point adjustment for flotation costs. By helping sustain
6 FPL's financial strength, the FPSC will facilitate the flow of capital on reasonable
7 terms that is required for the Company to maintain and improve the electric
8 infrastructure so vital to Florida's economic recovery and future growth.

9 **Q. In evaluating the fair ROE for FPL from within this range, is it appropriate**
10 **to recognize and encourage exemplary management?**

11 A. Yes. As discussed in the testimony of FPL's witnesses, FPL has distinguished
12 itself in numerous measures of operating efficiency and effectiveness while
13 maintaining moderate electric rates. As a result, consumers and the service area
14 economy have benefited from FPL's efficient and cost-effective operations,
15 excellent customer service, improved reliability, and prices that have declined in
16 real terms. To date, the FPSC has helped to foster an environment in which
17 customers are assured reliable service at reasonable rates, stockholders are fairly
18 treated, and stakeholders are not forced to commit significant resources and bear
19 the concomitant costs of multiple or annual rate cases. FPL's superior
20 management continues to be instrumental in achieving these results, and
21 considering exemplary performance when establishing a fair ROE from within my
22 recommended range is entirely consistent with regulatory economics and past
23 incentive mechanisms approved by the FPSC.

VI. CAPITAL STRUCTURE

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23

Q. Is an evaluation of the capital structure maintained by a utility relevant in assessing its return on equity?

A. Yes. Other things equal, a higher debt ratio, or lower common equity ratio, translates into increased financial risk for all investors. A greater amount of debt means more investors have a senior claim on available cash flow, thereby reducing the certainty that each will receive his contractual payments. This increases the risks to which lenders are exposed, and they require correspondingly higher rates of interest. From common shareholders' standpoint, a higher debt ratio means that there are proportionately more investors ahead of them, thereby increasing the uncertainty as to the amount of cash flow, if any, that will remain.

Q. Do the capital structure ratios reflected in FPL's MFRs provide a representative basis on which to evaluate FPL's capital structure?

A. No. Depending on their specific attributes, contractual agreements or other obligations that require the utility to make specified payments may be treated as debt in evaluating FPL's financial risk. PPAs and leases typically obligate the utility to make specified minimum contractual payments akin to those associated with traditional debt financing and investors consider a portion of these commitments as debt in evaluating total financial risks. Because investors consider the debt impact of such fixed obligations in assessing a utility's financial position, they imply greater risk and reduced financial flexibility. In order to offset the debt equivalent associated with off-balance sheet obligations, the utility

1 must rebalance its capital structure by increasing its common equity in order to
2 restore its effective capitalization ratios to previous levels.

3
4 Reflecting the longstanding perception of investors that the fixed obligations
5 associated with PPAs, leases, and other off-balance sheet obligations diminish a
6 utility's creditworthiness and financial flexibility, the implications of these
7 commitments have been repeatedly cited by major bond rating agencies in
8 connection with assessments of utility financial risks. For example, in explaining
9 its evaluation of the credit implications of PPAs, S&P affirmed its position that
10 such agreements give rise to "debt equivalents" and that the increased financial
11 risk must be considered in evaluating a utility's credit risks.⁶³ As the rating
12 agency explained:

13 For many years, Standard & Poor's Ratings Services has viewed
14 power supply agreements (PPA) in the U.S. utility sector as
15 creating fixed, debt-like, financial obligations that represent
16 substitutes for debt-financed capital investments in generation
17 capacity. In a sense, a utility that has entered into a PPA has
18 contracted with a supplier to make the financial investment on its
19 behalf. Consequently, PPA fixed obligations, in the form of
20 capacity payments, merit inclusion in a utility's financial metrics
21 as though they are part of a utility's permanent capital structure
22 and are incorporated in our assessment of a utility's
23 creditworthiness.⁶⁴

1 Apart from reaffirming the importance of imputed debt in its analysis of credit
2 standing, S&P also noted that it has refined its methodology to include imputed
3 debt associated with shorter-term PPAs.⁶⁵ Similarly, S&P affirmed its policy of
4 modifying a utility's balance sheet to include the debt equivalents associated with
5 operating leases.⁶⁶

6
7 As discussed earlier, a significant portion of FPL's power requirements are
8 currently obtained through purchased power contracts. These contractual
9 payment obligations are fixed commitments with debt-like characteristics and are
10 properly considered when evaluating the financial risks implied by FPL's capital
11 structure. S&P reported that it adjusts FPL's current capitalization to include
12 approximately \$1.2 billion in imputed debt from off-balance sheet obligations.⁶⁷
13 Unless the Company takes action to offset this additional financial risk by
14 maintaining a higher equity ratio, the resulting leverage will weaken FPL's
15 creditworthiness, implying a higher required rate of return to compensate
16 investors for the greater risks.⁶⁸

17 **Q. What capital structure is implied for FPL's 2010 test year once the off-**
18 **balance sheet obligations associated with purchased power contracts are**
19 **incorporated?**

20 A. Based on S&P's quantification, an upward adjustment to long-term debt of \$950
21 million was incorporated for 2010 to account for the debt equivalent attributed to
22 FPL's off-balance sheet obligations. This results in the adjusted capital structure

1 ratios shown on Exhibit WEA-14 of 1.1 percent short-term debt, 43.1 percent
2 long-term debt, and 55.8 percent common equity.

3
4 These calculations not only reflect the investment community's evaluation of
5 FPL's financial risks, they are also consistent with methodology used to derive the
6 55.8 percent adjusted equity ratio that forms the surveillance cap specified under
7 the terms of the Stipulation and Settlement approved in Docket No. 050045-EI.⁶⁹
8 Moreover, past decisions of the FPSC have acknowledged that an adjustment is
9 appropriate to address the capital structure impact associated with purchased
10 power.

11 **Q. How can FPL's requested capital structure be evaluated?**

12 A. It is generally accepted that the norms established by comparable firms provide
13 one valid benchmark against which to evaluate the reasonableness of a utility's
14 capital structure. The capital structure maintained by other electric utilities should
15 reflect their collective efforts to finance themselves so as to minimize capital costs
16 while preserving their financial integrity and ability to attract capital. Moreover,
17 these industry capital structures should also incorporate the requirements of
18 investors (both debt and equity), as well as the influence of regulators.

19 **Q. What capitalization ratios are maintained by other electric utility operating
20 companies?**

21 A. Exhibit WEA-15 displays capital structure data at year-end 2007 for the group of
22 electric utility operating companies owned by the firms in the Utility Proxy Group
23 (excluding FPL) used to estimate the cost of equity. As shown there, common

1 equity ratios for these electric utilities ranged from 42.5 percent to 77.1 percent
2 and averaged 54.2 percent. Incorporating the same short-term debt ratio reflected
3 in FPL's adjusted 2010 capitalization of approximately 1.1 percent results in an
4 average common equity ratio for this group of other utilities of 53.6 percent.

5 **Q. What was the average capitalization maintained by the Utility Proxy Group?**

6 A. As shown on Exhibit WEA-16, for the nineteen firms in the Utility Proxy Group,
7 common equity ratios at December 31, 2007 ranged between 38.7 percent and
8 66.0 percent and averaged 51.1 percent. Adjusting the average capitalization to
9 include short-term debt in the same proportion as FPL would result in an adjusted
10 equity ratio of 50.6 percent.

11 **Q. What capitalization is representative for the Utility Proxy Group going
12 forward?**

13 A. As shown on Exhibit WEA-16, Value Line expects an average common equity
14 ratio for the Utility Proxy Group of 52.2 percent for its three-to-five year forecast
15 horizon, with the individual common equity ratios ranging from 45.0 percent to
16 69.5 percent. Adjusting the average capitalization to include short-term debt in
17 the same proportion as FPL would result in an adjusted equity ratio of 51.6
18 percent.

19 **Q. What implication does the increasing risk of the utility industry have for the
20 capital structures maintained by utilities?**

21 A. As discussed earlier, utilities are facing energy market volatility, rising cost
22 structures, the need to finance significant capital investment plans, uncertainties
23 over accommodating future environmental mandates, and ongoing regulatory

1 risks. Coupled with the ongoing turmoil in capital markets, these considerations
2 warrant a stronger balance sheet to deal with an increasingly uncertain
3 environment. A more conservative financial profile, in the form of a higher
4 common equity ratio, is consistent with increasing uncertainties and the need to
5 maintain the continuous access to capital that is required to fund operations and
6 necessary system investment, even during times of adverse capital market
7 conditions.

8
9 Moody's has warned investors of the risks associated with debt leverage and fixed
10 obligations and advised utilities not to squander the opportunity to strengthen the
11 balance sheet as a buffer against future uncertainties.⁷⁰ Moody's noted that,
12 "maintaining unfettered access to capital markets will be crucial," and cited the
13 importance of forestalling future downgrades by bolstering utility balance
14 sheets.⁷¹ As Moody's concluded:

15 Our concerns are clearly growing, but we believe utilities have
16 adequate time to adjust and revise their corporate finance policies
17 and strengthen balance sheets, thereby improving their ability to
18 manage volatility and address uncertainty.⁷²

19
20 Moody's affirmed that, because of its significant investment plans, the utility
21 industry "will need to attract a significant amount of new equity capital in order to
22 maintain existing ratings."⁷³ This is especially the case for FPL, which faces the
23 prospect of financing significant capital expansion plans in a turbulent market

1 while at the same time maintaining its ability to respond to other significant
2 challenges.

3 **Q. What did you conclude regarding the reasonableness of FPL's requested**
4 **capital structure?**

5 A. Based on my evaluation, I concluded that the 55.8 percent common equity ratio
6 requested by FPL represents a reasonable mix of capital sources from which to
7 calculate FPL's overall rate of return. Although this adjusted common equity ratio
8 is somewhat higher than the average currently maintained by the group of electric
9 utility operating companies, it is well within the range of individual results for this
10 reference group and the Utility Proxy Group and consistent with the trend towards
11 lower financial leverage expected for the industry. As discussed earlier, it is also
12 consistent with the relatively greater financial strength required to counterbalance
13 the various exposures faced by FPL.

14
15 While industry averages provide one benchmark for comparison, each firm must
16 select its capitalization based on the risks and prospects it faces, as well as its
17 specific needs to access the capital markets. A public utility with an obligation to
18 serve must maintain ready access to capital under reasonable terms so that it can
19 meet the service requirements of its customers. The need for access becomes
20 even more important when the company has capital requirements over a period of
21 years, and financing must be continuously available, even during unfavorable
22 capital market conditions.

1 Financial flexibility plays a crucial role in ensuring the wherewithal to meet the
2 needs of customers, and utilities with higher leverage may be foreclosed from
3 additional borrowing, especially during times of stress. FPL's capital structure
4 reflects the Company's ongoing efforts to maintain its credit standing and support
5 access to capital on reasonable terms. The reasonableness of FPL's capital
6 structure is reinforced by the ongoing uncertainties associated with the electric
7 power industry, the need to accommodate the specific exposures faced by FPL,
8 and the importance of supporting continued system investment, even during times
9 of adverse industry or market conditions.

10 **Q. Does this conclude your direct testimony?**

11 **A. Yes.**

1 **BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**

2 **FLORIDA POWER & LIGHT COMPANY**

3 **REBUTTAL TESTIMONY OF WILLIAM E. AVERA**

4 **DOCKET NO. 080667-EI**

5 **AUGUST 6, 2009**

6
7 **INTRODUCTION**

8
9 **Q. Please state your name and business address.**

10 A. William E. Avera, 3907 Red River, Austin, Texas, 78751.

11 **Q. Did you previously submit direct testimony in this proceeding?**

12 A. Yes, I did.

13 **Q. What is the purpose of your rebuttal testimony in this case?**

14 A. My purpose is to respond to the testimony of Mr. Richard A. Baudino, submitted
15 on behalf of the South Florida Hospital and Healthcare Association and Dr. J.
16 Randall Woolridge, submitted on behalf of the Office of Public Counsel (OPC)
17 concerning a fair rate of return on equity (ROE) and regulatory capital structure
18 for Florida Power & Light Company (FPL). In addition, I also respond to the
19 capital structure recommendations of Mr. Jeffery Pollock, submitted on behalf of
20 the Florida Industrial Power Users Group, the testimony of Daniel J. Lawton,
21 submitted on behalf of OPC, regarding the impact of OPC's recommended excess
22 reserve adjustment on FPL's financial integrity, as well as the testimony of
23 Kimberly Dismukes, submitted on behalf of OPC, concerning the appropriate cost

1 of capital to determine costs charged to FPL by FiberNet. I will also rebut the
2 financial arguments of Mr. Thomas Saporito.

3 **Q. What is your conclusion regarding financial testimony you are rebutting?**

4 A. All of the witnesses I am rebutting recognize the financial strength of FPL and
5 then propose ROEs, regulatory capital structures, and other adjustments that
6 would undermine that strength. Indeed, the tenor of their testimony is that
7 because FPL is so strong, the Florida Public Service Commission (FPSC) can
8 allow returns at the lower end of the ranges indicated for other utilities, withdraw
9 its support for FPL's conservative balance sheet, and adjust depreciation to
10 decrease cash flow. These witnesses uniformly fail to consider that the financial
11 strength of FPL is the result of the FPSC's long-standing policy of regulatory
12 support, which includes a strong but reasonable equity ratio, that has protected
13 customers and saved them money. FPL has been able to maintain the ability to
14 raise capital and respond to challenges in the form of the raging storms in recent
15 years. Though buffeted by massive hurricanes, gas market volatility, and financial
16 turmoil, FPL has been able to borrow money at low rates that will benefit
17 customers for years to come. FPL's balance sheet also pays off for customers
18 when the company contracts for fuel as well as other commodities and services.
19 The strong balance sheet also enhances FPL's ability to hedge risks on behalf of
20 customers. FPL's financial strength also offsets the inherent risk of depending on
21 natural gas and nuclear power as the predominant fuel sources, which have
22 economic and environmental benefits for customers and the state of Florida.

1 As a result of the strategy of financial strength pursued by FPL and supported by
2 the FPSC, customers have not seen a base rate increase since 1984 and enjoy rates
3 that are below Florida and U.S. averages. Moreover, this strategy support's
4 Florida's economic growth and recovery because current and potential customers
5 can be confident that their electricity supplier is robust and resilient in the face of
6 future challenges and uncertainties.

7
8 The financial recommendations of the intervenor witnesses would be short-
9 sighted in the extreme, sacrificing the long-term security and economy of
10 customers for a temporary suppression of rates. There is no free lunch. If
11 investors and bond rating agencies perceive that the FPSC has withdrawn its
12 support for FPL's financial strength, they will reassess their risk evaluations
13 upwards. The outcome would be higher borrowing costs and less financial
14 flexibility for FPL. This loss of financial strength would expose FPL's customers
15 to the vagaries of weather and markets to which FPL is uniquely subject due to its
16 geographic location and energy mix.

17 **Q. How is your rebuttal testimony organized?**

18 A. The first three sections of my rebuttal discuss three fundamental fallacies that lead
19 the intervenor witnesses to recommend unreasonably low ROE's, debt-laden
20 capital structures, and depreciation policies that would undermine FPL's financial
21 strength and harm customers' long-run interest. The final section summarizes the
22 technical criticisms of the intervenor analyses that are detailed in Exhibit WEA-
23 18.

1 **Q. What are the three fallacies in the rebutted testimony?**

2 A. The first of these fallacies is that it is possible to “**Have your cake and eat it**
3 **too**”, wherein the rebutted witnesses use FPL’s past and present financial strength
4 as the basis of recommendations that would destroy that very strength. The
5 second fallacy is to “**Ignore the man behind the curtain**”, because Mr. Baudino
6 and Dr. Woolridge argue that investors’ expected return on book equity should be
7 ignored, even though these expected returns are directly comparable to the ROE
8 that the FPSC will be allowing in this case. In fact, the returns on book equity
9 reported in their testimonies reveal that their ROE recommendations are woefully
10 inadequate to compensate investors in FPL. The third fallacy is that “**Utilities are**
11 **an investment island**”, where Mr. Baudino and Dr. Woolridge reject my use of
12 investors’ required returns from non-utility companies as a benchmark and argue
13 that analyses should only look to utilities. In fact, FPL must compete with
14 utilities and non-utilities to obtain capital, a reality recognized in the *Hope* and
15 *Bluefield* cases.

16 **Q. Are you sponsoring an exhibit to your rebuttal testimony?**

17 A. Yes. I am sponsoring the following exhibit:

18 ▪ Exhibit WEA-18 – Rebuttal to Technical Arguments

19 **Q. What is the subject of Exhibit WEA-18?**

20 A. Exhibit WEA-18 presents a technical demonstration that my analyses are more
21 reasonable, reliable, and relevant to FPL’s unique facts and circumstance than
22 those presented by the intervenor witnesses. A main thrust of the exhibit is the
23 proper application of the discounted cash flow (DCF) and Capital Asset Pricing

1 Model (CAPM) exclusively relied upon by both Mr. Baudino and Dr. Woolridge
2 as the basis of their ROE recommendations. My testimony uses these same
3 methods (as well as the expected earnings approach) applied to my Utility Proxy
4 Group, as well as the DCF and CAPM applied to a Non-Utility Proxy Group.
5 Exhibit WEA-18 details the differences in our proxy groups and the application of
6 the DCF and CAPM to show why their analyses produce downward biased results

7 **Q. What is your conclusion regarding Intervenor's ROE and capital structure**
8 **recommendations?**

9 A. Investors have many options for their funds and competition for investment
10 dollars is intense. As documented in my rebuttal testimony, the cost of equity
11 recommendations of Mr. Baudino and Dr. Woolridge are significantly downward-
12 biased and out of touch the requirements of real-world investors in the capital
13 markets. Considering investors' heightened awareness of the risks associated
14 with the capital markets generally and the utility industry specifically, supportive
15 regulation remains crucial to maintaining FPL's access to capital and ensuring the
16 Company's continued ability to meet customer needs. The importance of
17 regulatory support is magnified by the challenges inherent in FPL's service area
18 and energy mix. Intervenor's recommendations would compromise these
19 regulatory objectives and deny FPL the opportunity to earn its required rate of
20 return. It would upset a strategy of financial strength that has been pursued by
21 FPL with the support of the FPSC that has paid off for customers in low rates,
22 reliable service, and the ability to weather hurricanes, energy market volatility and
23 financial market turmoil.

1 **I. THE “HAVE YOUR CAKE AND EAT IT TOO” FALLACY**

2
3 **Q. How do the intervenor witnesses fall into this fallacy?**

4 **A.** Mr. Baudino and Dr. Woolridge choose ROE estimates at the low end of their
5 ranges predicated on their claim that FPL is a “low risk utility” based on its
6 relatively high bond ratings and strong balance sheet (Baudino, p. 33, Woolridge,
7 p. 59). An even more extreme recognition of FPL’s financial strength is
8 recommended by Mr. Saporito, who advocates that the ROE be adjusted
9 downward to the “4% to 6% range” which he documents to be in the range of
10 risk-free returns (Saporito, p. 6).

11
12 As shown in my direct testimony and in Mr. Pimentel’s direct and rebuttal
13 testimony, financial strength is a good thing for customers and is necessary to
14 offset the inherent risks of FPL’s geographic location, energy mix, and exposure
15 to hurricanes. Mr. Baudino, Dr. Woolridge, and Mr. Saporito leap to the
16 conclusion that FPL is a “low risk utility” based only on financial risk measures
17 and without consideration of the business risk of FPL’s operations. To make
18 matters worse, Mr. Baudino and Dr. Woolridge recommend adjustments to FPL’s
19 regulatory capital structure that would increase leverage by substituting debt for
20 equity. Mr. Pollock also recommends that FPL’s capital structure be adjusted to
21 include more debt and Mr. Lawton relies on FPL’s financial strength to argue that
22 adjusting depreciation rates to reduce cash flow could be absorbed by FPL. The
23 problem with these recommendations is that all of them would undermine FPL’s

1 financial strength. Therefore, the intervenor recommendations would destroy the
2 very attribute that they rely upon for their recommendations.

3 **Q. Does FPL's financial strength depend on more than the amount of equity in**
4 **the capital structure?**

5 A. Yes. As discussed in my direct testimony, investors and bond rating agencies are
6 increasingly focused on the importance of regulatory support. In this regard, the
7 FPSC has established a well-earned reputation of constructive regulation. If the
8 FPSC were to deviate from this path, it would cause investors and bond rating
9 agencies to reassess their risk perceptions of FPL. If the intervenors' positions
10 were to be adopted, then the financial strength that has allowed FPL to save
11 customers money and weather hurricanes, gas market volatility, and financial
12 turmoil would be sapped. Making unwarranted adjustments to the capital structure
13 or adopting an unreasonably low ROE would undoubtedly have a negative impact
14 on investors' risk perceptions, and doing both would be outright alarming. The
15 end result would be a loss of financial strength that would harm customers and
16 expose them to higher costs and more uncertainty in the future.

17 **Q. Mr. Baudino and Mr. Lawton claim that their adjustments would not cause**
18 **FPL's bond rating to fall. Should the FPSC accept their representations?**

19 A. No. It is illogical to presume that FPL's equity ratio and cash flow are
20 "excessive" to maintain its current bond rating. First, if FPL's financial
21 parameters exceed those necessary for a single-A rating, then the rating agencies
22 would have already upgraded FPL. Second, the rating agencies clearly state that
23 they look beyond the numbers to consider the individual risk profile of each

1 issuer. In my contact with rating agency personnel, they jealously guard their
2 ability to depart from guidelines to reflect the risk of individual issuers. Given the
3 recent embarrassments from the ratings of mortgage securities that triggered the
4 financial meltdown, they are likely to be more, not less sensitive to individual
5 issuer characteristics. The exercise that Mr. Baudino presents is nothing more
6 than an attempt to second-guess the rating agencies based on their broad
7 guidelines, which is both unreliable and speculative. As S&P very recently
8 reiterated:

9 The ratings matrix indicative outcomes are what we typically
10 observe – but are not meant to be precise indications or guarantees
11 of future rating opinions. ... Moreover, our assessment of financial
12 risk is not as simplistic as looking at a few ratios (Standard &
13 Poor's Corporation. "Criteria Methodology: Business
14 Risk/Financial Risk Matrix Expanded," *RatingsDirect* (May 27,
15 2009).

16 **Q. Is there anything hidden or mysterious about the consideration of imputed**
17 **debt from purchased power agreements (PPAs) by FPL?**

18 A. No. Contrary to the suggestion of Mr. Baudino (p. 36) and Dr. Woolridge (p. 16),
19 the consideration of imputed debt is a long-standing issue before the FPSC. I
20 have submitted testimony on imputed debt in the last two rate cases and in several
21 capacity needs cases. Indeed, the FPSC stated in its recent TECO case that it was
22 familiar with this issue from previous cases (Order No. PSC-09-0283-FOF-EI, p.
23 36). I recognize that the imputed debt is not without controversy, but its

1 relationship to regulatory capital structure and the 55.8% equity ratio is well-
2 established in Florida regulatory lore. Mr. Pimentel and I have both discussed
3 why the adjustment is reasonable and necessary in this case.

4
5 I find particularly disingenuous Dr. Woolridge's claim that the imputed debt
6 should be rejected because it is not reported under Generally Accepted
7 Accounting Principles (GAAP). Investors and rating agencies begin their
8 analyses using accounting information prepared according to GAAP but then
9 make adjustments as necessary to reflect underlying economic reality. Indeed,
10 much of the Chartered Financial Analyst (CFA) curriculum is directed to making
11 adjustments to GAAP numbers. Moreover, it is common in the regulatory arena
12 to adjust GAAP numbers to comport with regulatory policies. For example, my
13 first encounter with Dr. Woolridge was in an SBC Ohio case in 2004 where we
14 both argued that the Public Utilities Commission of Ohio should use market value
15 capital structures that deviate from GAAP in determining the weighted cost of
16 capital for services provided to competitors. The Public Utilities Commission of
17 Ohio, and ultimately the Federal Communications Commission and federal
18 courts, agreed with us (Docket 02-1289-TP-UNC-2004). I recognize that the
19 FPSC has the discretion to recognize or ignore imputed debt, but it should do so
20 based on financial realities and regulatory policy, not merely because Dr.
21 Woolridge invokes GAAP to tie the Commission's hands.

1 **II. THE “IGNORE THE MAN BEHIND THE CURTAIN” FALLACY**

2

3 **Q. What is the nature of this fallacy?**

4 A. Both Mr. Baudino and Dr. Woolridge claim that returns earned on book value
5 should be totally ignored because they have no relevance to the ROE that FPL
6 should be allowed in this case and the focus should be completely on returns in
7 the stock market. Yet the allowed ROE set by the FPSC will be applied to rate
8 base not stock prices. If the focus is shifted to earned returns using data in my
9 testimony or their testimony, the downward bias of Mr. Baudino and Dr.
10 Woolridge’s ROE recommendation is all too apparent. Their position reminds me
11 of the wizard in the classic movie *The Wizard of Oz* who implores Dorothy and
12 here compatriots to pay no attention to the man behind the curtain.

13 **Q. Dr. Woolridge (p.5) claims the earnings on book value approach “has not**
14 **been used by regulatory commissions for years.” Is that your experience?**

15 A. Not at all. While Dr. Woolridge is correct that this method predominated before
16 the DCF model became fashionable with academic experts, I continue to
17 encounter it around the country. Indeed, the Virginia State Corporation
18 Commission (VSCC) is specifically required by statute (Code of Virginia at § 56-
19 585) to consider the earned returns on book value of electric utilities in its region
20 (including Florida). That methodology provides that the ROE allowed by the
21 VSCC must be within a range governed by the average historical earned return on
22 book equity for a peer group of regional utilities. Another example is Ms. Terri
23 Carlock, the long-time financial analyst for the Idaho Public Utilities

1 Commission. She has consistently presented evidence on book earnings for
2 decades, and Idaho regulators continue to confirm the relevance of return on book
3 equity evidence.

4
5 Perhaps the most ardent proponent of earned returns as a benchmark for fair ROE
6 is David C. Parcell, who frequently appears as a witness for regulatory agencies
7 and other intervenors. Mr. Parcell literally “wrote the book” for the Society of
8 Utility and Regulatory Financial Analysts (*The Cost of Capital – A Practitioner’s*
9 *Guide*, 1997 Edition). Mr. Parcell called the comparable earnings approach the
10 “granddaddy” of cost of equity methods (p. 7-1). He also points out that the
11 amount of subjective judgment required to implement this method is “minimal”,
12 particularly when compared to the DCF and CAPM methods (p. 7-3). Mr. Parcell
13 also notes that this method is “easily understood” and firmly anchored in the
14 regulatory tradition of the *Bluefield* and *Hope* cases (p.. 7-3).

15 **Q. What does Dr. Woolridge’s testimony report for earned returns?**

16 A. Dr. Woolridge reports (p. 28) that the earned return on equity for his utility proxy
17 group was 12.0 percent in 2008. In fact, the return on equity reflected on his
18 Exhibit JRW-4 for his electric utility proxy group is 12.2 percent. Indeed, had Dr.
19 Woolridge gone through the same exercise of averaging the mean and median that
20 he applies to company data throughout the remainder of his testimony, the ROE
21 result would be 12.4 percent. This book return estimate is an “apples to apples”
22 comparison to his recommended ROE of 9.5 percent and the 12.5 percent that
23 FPL has requested the FPSC to allow on rate base.

1 Q. What would be the effect of authorizing a book return for FPL that is so far
2 below the average earnings of the utilities Dr. Woolridge claims are
3 comparable?

4 A. Plain and simple, FPL will find it difficult to compete for investors' capital and
5 FPL would not be earning up to the Bluefield standard of comparable earnings:

6 A public utility is entitled to such rates as will permit it to earn on
7 the value of the property which it employs for the convenience of
8 the public equal to that generally being made at the same time and
9 in the same general part of the country on investments in other
10 business undertakings which are attended by corresponding risks
11 and uncertainties. (*Bluefield Water Works & Improvement Co. v.*
12 *Pub. Serv. Comm'n*, 262 U.S. 679 (1923))

13 Q. What is the relevance of Dr. Woolridge's discussion of market-to-
14 book ratios (pp. 25-27) to the deviation between his recommended
15 ROE and the earnings of comparable utilities?

16 A. Based on his testimony here and in previous cases, I understand that Dr.
17 Woolridge is trying to argue that utility earnings are generally too high
18 because the market-to-book ratios generally exceed one. He wants the
19 FPSC to sacrifice FPL's financial strength to favor a theoretical ideal of
20 market-to-book ratios equaling unity. The FPSC does not regulate utility
21 stock market prices, and as will be discussed in Exhibit WEA-18, there are
22 many leaps between his economic theory and reality. But if the theory is
23 correct, then Dr. Woolridge is asking the FPSC to order a return that

1 would almost certainly lead to a capital loss on the value of FPL's
2 investment. From an economic perspective, such an action would take the
3 value of FPL's property without compensation, the kind of behavior that
4 upset the American colonist against the English Crown.

5 **Q. How does Mr. Baudino dismiss returns on book equity?**

6 A. His answer is simply reflective of the "Ignore the man behind the screen" fallacy
7 in stating:

8 Forecasted earned returns on book value **may** have nothing
9 whatsoever to do with investors' required returns in the
10 marketplace. For example, if earned returns on book equity exceed
11 the market-based DCF return on equity, then investors **may** expect
12 a company to earn more on book equity than the market-based
13 required rate of return. Instead, I recommend that the Commission
14 utilize a range of returns generated by the DCF model in setting
15 FPL's cost of equity in this case. (pp. 55-56, emphasis supplied)

16
17 I think Mr. Baudino is saying that the FPSC should ignore what utilities are
18 expected to actually earn on book value in determining what comparable
19 companies are (in the words of *Bluefield*) expected to earn on investments of
20 "corresponding risks and uncertainties." In other words, ignore the actual
21 earnings and look on the other side of the curtain to the returns being conjured up
22 by his flawed application of the DCF model. I don't mean to suggest that the
23 DCF model is not a valuable tool, but it is built upon assumptions and judgments

1 that should be checked against the simple and straightforward expected earnings
2 approach that looks directly to book returns rather than through the lens of a
3 financial model based on stock market prices.

4 5 **III. THE "UTILITIES ARE AN INVESTMENT ISLAND" FALLACY**

6
7 **Q. What is the nature of this fallacy?**

8 A. Mr. Baudino and Dr. Woolridge dismiss out of hand my analysis of the cost of
9 equity for non-utility firms based on the claim that utilities are profoundly
10 different and therefore less risky from other companies in the economy. This
11 view is not consistent with reality, investor behavior, or the *Bluefield* and *Hope*
12 decisions. True enough, utilities are sheltered from competition, but they
13 undertake other obligations and lose the ability to set their own prices and decide
14 when to exit a market.

15
16 My Non-Utility Proxy Group was screened to have corresponding risk indicators
17 with FPL and is comprised of 66 of the best known and most stable corporations
18 in America. While these companies do not have the regulatory protections that
19 utilities have, neither do they bear the burdens of losing control over their prices,
20 undertaking the obligation to serve, and having to invest in infrastructure even in
21 unfavorable market conditions (such as the present). FPL can't relocate its
22 service territory to an area less threatened by hurricanes and more convenient to
23 fuel sources, postpone capital spending necessary to maintain reliability and

1 accommodate growth, or abandon customers when turmoil roils energy or capital
2 markets. As I documented in my direct testimony, investors are becoming
3 increasingly sensitive to the regulatory risk of utilities – and correspondingly the
4 greater benefit from the even-handed reputation of the FPSC. Indeed Mr.
5 Baudino quotes (p. 8) a May 29, 2009 Moody’s report that observes:

6 However, we are increasingly concerned with business and
7 operating risks, which are not new but appear to be accelerating
8 faster than previously understood.

9 **Q. Do utilities have to compete with non-regulated firms for capital?**

10 A. Most certainly. Mr. Baudino recognizes that the cost of capital is an opportunity
11 cost based on the returns investors could realize by putting their money in other
12 alternatives (p. 15), which according to Mr. Baudino include, “a utility stock,
13 utility bond, mutual fund, money market fund or any other number of investment
14 vehicles.” Clearly mutual funds invest in non-utilities, and the total money
15 invested in utility stocks is only the tip of the iceberg of total common stock
16 investment.

17 **Q. Does Dr. Woolridge apparently consider non-utility stock returns relevant to
18 determining the cost of capital?**

19 A. Indeed he does. Dr. Woolridge cites many studies of past and expected stock
20 market returns in his testimony, including a list of 30 studies included on Exhibit
21 JRW-11. **Not one** of these studies is limited to utilities, and all include a
22 predominance of non-utility common stocks, e.g., Standard & Poor’s 500 index.
23 Moreover, while Dr. Woolridge references a study of industry betas done at New

1 York University (p. 29) that suggests utilities have lower risks than the average
2 firm in the non-regulated sector, this establishes nothing more than the obvious;
3 while some unregulated firms have higher risks than utilities, others have lower
4 risks. As documented in my direct testimony and discussed further in Exhibit
5 WEA-18, the firms in my Non-Utility Proxy Group are also in the lower ranges of
6 risk as measured by objective, widely referenced benchmarks..

7 **Q. Would it be consistent with the *Bluefield* and *Hope* cases to disregard**
8 **required returns for non-utility companies?**

9 A. No. The quote from the *Bluefield* case presented above refers to “business
10 undertakings attended with comparable risks and uncertainties.” It does not
11 restrict consideration to other utilities. Indeed, if the requirement is business in
12 the same part of the country and the utility has the exclusive franchise, then the
13 Court could only be referring to non-utility businesses and any nearby utilities.
14 Similarly, the *Hope* case states:

15 By that standard the return to the equity owner should be
16 commensurate with returns on investments in other enterprises
17 having corresponding risks.

18 As in the *Bluefield* decision, there is no restriction of the other investments to
19 utilities.

1 Indeed, in teaching regulatory policy I usually mention that in the early
2 applications of the comparable earnings approach, utilities were explicitly
3 eliminated due to a concern about circularity. In other words, soon after the *Hope*
4 decision regulatory commissions did not want to get involved in circular logic by
5 looking to the returns of utilities that were established by the same or a similar
6 regulatory commission in the same geographic region. To avoid circularity,
7 regulators looked only to the returns of non-utility companies. Incidentally, the
8 requirement in the *Bluefield* case of restricting the comparable group to the
9 geographic region is often overlooked in the academic literature, but the Virginia
10 Code mentioned earlier is true to that directive by considering earned returns of
11 utilities in the Southeastern region, including Florida. It is interesting to note that
12 the utility proxy groups of Mr. Baudino and Dr. Woolridge only include two other
13 utilities that operate in Florida, while virtually all of the firms in my Non-Utility
14 Proxy Group have a significant presence in this state.

15 **Q. Does consideration of the results for the Non-Utility Proxy Group make the**
16 **estimation of the cost of equity using the DCF model more reliable?**

17 **A.** Yes. The estimates of growth from the DCF model depend on analysts forecasts,
18 or in the case of Dr. Woolridge, historical performance. It is possible for utility
19 growth rates to be distorted by historical trends in the industry (e.g., deregulation)
20 or the industry falling into favor or disfavor by analysts. The result of such
21 distortions would be to bias the DCF estimates for utilities. Because the Non-
22 Utility Proxy Group includes low risk companies from many industries, it

1 diversifies away any distortion that may be caused by the ebb and flow of
2 enthusiasm for a particular sector.

3 **Q. Do you have any closing comments about the opposing witnesses' assessment**
4 **of the relative risk of FPL?**

5 A. Yes. The statement of FPL Group's Mr. Hay that FPL is "best utility franchise in
6 the nation" is cited repeatedly, particularly by Mr. Baudino. He and others
7 apparently equate this statement with an admission that FPL is a low risk utility. I
8 do not think this statement is equivalent to granting that FPL is low risk; rather, it
9 reflects the pride that the company feels in its financial strength, reliable service,
10 and ability to surmount the many challenges inherent in its service area and
11 energy mix. I am reminded of the Navy SEALs that I encountered during my
12 military service, who would say in the face of physical exertion and extreme
13 danger, "We have the best job in the U.S. Navy." They definitely were not saying
14 they had the least risky job in the Navy.

15

16 **IV. SUMMARY OF EXHIBIT WEA-18**

17

18 **Q. Please summarize the conclusions of Exhibit WEA-18.**

19 A. Exhibit WEA-18 examines the fallacies underlying the approaches and criticisms
20 in the testimony of Mr. Baudino and Dr. Woolridge and demonstrates that the
21 analyses and conclusions presented in my direct testimony are more reasonable,
22 reliable, and relevant with investors' and FPL's requirements. Specifically, my

1 detailed response to the technical arguments raised by Mr. Baudino and Dr.
2 Woolridge concluded:

- 3 • *The revenue test that Mr. Baudino and Dr. Woolridge used to define their*
4 *proxy groups has no demonstrable relationship to comparable risk, only*
5 *partially accounts for regulated operations, and is entirely subjective.*
- 6 • *Reference to my Non-Utility Proxy Group is entirely consistent with*
7 *established regulatory principles and there is no objective evidence that*
8 *these firms have higher investment risks than FPL or the firms in my*
9 *Utility Proxy Group.*
- 10 • *The DCF results of Mr. Baudino and Dr. Woolridge do not reflect*
11 *investors requirements because they either fail to focus on future*
12 *expectations, rely on illogical inputs, and/or contain errors in the*
13 *calculation of underlying growth rates.*
- 14 • *There is no basis for the contention that relying on security analysts'*
15 *projected growth rates results in a biased DCF cost of equity or that*
16 *dividend growth rates are likely to provide a superior guide to investors'*
17 *expectations.*
- 18 • *Dr. Woolridge's CAPM analysis is incorrectly premised on stale,*
19 *historical data that violates the assumptions of this method and produces*
20 *results that are patently illogical in today's capital markets.*
- 21 • *The forward-looking estimate of the market rate of return used in my*
22 *CAPM analysis is entirely consistent with the requirements of this*
23 *approach and there is no basis to claim that it is overstated.*

1 • *The expected earnings approach applied in my direct testimony is entirely*
2 *consistent with established regulatory principles and provides a*
3 *meaningful guide to investors' required ROE.*

4 • *Flotation costs are a valid consideration in establishing the ROE for FPL*
5 *and there is no basis to ignore the impact of these legitimate costs.*

6 • *There is no basis to use Dr. Woolridge's recommended ROE as the basis*
7 *for the costs charged to FPL by FiberNet.*

8 **Q. Does this conclude your rebuttal testimony?**

9 **A. Yes.**

1 **BY MR. ANDERSON:**

2 **Q.** Have you prepared a summary of your direct and
3 rebuttal testimony?

4 **A.** Yes, I have.

5 **Q.** Please provide it to the Commission.

6 **A.** Good morning, Commissioners. I'm Bill Avera.
7 My direct testimony analyzes the fair rate of return on
8 common equity for FPL. I also examined the
9 reasonableness of FPL's capital structure.

10 My analysis uses three recognized methods
11 applied to a proxy group of 19 utilities with comparable
12 risk. FPL must compete with capital -- for capital with
13 other companies in the economy outside the utility
14 sector. I therefore analyzed the cost of equity for a
15 proxy group of 66 low-risk nonutility companies.

16 My quantitative analyses resulted in a range
17 between 12 -- or 11 and 13 percent. I narrowed the fair
18 rate of return equity range to 12 to 13 percent to
19 account for the need to maintain FPL's strong financial
20 position and provide a return on flotation costs.

21 My testimony further demonstrates that FPL's
22 actual capital structure is required to meet FPL's
23 financial challenges. A major challenge for FPL is to
24 fund 16 million -- billion dollars of capital to sustain
25 its efficient and reliable system. If FPL can raise

1 private capital for this vital infrastructure spending,
2 customers and the economy of Florida will benefit.

3 The value of FPL's single A credit rating was
4 confirmed during the recent capital market turmoil. FPL
5 had the financial flexibility to weather the financial
6 storm because of its strength. This strength depends on
7 investors' confidence that this Commission will continue
8 constructive regulation of FPL.

9 FPL needs financial resilience to protect its
10 customers. Due to its location on the Florida
11 peninsula, FPL is remote from fuel supply and
12 transmission resources. FPL's service area economy is
13 exposed to swings in consumer confidence and real estate
14 markets. FPL's development of nuclear power is favored
15 by this Commission and state leaders because of its
16 economic and environmental advantages, but financial
17 strength is necessary to offset nuclear risk.
18 Similarly, natural gas is a clean fuel but imparts risk
19 and financial requirements.

20 FPL needs financial strength to recover from
21 hurricanes. The return on equity in the 12 to
22 13 percent range in FPL's capital structure are needed
23 to meet these financial challenges.

24 My rebuttal testimony responds to Intervenors
25 who use FPL's financial strength to justify proposals

1 that would undermine that strength. Their testimony
2 argues that because FPL is strong, the Florida Public
3 Service Commission can allow returns at the lower end of
4 ranges indicated for other utilities, withdraw its
5 support for FPL's conservative balance sheet and adjust
6 depreciation to the detriment of cash flow. In other
7 words, the Intervenors want to have their cake and eat
8 it too.

9 FPL's financial strength is the product of
10 this Commission's long-standing policy of regulatory
11 support, including a strong but reasonable equity ratio.
12 If investors believe that this policy has changed, FPL's
13 financial strength is history. This Commission's policy
14 of financial strength has protected customers and saved
15 them money. Though buffeted by massive hurricanes, gas
16 market volatility and financial turmoil, FPL has been
17 able to borrow money at low rates that will benefit
18 customers for years to come. FPL's balance sheet saves
19 customers money when the company contracts for fuel and
20 other commodities and the balance sheet also enhances
21 FPL's ability to hedge risk to protect its customers.

22 Now my rebuttal testimony boils down to three
23 simple truths. Number one, investors are aware the
24 Commission, this Commission has long recognized the
25 importance of regulatory support, but FPL has only been

1 able to maintain its current stable A rating. It has
2 not been upgraded. Notwithstanding this Commission's
3 support and a strong capital structure, FPL clearly
4 needs this kind of strength to offset the geography
5 risk, the nuclear risk, the natural gas risk, the
6 hurricane risk. In other words, the Commission's
7 support and the strong capital structure are just enough
8 to offset the inherent risk of FPL.

9 Two, this strategy has worked. The financial
10 strength has led to low rates, reliable service and
11 efficiency improvements.

12 Three, there is no free lunch. The financial
13 recommendations of the Intervenor witnesses would
14 sacrifice long-term security and well-being of FPL's
15 customers for only a temporary suppression of rates.
16 Investors' confidence once lost takes years to restore.
17 The Intervenors would have FPL's customers waste a
18 valuable asset. That completes my summary.

19 **MR. ANDERSON:** Dr. Avera is available for
20 cross-examination.

21 **CHAIRMAN CARTER:** Mr. Mendiola.

22 **MR. MENDIOLA:** Thank you, Mr. Chairman.

23 **CROSS EXAMINATION**

24 **BY MR. MENDIOLA:**

25 **Q.** Good morning, Dr. Avera. How are you?

1 **A.** I'm well, sir. And you?

2 **Q.** Good. I'm good.

3 You are an outside consultant for FPL
4 addressing the issue of return on equity; is that
5 correct?

6 **A.** Yes, as well as capital structure.

7 **Q.** Yes. And you're from the great city of
8 Austin, Texas; is that correct?

9 **A.** Well, I live in the greater city of Dripping
10 Springs. But I work in Austin, as you do.

11 **Q.** Yes. Very good. All right.

12 And you've made a career out of testifying on
13 behalf of utility companies; isn't that true?

14 **A.** No, sir. I've testified on behalf of
15 commissions, industrial customers. In fact, I've
16 testified for members of your firm on many occasions.

17 **Q.** And today you're testifying on behalf of FP&L;
18 isn't that correct?

19 **A.** Yes, sir.

20 **Q.** And you've testified on behalf of many
21 investor-owned utilities; isn't that correct?

22 **A.** I have.

23 **Q.** How many would you guess?

24 **A.** I would guess, if you consider state and FERC,
25 I've been in 300 cases. Probably one-third of those

1 have been for commissions and customers, and --

2 Q. And two-thirds for utility companies?

3 A. Two-thirds for utilities, and that probably
4 covers 120 utilities.

5 Q. All righty. Now --

6 A. A guess -- that's not just electric, however.
7 You know, it's --

8 Q. Very good. Thank you for that clarification.

9 Now, Dr. Avera, I want to start kind of with
10 the general picture and come down to a greater level of
11 specificity. Your analysis shows a required return on
12 equity in the range of 11 to 13 percent; is that
13 correct?

14 A. Yes, sir.

15 Q. All right. Now have you heard it testified to
16 in this proceeding that every 100 basis points of return
17 on equity equates to approximately \$130 million of
18 annual revenue requirement?

19 A. Yes, sir.

20 Q. All right. So your range, that is the range
21 from 11 to 13 percent, is a range of about \$260 million
22 of annual revenue requirement that customers would be
23 required to pay; is that correct?

24 A. That is correct. Now my recommended range
25 narrows that to 12 to 13.

1 Q. Yes, sir. And I'm going to get to that.

2 And if the range were expanded down to
3 10 percent -- and there are some Intervenors who are
4 below 10 percent on ROE; isn't that correct?

5 A. Yes, there are such recommendations.

6 Q. All right. Now if the range were expanded
7 from 10 to 13 percent, the impact on the annual revenue
8 requirement would be a range of \$390 million; isn't that
9 right?

10 A. That's approximately correct. As I explained
11 in my deposition, I'm not sure that --

12 Q. It's exactly dollars to dollars.

13 A. Yeah. Because there are lots of changes as
14 you go up and down the revenue requirement.

15 Q. Very good. Right.

16 Now as you, as you just testified, you
17 actually recommended that the upper half of your range
18 be considered to, for this Commission to set an
19 appropriate ROE, that is, the range from 12 to
20 13 percent; isn't that correct?

21 A. Yes, sir. That's correct.

22 Q. All right. And then it was actually the Chief
23 Financial Officer, Mr. Pimentel, who selected the
24 midpoint of the upper half of your range; is that
25 correct?

1 A. Yes.

2 Q. So your analysis demonstrated a range from
3 11 to 13, and then you suggested the range from 12 to
4 13, and then Mr. Pimentel selected 12.5, is that right,
5 as far as the process goes?

6 A. Yes. But I need to clarify. I didn't just
7 suggest. I gave reasons why it is important for FPL's
8 return to be in the 12 to 13, to consider flotation cost
9 and to consider the financial requirements and unique
10 risk.

11 Q. And another thing that you suggested that
12 should be considered was the, quote, exemplary
13 management; isn't that correct?

14 A. I said it should be considered. I did not
15 consider it. That's a consideration that Mr. Pimentel
16 used in positioning the return within the 12 to
17 13 percent range.

18 Q. And you testified, if you look with me, at
19 Page 73 --

20 **CHAIRMAN CARTER:** Mr. Mendiola, pull your
21 mike -- you're okay. Just pull it. There you go.
22 That's better. You may proceed.

23 **MR. MENDIOLA:** Thank you. Thank you.

24 **BY MR. MENDIOLA:**

25 Q. You testified, you asked yourself the question

1 on Page 73 that, "In evaluating the fair ROE for FPL
2 from within this range, is it appropriate to recognize
3 and encourage exemplary management;" isn't that correct?

4 **A.** Yes.

5 **Q.** And you answered that, "Yes," with an
6 explanation; isn't that right?

7 **A.** That's right. That it's good regulatory
8 policy.

9 **Q.** All right. And you understand as an expert in
10 this field, Dr. Avera, that management has a statutory
11 obligation to provide adequate and reliable service to
12 FPL's customers; isn't that correct?

13 **A.** Yes.

14 **Q.** And you've also been doing this for a long
15 time and you understand that management has a fiduciary
16 duty to maximize return for shareholders; isn't that
17 correct?

18 **A.** Yes. The fiduciary duties go far beyond that.

19 **Q.** That's one of the --

20 **A.** But the fiduciary duties are to the interest,
21 the financial interest of shareholders, which includes
22 their return.

23 **Q.** And the obligation that management has to
24 provide adequate and reliable service at fair and
25 reasonable rates, that doesn't change whether the ROE is

1 11 percent or 13 percent; isn't that right?

2 A. That's correct.

3 Q. And you have no testimony that management will
4 fail to carry out its duty if the ROE is set at
5 11 percent, for example, do you?

6 A. No. That's not my contention. But I'm saying
7 that it's good policy to encourage effective management
8 because the customer ultimately benefits, and that's the
9 way it works in the free enterprise economy.

10 Q. Sure. But in terms of management carrying out
11 its duties to provide adequate and reliable service,
12 that, that duty will not change whether the ROE is at
13 10.4 percent or 13 percent; isn't that right?

14 A. No. The duty doesn't change.

15 Q. All right.

16 A. I think the effectiveness of the regulatory
17 structure may change.

18 Q. And, and as would perhaps the return of
19 shareholders change; is that right?

20 A. Yes.

21 Q. But the duty to provide adequate and reliable
22 service would not change.

23 A. No, it does not.

24 Q. All right. And neither would the fiduciary
25 duty to maximize shareholder return change whether the

1 ROE is at 10.4 percent or at 13 percent; isn't that
2 right?

3 A. No, it wouldn't change. But --

4 Q. All right.

5 A. But as I say in my testimony, oftentimes to
6 get efficiencies management has to take risks. Now when
7 these risks turn out, the customers and shareholders
8 benefit.

9 Q. Thank you.

10 A. When these risks don't turn out, shareholders
11 suffer. So if you want shareholders to encourage
12 management to take risks, you have to have some payoff,
13 and I think that's what this exemplary management does.
14 Because there is risk involved in trying to improve your
15 operation.

16 Q. Thank you. That actually --

17 A. It doesn't always work.

18 Q. -- goes right into my next topic regarding
19 risk. This company is a monopoly; isn't that correct?

20 A. Yes.

21 Q. And what that means is that consumers, when
22 they're selecting their electricity provider, have no
23 choice about whom they can select; isn't that right?

24 A. That's generally true. At the margins --

25 Q. There might be some cogeneration options --

1 **A.** Right.

2 **Q.** -- or something like that.

3 **MR. ANDERSON:** Chairman Carter? I'm sorry.

4 **CHAIRMAN CARTER:** Mr. Anderson.

5 **MR. ANDERSON:** Could we perhaps have people
6 speak one at a time? There's a pattern of speaking over
7 the witness. That's going to make it very difficult for
8 the court reporter.

9 **MR. MENDIOLA:** I'm just trying to move things
10 along. But I'll be happy to slow down, Mr. Chairman.

11 **CHAIRMAN CARTER:** Thank you, Mr. Mendiola.

12 **MR. MENDIOLA:** All right.

13 **BY MR. MENDIOLA:**

14 **Q.** And as a monopoly, this company is protected
15 from competition; isn't that correct?

16 **A.** It's protected from competition providing
17 exactly the same service. It's not protected from
18 customers making choices that would lead to less use of
19 electricity.

20 **Q.** Sure. Customers can elect to turn off their
21 lights a little bit earlier in the day if they wanted
22 to; right?

23 **A.** Or go to more efficient options or any number
24 of alternatives. But as to the certificated electric
25 company, in the areas it serves FPL is the

1 government-regulated monopoly.

2 Q. And as a government-regulated monopoly this
3 company is guaranteed a reasonable opportunity to earn a
4 reasonable return on its investment; isn't that correct?

5 A. Well, the guaranteed part I can't agree with,
6 no.

7 Q. You --

8 A. It is allowed a reasonable opportunity to earn
9 its allowed return. Whether it earns that or not
10 depends on economic circumstances and management
11 effectiveness.

12 Q. And I didn't, I didn't ask whether the company
13 was guaranteed to earn a reasonable return. What I
14 asked was whether you would agree with whether the
15 company is guaranteed a reasonable opportunity to earn a
16 reasonable return.

17 A. I can't agree.

18 Q. You don't agree with that?

19 A. Because my understanding is there's no
20 guarantee in there.

21 Q. All right.

22 A. And a guarantee to try is to me not a
23 guarantee. I think there are constitutional protections
24 that are very important. But I think what the
25 constitutional protections say is there is a limit to

1 what the commissions can do in terms of they must allow
2 an opportunity to earn a reasonable return, maintain
3 financial integrity and access the capital markets.

4 Q. And when this Commission sets a fair and
5 reasonable return, what that means is that if there's
6 \$100 that's invested in invested capital for this
7 utility, then this utility has an opportunity to earn
8 the return that this Commission sets; isn't that
9 correct?

10 A. It does have an opportunity. Of course, how
11 the rates are set, if you consider, for example,
12 flotation costs, which are monies that the investor
13 started with that never make it to the investment base
14 of the company, so in order for the company to have an
15 opportunity to earn, you have to have a return that
16 considers flotation costs, considers reasonable
17 operation and maintenance expenses and valuation of rate
18 base.

19 Q. All right. And we'll talk about flotation
20 costs in a little while.

21 And now if for some reason the management of
22 this firm, this company does not act in an exemplary
23 way, consumers have no choice to select a different
24 electricity provider; isn't that correct?

25 A. No, they don't have a choice.

1 Q. All right.

2 A. They do have recourse through this Commission.
3 For example, if the utility invests imprudently or
4 incurs imprudent expenses, this Commission can prevent
5 consumers from having those expenses incorporated into
6 the revenue requirement.

7 Q. Thank you.

8 A. So consumers are protected by this Commission.

9 Q. Very good. We can agree with, on that point.

10 And also if this utility provides less than
11 reasonable and adequate service, consumers have an
12 opportunity to apprise the Commission of that through
13 service hearings; isn't that correct?

14 A. That's correct. Or any number of other ways.
15 Your hometown utility or the -- the Houston utility, you
16 might remember, several years ago was threatened by the
17 Texas Public Utility Commission with decertification
18 because of shortfalls in their service quality. So the
19 Commission has the ability to, to enforce service
20 quality standards and it has sanctions that the
21 utilities have to be mindful of.

22 Q. Thank you. Now as an expert in finance, you
23 agree with me that one of the fundamental principles of
24 finance is the risk reward trade-off, such that
25 investors require a greater return for greater risk;

1 isn't that true?

2 **A.** Yes, sir.

3 **Q.** All right. And so all other things being
4 equal, if two companies exist, one exhibiting greater
5 risk than the other, then investors will require a
6 greater return to invest in that company with the
7 greater risk; isn't that correct?

8 **A.** All else being equal? Yes.

9 **Q.** Very good. And the opposite is true as well.
10 If two companies exist, one that has greater risk and
11 one that has lower risk, the investors who invest in the
12 company that exhibits lower risk will require a lower
13 return; isn't that correct?

14 **A.** That is correct. The dollars go to the best
15 risk reward trade-off.

16 **Q.** All right. Now one -- you would agree with
17 me, first of all, that in terms of equity, equity isn't
18 rated in the same way that bonds are rated; isn't that
19 right?

20 **A.** They are not rated. There are valuations on
21 risk, like Value Line's safety rank, which Mr. Baudino
22 says is really superior to bond ratings as a measure of
23 risk. So, so financial strength, another measure that I
24 use is an equity measure by Value Line.

25 **Q.** And so one -- but one way to observe the

1 investment community's perception of a company's risk is
2 to observe that company's bond rating; isn't that
3 correct?

4 **A.** Yes. There is a correlation between the level
5 of bond rating generally and the level of risk for
6 equity holders. It's not one-to-one. As Mr. Maurey
7 testified in 2002, the bond rating agencies have a
8 different constituency --

9 **Q.** Sure.

10 **A.** -- the bondholders from the equity holders, so
11 they look at the same risk but they evaluate them
12 somewhat differently.

13 **Q.** And so, generally speaking, you would agree
14 that a company that has a triple A bond rating is less
15 risky than a company with a triple B minus bond rating?

16 **A.** It is as to bonds unambiguously. As to
17 equity, you would have to look behind the bond rating to
18 see the other circumstances and facts. So there's a
19 general correlation, but it's not a one-to-one.

20 **Q.** Very good. It's not a one-to-one, but you
21 would agree that there's a general correlation in equity
22 risk that correlates to bond ratings.

23 **A.** Yes.

24 **Q.** All right.

25 **A.** So it's a good starting point, as I said in my

1 deposition, a good rough cut for establishing a
2 comparable group.

3 Q. We can agree on that. And so you would agree
4 that a company such as FPL that has a single A rating is
5 less risky than a company such as TECO with a triple B
6 rating; isn't that correct?

7 A. No. I will agree that the bond rating
8 agencies say that the bonds are less risky.

9 Q. Uh-huh.

10 A. But I can't with that information agree as to
11 the risk of the equity.

12 Q. And so it's going to be your testimony that
13 that general correlation between equity risk and bond
14 ratings breaks down when we examine TECO versus FP&L; is
15 that correct?

16 A. No. I'm saying that you can't use the general
17 correlation to say what the relative risks are based
18 only on bond ratings. You can only speak to the bonds.
19 It's very much like the size of a student population is
20 generally correlated with football success, but you have
21 to play the game to know whether Texas will beat Ohio
22 State.

23 Q. Or Michigan will beat Ohio State.

24 Now --

25 **CHAIRMAN CARTER:** Or Florida.

1 **MR. MENDIOLA:** Or Florida.

2 **COMMISSIONER SKOP:** Or whether Florida will
3 beat Florida State.

4 **MR. MENDIOLA:** The only thing we can be
5 certain --

6 **CHAIRMAN CARTER:** I'm nice to the guy and what
7 do I get, you know?

8 **MR. MENDIOLA:** USC will always beat Ohio
9 State, I think.

10 **THE WITNESS:** Ohio State's larger though.
11 (Laughter.)

12 **BY MR. MENDIOLA:**

13 **Q.** Now my question to you, I think we agreed
14 earlier that, that a general correlation exists between
15 perceived risk and equity investments with the bond
16 rating of two companies. Did we agree on that earlier?

17 **A.** We did.

18 **Q.** All right. And then my question to you was
19 whether we can determine based on that general
20 correlation that FP&L with a single A rating is less
21 risky from an equity perspective than TECO with a triple
22 B rating?

23 **A.** And my answer was no. And I think
24 Mr. Pimentel in his testimony goes into some length
25 about the relationship between TECO and FPL from an

1 equity investor's perspective. They are different than
2 bond investors. General correlation, yes. One-to-one
3 mapping, no.

4 Q. All right. And so your testimony is that
5 although that general correlation exists, when we
6 examine that general relationship in the context of FP&L
7 and TECO, the general relationship breaks down and
8 doesn't apply; is that correct?

9 A. I haven't done my own study. Mr. Pimentel
10 does a, has done a study. I agree with the points he
11 raises. I think FPL's fuel mix, its participation in
12 nuclear, its geographic location, all of those militate
13 in favor of higher risk for the equity holders.

14 Q. Now is your testimony that FP&L equity holders
15 actually have higher risk than TECO equity holders?

16 A. I haven't done a comparison of FPL and TECO in
17 detail to try to reach that conclusion. But I can agree
18 with Mr. Pimentel that there are significant risk
19 factors that FPL has that TECO does not. And also I
20 think, because of the natural gas, because of the
21 nuclear, because of the physical location, FPL needs
22 financial strength because it has to deal with financial
23 requirements that come from nuclear power and from
24 natural gas. And therefore a strong posture is better
25 for the customers for FPL because of its, the nature of

1 its generation and geography.

2 Q. Let me see if we can close the loop on, on
3 TECO. We can agree that while you agree with
4 Mr. Pimentel, you didn't conduct your own analysis of
5 the relative risk perceived by equity holders, equity
6 investors between FP&L and TECO; is that correct?

7 A. I have, I have not.

8 Q. All right. Now -- but you do know that, that
9 TECO has been awarded by this Commission an
10 11.25 percent return on equity; is that correct?

11 A. I know that. Yes.

12 Q. All right. And you also are aware that TECO's
13 capital structure includes 54 percent equity; is that
14 correct?

15 A. Yes. Now there is a difference in the way
16 that TECO presented its equity for regulatory purposes
17 and the way that FPL does. FPL is asking for its actual
18 capital structure. The PPA imputed debt is a
19 consideration in the actual capital structure.

20 Q. Now --

21 A. But there is no claim that the PPAs should be
22 considered in the regulatory capital structure.

23 Q. Now when you say actual, I think
24 Mr. Pimentel's word is actual adjusted; isn't that
25 correct? I'm just asking whether you know how

1 Mr. Pimentel phrased it.

2 A. I don't know -- I don't recall, but
3 Mr. Pimentel and I have talked about this a lot. And
4 the big difference between Mr. Pimentel and myself and
5 some of the Intervenor witnesses is they would adjust
6 the capital structure. It turns out that Dr. Woolridge
7 and I are in perfect agreement because he advocates for
8 actual capital structure as we do, he just doesn't
9 implement it. Ms. Brown doesn't implement it correctly.

10 Q. All right. Now you filed your direct
11 testimony in approximately March of 2009; isn't that
12 correct?

13 A. Yes, sir.

14 Q. And you testify, I'm looking at Page 4, Line
15 6, that "The nation is in the midst of a financial
16 crisis that has made investors wary of putting their
17 money into anything other than the safest investments."
18 Do you recall that?

19 A. Yes, sir.

20 Q. All right. And you would agree with me that
21 since the time that you filed your direct testimony, the
22 nation and its financial system has returned to a level
23 of normalcy; isn't that right?

24 A. No, sir. I cannot agree. It has --

25 Q. Well, let's, let's -- let me ask you about it

1 directionally.

2 **MR. ANDERSON:** May the witness finish his
3 question -- answer, please?

4 **CHAIRMAN CARTER:** Mr. Mendiola.

5 **MR. MENDIOLA:** Well, I simply asked him
6 whether he agreed --

7 **CHAIRMAN CARTER:** Give him a chance. Just
8 give him a chance.

9 **MR. MENDIOLA:** Okay. Sure.

10 **BY MR. MENDIOLA:**

11 **Q.** Take your chance there, Mr. Avera.

12 **A.** We have stepped back from the brink. This
13 morning I happened to listen to Warren Buffett analyzing
14 his views, and he said, you know, we're no longer going
15 down but we're not going up. We've stepped back from
16 the brink. The crisis that we were looking at a year
17 ago with the failure of Lehman Brothers, we've survived
18 that, but we are by no means into a normal situation in
19 the financial markets. Investors are still very
20 sensitive to risk and the future course of the economy
21 is not certain.

22 **CHAIRMAN CARTER:** Warren Buffett also said
23 that he's buying again; right?

24 **THE WITNESS:** That's correct, sir. And that's
25 good news. And I like to be optimistic like he is, but

1 we still have to deal with the fact that investors lived
2 through this turmoil and I think it's, they will be very
3 mindful of the risk going forward.

4 **BY MR. MENDIOLA:**

5 Q. And you would agree with me that, that the
6 financial crisis has been mitigated somewhat since March
7 to the current time; isn't that correct?

8 A. Yes. We have stepped back from the brink.
9 There are a lot of good trends, but we still are in a
10 dicey condition, I would say.

11 Q. Well, and, for example, the flight to
12 safety -- yes, I'll get to it in just one minute, Mr.
13 Chairman.

14 The flight to safety as measured by the demand
15 on U.S. Treasury bonds has abated somewhat since,
16 certainly since the third and fourth quarter of last
17 year; isn't that correct?

18 A. That is correct. You can see it in the CAPMs
19 that Mr. Baudino and Dr. Woolridge do compared to mine.
20 I use the 3.3 Treasury, Dr. Woolridge uses 4.5,
21 Mr. Baudino uses 3.93.

22 Q. Now another way that you attempted to
23 demonstrate the extent of the financial crisis was
24 through an illustration of the Chicago Board Options
25 Exchange Volatility Index; is that correct?

1 **A.** Yes.

2 **Q.** And that's known as the VIX, the V-I-X; isn't
3 that right?

4 **A.** Yes, sir.

5 **Q.** And you have a chart of the VIX at WEA-3.
6 That's the one-month moving average; isn't that right?

7 **A.** I believe so.

8 **Q.** And you've heard the VIX characterized as the
9 fear index, have you not?

10 **A.** It has been so characterized.

11 **Q.** All right. And it's a, it's a graphical way
12 of illustrating investors' concern about future equity
13 prices and vol -- really future equity volatility; isn't
14 that correct?

15 **A.** Yes. It is derived from the Black-Scholes
16 model of option valuation, which has in it embedded a
17 future volatility. So it takes the apparent volatility
18 expectation based on observed market prices.

19 **Q.** And one of the reasons that you included
20 Exhibit WEA-3 in your direct testimony was to
21 demonstrate in a graphic way the financial crisis as
22 illustrated through the VIX; isn't that right?

23 **A.** Yes, sir.

24 **Q.** All right. Now I've handed you a
25 cross-examination exhibit.

1 **MR. MENDIOLA:** And, Mr. Chairman, I would like
2 to have a number, please.

3 **CHAIRMAN CARTER:** The number, Commissioners,
4 will be 492. And fortunately Mr. Mendiola is doing a
5 great job with the short title. CBOE Volatility Index.
6 Outstanding.

7 **MR. MENDIOLA:** Thank you, Mr. Chairman.

8 (Exhibit 492 marked for identification.)

9 **BY MR. MENDIOLA:**

10 **Q.** Dr. Avera, would you look at this and confirm
11 my understanding that this is a Yahoo! Finance chart of
12 the, of the VIX?

13 **A.** Yes, sir.

14 **Q.** All right. And what this illustrates, this
15 is -- you can see the date. Let's see. You can see the
16 date -- where can you -- oh, at the very -- well, let's
17 see. I'm not sure where you can see the date.

18 **A.** Well, at the bottom it says September 10th,
19 2009.

20 **Q.** Oh, there is it. September 10th, 2009. And,
21 and the slope of the VIX has been going down and to the
22 right since the time that you filed your testimony in
23 March of this year; isn't that correct?

24 **A.** It has been.

25 **Q.** All right. And it closed at somewhere around

1 approximately 25 on September 10th; isn't that correct?

2 A. That's correct.

3 Q. Compared to somewhere in the 40 to 50 range at
4 the time that you filed your testimony.

5 A. That's correct. It's basically returned to a
6 level that it had in 2007.

7 Q. All right. Thank you.

8 Now you're not a CFO; isn't that right?

9 A. That's correct.

10 Q. All right. And you never have been?

11 A. Well, I've had several family business
12 ventures and I've acted as CFO in a family -- we operate
13 a family farm and have for many years, and we also
14 operate a family print shop. So I'm CFO, but those are
15 relatively small and very family operations.

16 Q. Fair enough. And I should have recalled that
17 you have Avera Farms in Dripping Springs.

18 But you're not a CFO nor have you been a CFO
19 of an investor-owned utility?

20 A. That's correct.

21 Q. All right. And you didn't go to Wall Street
22 to interview investors about their perceived risk of
23 this company or -- is that correct?

24 A. That's correct. I have done many assignments
25 that required me to go to Wall Street to talk to

1 investors and rating agencies, and I also teach courses
2 where many of the students, these are executive courses,
3 are personnel of rating agencies and Wall Street
4 investment firms. But I did not go for the purposes of
5 looking at their perceptions of FPL for this case.

6 Q. So you did not do that in this case?

7 A. That is correct. I am generally familiar with
8 those folks, but I didn't visit for the purposes of this
9 case. Mr. Pimentel, of course, talks to them every day.

10 Q. Sure. Now what you did do, however, was to
11 run several models, including a discounted cash flow
12 model, a CAPM model and an expected earnings analysis,
13 in order to calculate your estimation of a required
14 return on equity for FP&L; is that correct?

15 A. Yes. That's part of the analysis. I also
16 looked at rating agency reports for the industry and for
17 FPL. So throughout my direct and rebuttal you'll see
18 references to what investors are saying about FPL and
19 what rating agencies are saying about FPL.

20 Q. You examined a number of rating agency
21 reports. But in terms of calculating the quantitative
22 analysis that resulted in your 11 to 13 percent range,
23 you did that with, with several different formulae;
24 isn't that correct?

25 A. That's correct. Three accepted models. The

1 DCF, CAPM --

2 Q. Right. The DCF, CAPM and expected earnings.

3 A. -- and expected earnings.

4 Q. All right. And you mentioned Warren Buffett
5 earlier in your testimony, and you're aware of Warren
6 Buffett's statement of beware of geeks with formulas?

7 A. I know he said that and it broke my heart, but
8 I still love him.

9 Q. So do I.

10 All right. Now you would agree with me that
11 there is a good bit of judgment involved in the DCF
12 model, wouldn't you?

13 A. That is correct. There is professional
14 judgment. There is a good bit of industry knowledge and
15 empirical research supporting various applications, but
16 there are areas of judgment.

17 Q. Now DCF stands for discounted cash flow;
18 right?

19 A. Correct.

20 Q. All right. And the DCF method is a method
21 that investors can apply to determine the value of an
22 asset; isn't that right?

23 A. Yes. Now what we're doing when we apply it in
24 the regulatory arena is turning it on its head. We're
25 observing what investors are actually paying for assets

1 and we're trying to infer what their requirements must
2 have been based on what we think they were expecting in
3 terms of cash flow.

4 Q. Uh-huh.

5 A. And then we derive what we think their
6 required return is.

7 Q. And at its essence the discounted cash flow
8 model is a way to estimate the future cash flows that
9 are derived from an asset and then discount that back to
10 a current price; isn't that right?

11 A. No, I can't agree with that. You estimate the
12 cash flows. Investors estimate the cash flows however
13 they can estimate the cash flows. Because we're doing
14 the future, nobody knows the future, not even Warren
15 Buffett.

16 So what we're trying to do is say if we can
17 figure out what the investors had in mind for cash flows
18 and look at what they were willing to pay for those cash
19 flows, we can use discounting to calculate the return
20 they used to bring those future cash flows back to
21 present value.

22 Q. Right. And that's why you said in the utility
23 context we're kind of reverse-engineering the DCF model.

24 A. That's correct. It is used by investors
25 because what they do is they look at the cash flows,

1 they put in the discount rate they think is appropriate,
2 and they come out with a fair price. And if that fair
3 price is lower than the current market price, they buy.
4 If it's higher, they sell.

5 Q. All right. Now we can look at your utility
6 proxy group DCF model in your Exhibit WEA-7; isn't that
7 right?

8 A. That is correct.

9 Q. Now the DCF model as, as -- at its most
10 simplified, in its most simplified form in the context
11 of using it in regulatory settings, is basically
12 dividend yield plus growth; would you agree with that?

13 A. That is correct. As I mention in my
14 testimony, there are lots of assumptions you have to do
15 to get it back to that very simple format. But that's
16 the one that's routinely used in the investment world
17 and the one that all three experts used in this case.

18 Q. And we're going to talk about some of those
19 assumptions. But if you look, for example, at, at
20 schedule WEA-7, the dividend yield is found in the
21 column that is identified as yield. And that's
22 observable, that's simply the dividend divided by the
23 price of the stock; isn't that correct?

24 A. Well, it's semi observable. Because to
25 implement the DCF model you have to account for the

1 dividends in the coming year.

2 Q. Right.

3 A. D1. So that, you have to look a little bit in
4 the future. Generally looking one year in the future is
5 easier than looking a long way in the future.

6 Q. Let's look, for example, at Line Number 16,
7 the Southern Company. Are you there with me?

8 A. Yes.

9 Q. The dividend yield that you've calculated is
10 4.7 percent; right?

11 A. That's correct.

12 Q. And then you have several different estimates
13 of growth. If you take, for example, the fourth column
14 under the growth rate Zacks, that's 5.2 percent. Do you
15 see that?

16 A. Yes.

17 Q. And then if you go over to Column G, then you
18 get the Zacks DCF estimated return on equity, which is
19 simply the 4.7 plus the 5.2, for a total of 9.9 for the
20 Southern Company; isn't that correct?

21 A. Yes, sir.

22 Q. All right. So that's my attempt to kind of
23 get my mind around the fact that what we're really doing
24 here is dividend yield plus growth rates.

25 A. That's correct. Because the investor gets the

1 dividend in the mailbox, and then the investor hopes to
2 sell the stock for a higher price as the value grows.
3 So those are the two kinds of cash flows an investor
4 gets, money in the mailbox and then money from the
5 broker when the stock is sold.

6 Q. And one of the areas of dispute in this case
7 is in relation to the growth rates that are applied,
8 because some of the witnesses such as Mr. Baudino used a
9 growth rate that includes both a dividend growth rate
10 and an earnings growth rate; isn't that correct?

11 A. That's correct.

12 Q. And now what you did was to select only the
13 earnings growth rate, and you chose not to incorporate
14 the dividends growth rate; isn't that right?

15 A. That's correct. I also did the $br+sv$.

16 Q. Right.

17 A. But, but as to the forecast growth rates, I
18 use only earnings because I believe, and there's lots of
19 empirical evidence and I cite it in my testimony, that
20 that's what investors look at. They consider earnings
21 growth rate to correlate with that buyout that they're
22 going to be able to achieve to get the cash flow from
23 selling the stock.

24 Q. Now you would agree that had you taken into
25 account the dividend growth rate, your DCF model would

1 have yielded lower returns on equity; isn't that
2 correct?

3 **A.** That is correct. But it wouldn't have been a
4 reasonable application of the DCF model. As I explained
5 in my direct and in my rebuttal of Mr. Baudino, there
6 are good reasons for disregarding dividends generally,
7 and especially for utilities now.

8 **Q.** Right. I understand that's, that's your
9 testimony. And I'm simply asking you directionally
10 whether you would agree with me that had you included
11 the dividend growth rate, as Mr. Baudino did, the
12 results of your DCF model would have been lower?

13 **A.** That's correct. And that's really the only
14 material difference between our DCF results.

15 **Q.** Now, so you focused exclusively on the
16 earnings growth rate in your G variable; isn't that
17 correct?

18 **A.** That is correct, with the addition of the
19 $br+sv$.

20 **Q.** Of the $br+sv$. And you understand that there
21 has been commentary from time to time that the earnings
22 estimates that are fed into the analyst reports by Value
23 Line, IBES and First Call are sometimes too rosy. You
24 understand that there's been commentary about that,
25 don't you?

1 **A.** I understand there's been commentary, and I
2 present commentary going the other way for large firms
3 and utilities. So it is a dispute. And I think most
4 importantly it's -- it really doesn't matter whether
5 they're too rosy or not rosy enough. If that's what
6 investors are using to estimate those cash flows and
7 we're trying to backward-engineer what they required, we
8 ought to use what investors use. And there's a great
9 deal of evidence that that's what investors use.

10 **Q.** But it does matter from the perspective of
11 ratepayers, because if the DCF model yields an ROE
12 that's too high, ratepayers pay more money in their
13 electricity costs; isn't that correct?

14 **A.** It does, but the DCF is not too high because
15 we have correctly inferred what investors require.

16 **Q.** Well, I understand --

17 **A.** And what we have to do to meet Hope and
18 Bluefield is allow a return consistent with what
19 investors require.

20 **Q.** I understand that's your testimony. And we
21 discussed earlier in the cross-examination that there's
22 more than a \$390 million swing in annual revenue
23 requirement that ratepayers will have to pay based on
24 the return on equity recommendations in this case; isn't
25 that right?

1 **A.** That is, that is correct.

2 **Q.** And there's nothing --

3 **A.** But it's in the ratepayers' long-term
4 interest --

5 **CHAIRMAN CARTER:** Hang on. Hang on.

6 **MR. MENDIOLA:** Excuse me.

7 **BY MR. MENDIOLA:**

8 **Q.** Please continue, Dr. Avera.

9 **A.** It's in the ratepayers' long-term best
10 interest that the company be able to attract capital and
11 maintain its financial integrity. So their interest is
12 not that the ROE be as low as possible, it's that it be
13 as correct as possible.

14 **Q.** Now -- all right. And so to the extent that
15 you relied solely on earnings growth rates and did not
16 consider dividend growth rates, I wanted to show you an
17 article, which I'm sure you're familiar with, and I've
18 just passed it out.

19 **MR. MENDIOLA:** Did I pass out --

20 **CHAIRMAN CARTER:** Yes, you did.

21 **MR. MENDIOLA:** I did. I'd like --

22 **THE WITNESS:** Yes. I'm very familiar with
23 this article.

24 **CHAIRMAN CARTER:** That would be --

25 **MR. MENDIOLA:** I'd like to have a number.

1 **CHAIRMAN CARTER:** -- Commissioners, Number one
2 four -- excuse me. One four -- wait a minute. 493.
3 493. And I'm going to give you a short title, because I
4 gave you a compliment and then you blew it, so.

5 **MR. MENDIOLA:** That's what my wife always
6 says.

7 **CHAIRMAN CARTER:** Okay. Let's do this. The
8 description will be the Steven G. Kihm Article.

9 **MR. MENDIOLA:** Very good.

10 **CHAIRMAN CARTER:** Okay. We'll, we'll go with
11 that.

12 **MR. MENDIOLA:** Thank you, Mr. Chairman.

13 (Exhibit 493 marked for identification.)

14 **CHAIRMAN CARTER:** Okay. 493. You may
15 proceed.

16 **BY MR. MENDIOLA:**

17 **Q.** And I'd like you to turn with me, Dr. Avera,
18 to Page 98 of this article, on the second column. And
19 if you could please read that paragraph that begins "The
20 other problem with using analyst forecasts."

21 **A.** "The other problem with using analyst
22 forecasts as the long-term growth in a DCF model is that
23 such forecasts are biased to the upside. The evidence
24 on the issue is overwhelming. The forecast bias
25 persists year after year in large part due to incentive

1 structures in place at many Wall Street firms that tend
2 to reward more optimistic projections and to discourage
3 the incorporation of potentially negative views of
4 analyst forecasts."

5 **MR. WRIGHT:** Mr. Chairman.

6 **CHAIRMAN CARTER:** Yes, sir, Mr. Wright.

7 **MR. WRIGHT:** I apologize for the interruption,
8 but I thought he said Page 98, and I can't find where
9 we're talking about.

10 **CHAIRMAN CARTER:** Okay. Mr. Mendiola, what
11 page are we on?

12 **MR. MENDIOLA:** We're on Page 98 in the lower
13 left-hand corner, second column, second full paragraph.
14 Do you see it there, Schef?

15 **MR. WRIGHT:** Could, could I --

16 **CHAIRMAN CARTER:** Are you there, Mr. Wright?

17 **MR. WRIGHT:** Could I please ask for the first
18 few words of the relevant sentence? I was looking and I
19 just could not follow. I apologize.

20 **CHAIRMAN CARTER:** Mr. Mendiola, could you help
21 us?

22 **MR. MENDIOLA:** "The other problem with using
23 analyst forecasts."

24 **CHAIRMAN CARTER:** It's on the right-hand side.

25 **MR. WRIGHT:** I have it, Mr. Chairman. Thank

1 you.

2 **CHAIRMAN CARTER:** Okay. No problem, Mr.
3 Wright.

4 You may proceed.

5 **MR. MENDIOLA:** Thank you, Mr. Chairman.

6 **BY MR. MENDIOLA:**

7 **Q.** So, Dr. Avera, according at least to this, to
8 this commentator, the problem with using analyst
9 forecasts in the long-term growth rate is that the
10 earnings estimates are sometimes too rosy; isn't that
11 correct?

12 **A.** Right. That's based on a 2002 study that was
13 before the global settlement in 2003 that I discuss in
14 my testimony. And I have more recent evidence, a 2008
15 article from the financial analyst journal, the *Journal*
16 *for Chartered Financial Analysts*, of which Mr. Kihm is
17 one, that says that this is no longer the case.

18 **Q.** You agree with me that Wall Street firms still
19 tend to reward more optimistic projections generally, do
20 you not?

21 **A.** I don't recall agreeing with you about that.

22 **Q.** No. I'm asking if you do.

23 **A.** No, I don't agree with that. I don't think
24 that's the case. And this 2008 article that I cite in
25 my rebuttal actually did a study of the compensation

1 practices now of Wall Street analysts and found that to
2 not be the case.

3 Q. Well, let's see. Let me ask you if you read
4 the *Wall Street Journal*. Do you?

5 A. Yes, sir.

6 Q. And are you familiar with a March 21st, 2008,
7 *Wall Street Journal* article that -- entitled "Study
8 Suggests Bias in Analysts' Rosy Forecasts"?

9 A. Is this --

10 **MR. MENDIOLA:** May I approach?

11 **CHAIRMAN CARTER:** Yes, you may approach.

12 **THE WITNESS:** Is this the one about Professor
13 Woolridge?

14 **BY MR. MENDIOLA:**

15 Q. Yes, it is.

16 A. I'm very familiar with that article; and I
17 talk about it in my rebuttal.

18 Q. You can ignore my writing on that, please.
19 And so while you testified that the article I pointed
20 you to earlier was from 2002, this article from the *Wall*
21 *Street Journal* is dated March 21st, 2008; isn't that
22 correct?

23 A. It is.

24 Q. And, and that article addresses the phenomenon
25 of Wall Street analysts still projecting earnings growth

1 to be too rosy; isn't that correct?

2 **A.** Well, it does based on a particular way of, of
3 analyzing the, the myths (phonetic). As I explained in
4 my rebuttal, that is not an adequate measure of the
5 suitability of analyst forecasts for the DCF model, and
6 I think there are significant shortcomings to its
7 empirical results. That's why it hasn't been published.

8 **Q.** And the bottom line is that you did not
9 consider dividend growth in your DCF. And had you
10 considered dividend growth, your ROE estimates would
11 have been lower; isn't that correct?

12 **A.** They would have been lower but they wouldn't
13 have been as accurate.

14 **Q.** Thank you. Now this company by the way does
15 pay a dividend, doesn't it?

16 **A.** FPL Group does, yes.

17 **Q.** Yes. And when investors receive cash for
18 holding a stock before it's sold, they receive that cash
19 in the form of dividends; isn't that correct?

20 **A.** That is right. Part of the cash flow is what
21 you get in the mail or what gets credited to your
22 brokerage account, and the rest of it is what you get
23 when you sell the stock, because we don't generally hold
24 it forever.

25 **Q.** And in some of your prior testimony -- in the

1 100 or so cases where you've testified on behalf of
2 investor-owned utilities, you have included dividend
3 growth rates in your DCF model, have you not?

4 A. I have.

5 Q. All right.

6 A. Sometimes -- you know, one of the reasons I
7 don't use it for electric utilities is the circumstances
8 of electric utilities now. Because they're
9 transitioning, as I explained, from a relatively high
10 payout to a lower payout. So while they're making that
11 transition, that depresses the dividend payout. For
12 other industries like the water industry and the natural
13 gas industry, you don't have that kind of transition,
14 and you didn't have that kind of transition for the
15 electric utility industry in the '80s, for example.

16 Q. And my question to you, sir, is whether in the
17 earlier drafts of your testimony in this case did you
18 conduct a DCF model with a dividend growth rate being
19 included in the G variable and then rejected that?

20 A. No, I did not.

21 Q. You never even considered it?

22 A. I considered it.

23 Q. But you never, you never did it?

24 A. But I didn't consider it to be a way to
25 capture investor expectations for electric utilities

1 now, given the industry facts and circumstances.

2 Q. Now if you can turn back with me, sir, to
3 Exhibit WEA-7. This is the DCF model results for your
4 utility proxy group; isn't that right?

5 A. Yes.

6 Q. Now the, the recommendation in this case based
7 on your recommended range and the midpoint selected by
8 Mr. Pimentel is 12.5 percent; isn't that correct?

9 A. That is correct. That's what he selected.

10 Q. All right. Now -- but your own DCF model, as
11 illustrated here on this exhibit, at the very bottom
12 where, underneath columns, cost of equity estimates, the
13 very bottom demonstrates a range of 10.6 to 11.5; isn't
14 that correct?

15 A. That is correct. That's one of the analyses I
16 did, and that's the result of the utility proxy group
17 DCF model.

18 Q. And so your recommended ROE in this case is
19 100 basis points higher than the highest ROE calculated
20 in your investor-owned utility proxy group DCF model;
21 isn't that correct?

22 A. That is correct. But I didn't rely on just
23 one study. I did multiple studies for reasons that I
24 talk about in my direct. But each study has strengths
25 and weaknesses, requires different estimates. So by

1 having several studies to cross-check each other you get
2 a robust result. So I didn't rely just on this study.

3 Q. I understand that. I'm just asking you about,
4 about this model because this is your, this is your,
5 this is your utility proxy group DCF model; isn't that
6 right?

7 A. That's correct.

8 Q. And so based on your utility proxy group DCF
9 model, an ROE of 11.5 is at the very top range of those
10 results; isn't that right?

11 A. That is correct. And by the way, if you look
12 at Mr. Baudino's testimony and look only at earnings,
13 you get essentially the same results. So the big
14 difference between us is as to whether you use
15 dividends, and then he goes to the bottom of the range
16 of his DCF to get his 10.4.

17 Q. And the difference between 11.5, which is the
18 highest number on this exhibit, and the 12.5 percent
19 that you recommend in this case is, again, about
20 \$130 million ratepayers have to pay; isn't that right?

21 A. It's something in that neighborhood, but of
22 course this doesn't consider flotation costs and it
23 doesn't consider the other study.

24 Q. Right. Now in addition to the utility proxy
25 group -- by the way, you rejected some of the, the what

1 you considered outliers in the utility proxy group, and
2 those are in the shaded boxes; isn't that correct?

3 A. That's right. Three because they were too
4 high to be reasonable, two because they were too low to
5 be reasonable.

6 Q. All right. And, in fact, if you look at all
7 those numbers in there, how many do you see that are
8 12.5 or higher? Not that many; isn't that right?

9 A. Well, there's some.

10 Q. There's a few, but not that many.

11 A. That's correct.

12 Q. All right.

13 A. The ones for FPL are higher, FPL Group.

14 Q. Now FPL Group includes a significant
15 unregulated business; isn't that right?

16 A. That is correct. A diversified set of
17 businesses that have contractual protections.

18 Q. And you would agree, all other things being
19 equal, a company that operates in the unregulated market
20 is, is more risky from an investor perspective than a
21 company that operates in a regulated monopoly market.

22 A. No, I cannot agree with that.

23 Q. You don't agree with that?

24 A. Because regulation eliminates some risk but it
25 brings a whole set of risks with it: The risk of

1 regulation, the risk of politics. There are lots of
2 risks that a regulated company has that an unregulated
3 company doesn't.

4 Q. A company that operates in a monopoly
5 regulated market that serves a basic human need like
6 electricity in your opinion is more risky than a company
7 that goes out there and competes selling widgets to
8 consumers who can choose whatever supplier they want?

9 A. No. I said there's some that --

10 Q. I'm asking you yes or no on that question,
11 sir.

12 A. I can't agree because we need to know more
13 about the widget company. One thing about the widget
14 company, if it wants to change its prices, it doesn't
15 have to come up to Tallahassee and spend weeks asking
16 the Commission for permission. If a widget company
17 wants to change prices, it changes prices. If it wants
18 to move its market, it moves its market. If it wants to
19 close its factories, it closes its factories. There are
20 different risks. Now we can agree that in general most
21 unregulated companies are more risky than most
22 utilities.

23 Q. All right.

24 A. But my unregulated companies, my nonutility
25 group, out of 1,700 companies I picked the 66 least

1 risky. So the fact that generally unregulated companies
2 are more risky than regulated companies doesn't say that
3 all unregulated companies are more risky than all
4 utilities.

5 Q. All right. But we can agree that, generally
6 speaking, unregulated companies are more risky than
7 regulated monopoly investor-owned electricity companies.

8 A. We can agree in general across the broad scope
9 of the economy. But, again, if we're trying to really
10 compare two companies or parts of one company like FPL
11 Group, you have to look at the nature of the businesses
12 and the risk to which they're exposed.

13 Q. Now your second DCF model was conducted on a
14 nonutility proxy group; isn't that correct?

15 A. Yes, sir.

16 Q. And so this is illustrated in, in Exhibit
17 WEA-9; is that right?

18 A. Yes.

19 Q. And this includes, as you mentioned, 66
20 companies, none of which are investor-owned utilities;
21 isn't that right?

22 A. That is correct.

23 Q. And none of which are monopoly companies;
24 isn't that right?

25 A. They don't have government guaranteed

1 monopolies in the same way of a service territory. But
2 you take Johnson & Johnson, the Purell people.

3 Q. Uh-huh.

4 A. I mean, that's a good business right now.

5 Q. But it's not a monopoly.

6 A. It's not a monopoly. But if you want Purell,
7 you buy it from Johnson & Johnson.

8 Q. And if you want Coke, you buy from Coca-Cola,
9 but it's not a monopoly.

10 A. That's right. And if you want Jack Daniels,
11 you buy it from Brown-Forman, I'm told.

12 Q. And so your, your testimony is that these 66
13 nonregulated companies are sufficiently similar to a
14 regulated monopoly electricity company to serve as a
15 proxy for determining return on equity; is that, is that
16 correct?

17 A. In the relevant dimension, which is the risk
18 as investors perceive it, because they were screened
19 based on bond ratings, on Value Line safety rank, on
20 Value Line financial strength, so based on those
21 measures as investors see them, they lump them into
22 similar risk categories. And since FPL has to compete
23 with all of these companies and all the other companies
24 in the economy for capital, it is relevant to look at
25 the required return for these competing companies.

1 **Q.** And how many of these companies, sir, receive
2 an automatic pass-through of their primary cost of
3 production as FPL does for fuel?

4 **A.** Some may have contracts that for some
5 customers are cost-based, but they all have the freedom
6 to change their prices in the market as they judge it to
7 be in their interest.

8 **Q.** Can you identify any one of these 66 companies
9 that has an automatic pass-through for its primary cost
10 of production input?

11 **A.** Well, Mr. Mendiola, if we want to get down to
12 details, if we look at Exxon or Chevron or the other oil
13 companies, they generally have contracts that allow them
14 to pass through the cost of the petroleum they provide.
15 So there are some exceptions.

16 **Q.** Well --

17 **A.** But generally we can agree that prices for
18 regulated companies, pass-throughs, base rates are all
19 regulated by the Commission.

20 The unregulated companies don't need that
21 because they can change their prices as they want to,
22 either because they think the market will bear a higher
23 price or because their costs have increased.

24 **Q.** Well, let's take Exxon or Chevron, for
25 example. If, if Exxon or Chevron -- those are

1 exploration and production companies, are they not?

2 **A.** Yes. Among their --

3 **Q.** Among various businesses. If they want to
4 have a major capital expenditure, an offshore drilling
5 well in the Gulf of Mexico, and they spend a billion
6 five to do it, they have to recover that billion five in
7 the market; isn't that correct?

8 **A.** That is correct.

9 **Q.** Now if FPL wants to have a major capital
10 investment, such as a nuclear power plant, and spends a
11 billion five to install that after a determination of
12 need by this Commission, it gets to recover that
13 directly from ratepayers; isn't that correct?

14 **A.** That is correct to the extent it's deemed
15 prudent. But FPL's returns are limited to a fair rate
16 of return. Exxon, if it hits the elephant, its returns
17 are unbounded.

18 **Q.** Dr. Avera, what was FPL's achieved return on
19 equity in 2008, if you know?

20 **A.** I believe it was 10.4 or something like that.

21 **Q.** What was the Standard & Poor's 2008 overall
22 return?

23 **A.** As I sit here today, I can't recall what it
24 is.

25 **Q.** Do you know what Exxon Mobil or Chevron's

1 achieved return on equity was in 2008?

2 **A.** I can tell you from Value Line and my work
3 papers. Oh, they only earned 26.9 percent.

4 **Q.** And that was because oil was at \$140 a barrel;
5 isn't that right?

6 **A.** That's right.

7 **Q.** All right. And, and you're saying that, that
8 Exxon Mobil with its 20 -- did you say 26 percent --

9 **A.** 26.9.

10 **Q.** -- return on equity that operates in a
11 worldwide competitive market is sufficiently similar to
12 FP&L's monopoly electricity company to serve as a proxy
13 for ROE purposes?

14 **A.** That is correct. Because investor risk
15 measures place Exxon Mobil in the same area of risk as
16 FPL.

17 **Q.** How many of these --

18 **A.** You know, to an investor, you're investing
19 money and you want money back. Whether that money comes
20 from drilling oil wells or making electricity doesn't
21 matter. You're looking, as we talked at the beginning
22 of our cross, at risk return bundles. And the risk
23 return bundle of an Exxon or a Chevron competes with the
24 risk return bundle of an FPL Group.

25 **Q.** And you're aware that historically utility

1 stocks have been characterized as stocks that are owned
2 by widows and orphans; isn't that right?

3 **A.** That used to be the case. I think in recent
4 years, because you've had utility bankruptcies, you've
5 had six utility bankruptcies in the last 50 years, four
6 of them caused by regulatory problems. So I think the
7 widows and orphans have kind of gone to greener
8 pastures, and I think utility stocks are now viewed, as
9 I document in my direct testimony, as a more risky set
10 of opportunities. Still in general less risky than the
11 whole body of unregulated companies, but certainly not
12 less risky than these 66 low-risk nonutilities.

13 **Q.** How many of these companies own and operate
14 nuclear power plants?

15 **A.** I know of none.

16 **Q.** How many of these companies have direct
17 pass-throughs for any renewable energy investment that
18 they make?

19 **A.** I know of none.

20 **Q.** How many of these companies enjoy revenue
21 decoupling related to conservation measures?

22 **A.** I know of none. But of course they have the
23 flexibility, if their revenues change, to make whatever
24 appropriate change in their prices, production or
25 geographic location they deem in their interest of their

1 shareholders.

2 Q. I was just looking at Number 21, Ecolab. What
3 does Ecolab do, if you know?

4 A. Ecolab is a -- produces drugs and other
5 chemicals.

6 Q. All right. And how many bankruptcies have
7 there been in the commodity chemical sector, if you
8 know, in the last 50 years?

9 A. I don't know. I suspect there have been some.

10 Q. More than six?

11 A. But I don't know how many. I wouldn't know.
12 I don't want to speculate.

13 Q. All right.

14 A. I think the point about the six is at one
15 point it was unthinkable to have a utility go bankrupt.
16 In recent years it is not only thinkable, it's reality.
17 And in four of the six cases as identified by Moody's
18 this year, regulatory problems were the triggering
19 cause.

20 Q. You agree that as a sector the utility sector
21 is expected to have lower occurrences of credit defaults
22 than other sectors.

23 A. Well, the probability of credit defaults is
24 measured in the bond ratings. That's what the bond
25 rating agencies do is try to estimate credit defaults.

1 So I think if you have companies like these that average
2 A plus, these nonutility companies, they are expected to
3 have approximately the same level of credit defaults as
4 an A plus utility.

5 Q. And my question was whether or not you agree
6 that as a sector the utility sector is expected to have
7 a lower occurrence of credit defaults than other sectors
8 in the economy.

9 A. Again, if you say all sectors, yes, probably.

10 Q. All right.

11 A. But, but that doesn't mean there's some
12 companies in some sectors in the nonutility that have
13 the same or lesser levels as indicated by the bond
14 ratings they carry. My 66 carry an A plus bond rating.

15 Q. Now -- one second, please.

16 Another one of your models that you conducted
17 was the, the CAPM; is that correct?

18 A. That's correct.

19 Q. All right. Now -- but you -- there are a
20 couple of different ways to do a CAPM. One is a
21 historical and one is a forward-looking; isn't that
22 right?

23 A. That is correct.

24 Q. And you conducted only a forward-looking CAPM;
25 isn't that correct?

1 **A.** That is correct. Because I think many people
2 are coming to the view that the historical is
3 problematic. In the TECO case this Commission found the
4 historical problematic. Mr. Baudino found the
5 historical problematic. So, so I have used the
6 historical in the past. But as I've moved through,
7 observed how investors are behaving and seen that the
8 historical has less and less applicability to the CAPM,
9 which is a forward-looking model, I have quit using it.

10 **Q.** Well, you've actually used it in the recent
11 past, have you not, as in testimony that was filed in
12 late 2008 or early 2009; is that correct?

13 **A.** I've been transitioning away. Now some
14 Commissions say we believe in historical and we like to
15 see historical evidence. But I believe that a more
16 sound and consistent application of the CAPM is to use
17 forward-looking, as I have done and as Mr. Baudino
18 attempted to do.

19 **Q.** Well, let me -- excuse me. Let me ask you
20 this. Had you considered a historical CAPM, speaking
21 directionally, the results would have yielded a lower
22 return on equity than only using a forward CAPM; isn't
23 that correct?

24 **A.** That's correct. And I would have done exactly
25 as Mr. Baudino did and rejected the CAPM because the

1 answer was unbelievable.

2 Q. And I'm not here to ask you about --

3 A. It was not reasonable.

4 Q. -- Mr. Baudino's testimony, sir. I'm here to
5 ask you about your own testimony. And so we've
6 established that had you considered the historical CAPM,
7 the result would have been lower than had you considered
8 solely the forward-looking CAPM; correct?

9 A. Generally, yes. At present that's the case.

10 Q. All right. Now you filed testimony in
11 Washington, is that correct, for the investor-owned
12 utility known as Avista?

13 A. Yes.

14 Q. All right. When did you file that testimony,
15 sir?

16 A. Well, it was in late 2007 or 2008. I really
17 can't place it without looking at my list of
18 testimonies.

19 Q. Well, I thought I had a date on it, but
20 apparently I don't. But we can agree -- in fact, the
21 docket number is UE-08. Does that indicate that that
22 was done in 2008?

23 A. I believe it probably does. This case has
24 been resolved. It's been settled.

25 Q. I understand that.

1 **A.** And it was several months ago.

2 **Q.** I'm going to ask you about that in a second.
3 But in this testimony that you filed on behalf of
4 Avista, you also conducted two DCF analyses, utility
5 proxy group and nonutility proxy group, and you
6 conducted two CAPM analyses; isn't that correct?

7 If you look, for example, sir, at the very
8 last page 21 of 21, there's a summary of your
9 quantitative results.

10 **A.** I'm almost there. Yes.

11 **Q.** And you will see that there's CAPM
12 forward-looking and historical; isn't that correct?

13 **A.** Yes.

14 **Q.** All right. So it's your testimony that you
15 have conducted historical CAPM analyses as recently as
16 2008; isn't that correct?

17 **A.** That's correct.

18 **Q.** All right. And, in fact, if you go to the
19 testimony, substantively at Page 18, you testified at
20 Page 18, Line 4, with respect to the historical CAPM
21 that "This approach to estimating investors' equity risk
22 premiums is premised on the notion that past experience
23 heavily conditions future expectations." Isn't that
24 your testimony?

25 **A.** Yes.

1 Q. And that was true and correct at the time that
2 you filed it; isn't that right?

3 A. Yes.

4 Q. And that was part of your professional
5 judgment; right?

6 A. That is correct. It --

7 Q. All right.

8 A. But I think my judgment then as now is it's
9 decreasingly so. And I think we've --

10 Q. All right. So your judgment has changed --
11 when someone --

12 **CHAIRMAN CARTER:** Hang on.

13 **MR. ANDERSON:** Commissioner Carter -- yes.
14 Thank you.

15 **CHAIRMAN CARTER:** Hang on. Hang on.

16 You may answer the question.

17 **THE WITNESS:** Yes. Investors have used these
18 historical numbers. You see them in the newspaper, you
19 see them in your pension fund reports. But I think as
20 we've moved through time, I think there's less and less
21 reliance on historical risk premiums because people
22 think that the future may be somewhat different than the
23 long-term hysterical -- historical past stretching back
24 to 1926.

25 **BY MR. MENDIOLA:**

1 **Q.** The historical past, when someone conducts a
2 historical CAPM, can go back 82 years; isn't that
3 correct?

4 **A.** Well, that's when there's a consistent set of
5 data. There are, there are other data sources that go
6 back even further. But most people use what's the
7 Ibbotson data that's now Morningstar that started in
8 1926 that consistently measured the realized returns for
9 bonds and stock over each year.

10 **Q.** And going back to 1926 would be 82 or 83 years
11 of data; isn't that right?

12 **A.** Yes.

13 **Q.** All right. And so your testimony is that in
14 2008 it was appropriate to consider 82 years of data but
15 in 2009 it's not?

16 **A.** Well, in 2008 I used both. I think -- and let
17 me see what I said about forward-looking. I think I'm
18 pretty clear that the CAPM is a forward-looking model.

19 **Q.** Are you finished?

20 **A.** Yes.

21 **Q.** All right. Another point about the CAPM is
22 that the whole theory behind the CAPM is that investors
23 will diversify away risk in their portfolio; isn't that
24 correct?

25 **A.** Yes, it is.

1 Q. And so risk can be measured with respect to
2 one particular investment by observing the beta of that
3 asset, which is the relative volatility of that asset
4 compared to the market as a whole; isn't that right?

5 A. That is correct. Mr. Mendiola, do you want
6 me -- I found the sentence I was thinking about in terms
7 of the CAPM.

8 Q. Please. Sure.

9 A. It's on Page 18 at Line 12. And it says, "The
10 cost of capital is a forward-looking or expectational
11 concept that is focused on the perceptions of today's
12 capital market investors. Past returns are frequently
13 referenced and may provide a useful benchmark, but the
14 only factors that actually determine the current
15 required rate of return are investors' expectation of
16 the future."

17 Q. All right. And, and you testified that
18 investors' expectations of the future are premised in
19 the notion that past experience heavily conditions
20 future expectations; isn't that right?

21 A. That's the case. In early 2008 I was
22 transitioning away. I presented the forward-looking.
23 The first time I encountered the forward-looking was
24 from the staff of the Illinois Commerce Commission in a
25 case that we did, and I was really convinced it made

1 sense and I've been using it ever since.

2 Q. All right. Nevertheless, had you considered
3 the historical, as you did in 2008 for Avista, your ROE
4 recommendations would have been lower.

5 A. No. Because if I had applied the historical
6 with the interest rates prevailing at the time that I
7 did the analysis, the 3.3 percent Treasury, I would have
8 gotten a result that was so unreasonable on its face I
9 would have rejected it. So I --

10 Q. You would have exercised --

11 A. -- don't think I would have changed my
12 recommendation.

13 Q. You would have exercised your professional
14 judgment to reject that?

15 A. My professional judgment and the objective
16 evidence, just as I rejected the DCF and just as
17 Mr. Baudino rejected his CAPM, because they were so far
18 out of line with other indicia of the required return.

19 **MR. MENDIOLA:** Now, Mr. Chairman, I have a
20 good bit left. So whenever your wish is to take a
21 break, I'm happy to.

22 **CHAIRMAN CARTER:** Roll it.

23 **BY MR. MENDIOLA:**

24 Q. All righty. Let's keep on going.

25 Now I was asking you about the theory behind

1 the CAPM, which is that investors will diversify away
2 risk --

3 **CHAIRMAN CARTER:** Oh, one second. Do you need
4 a break? I'm sorry.

5 **THE WITNESS:** I can keep going. I want this
6 thing to finish, too, Mr. Chairman.

7 **CHAIRMAN CARTER:** Okay. Go ahead, Mr.
8 Mendiola.

9 **MR. MENDIOLA:** Very good.

10 **BY MR. MENDIOLA:**

11 **Q.** We were discussing one of the theories of the
12 CAPM, which is that investors will diversify away risk
13 by having a diversified portfolio; isn't that correct?

14 **A.** Yes, sir.

15 **Q.** And so one measure of an asset's, the cost of
16 an asset is to, is to examine the beta of that asset in
17 comparison to, to the market as a whole; is that
18 correct?

19 **A.** Well, the beta is a measure of risk.

20 **Q.** Right.

21 **A.** You can use it in the context of the CAPM to
22 come up with a required return, making assumptions about
23 the market.

24 **Q.** But the point is that it's measured against
25 the market as a whole; isn't that correct?

1 **A.** That is correct. The theory is that the
2 return to an individual asset is proportional to the
3 market as it is to its beta, to the market beta, which
4 is one.

5 **Q.** All right. But, but you didn't compare the,
6 the beta or the expected return against the market as a
7 whole because you began your CAPM with the universe of
8 only dividend paying stocks; isn't that correct?

9 **A.** No. That is -- well, first I began with the
10 Standard & Poor's 500, which are the 500 largest
11 companies in the economy. They make up 75 percent of
12 the market value. So these are the companies like Exxon
13 that have the most market value capitalization. And in
14 order to apply the DCF you have to have a dividend
15 yield. Mr. Baudino applied it where there's no dividend
16 yield and that's where the model doesn't fit.

17 **Q.** Did you say DCF or CAPM? Because I'm asking
18 you about CAPM.

19 **A.** Well, the CAPM, in order to come up with an
20 expected market return, I started with the S&P 500.

21 **Q.** Uh-huh.

22 **A.** Which most people that measure the market use
23 the S&P 500. Professor Woolridge did, for example.
24 Then I wanted to get investors' forward-looking
25 requirements, so I conducted a DCF on those companies.

1 Now to do a DCF you have to have a dividend yield, and
2 346 of the 500 had dividend yields. So those were the
3 ones that I used. Now they happened to be generally the
4 largest, like Exxon Mobil is 6 percent of the S&P. It
5 has a dividend, I used it.

6 Q. Now --

7 A. Chevron is 4 percent of the S&P. It has a
8 dividend, I used it.

9 Q. Is that a fancy way of saying that you
10 screened out the companies that didn't pay a dividend
11 or, in other words, had no dividend yield?

12 A. That is correct, because they do not fit the
13 model.

14 Q. And had you not screened out those companies
15 that didn't have a dividend yield, your CAPM results
16 would have been lower still; is that correct?

17 A. I do not know. I don't think that necessarily
18 follows. But I think they would have been unreliable
19 because you would have been applying a model that
20 doesn't fit.

21 Q. And you don't know because you didn't do the
22 analysis.

23 A. That is correct. Because I'm not sure you
24 could do the analysis because you are applying a
25 dividend model to companies that have no dividend.

1 **Q.** By the way, let me go back and pick up
2 something that I meant to ask you about relating to your
3 nonutility proxy group.

4 Dr. Avera, were you here when Mr. Olivera
5 testified regarding executive compensation?

6 **A.** Yes. I was not here. I watched it on TV.

7 **Q.** All right. And did you hear Mr. Olivera say
8 that for purposes of executive compensation it was
9 inappropriate to measure FPL's executive compensation
10 against companies that were not in the same industry?

11 **A.** I seem to remember that. I mean, executive
12 compensation is not my issue. But I remember him
13 talking about that, but I didn't pay a whole lot of
14 attention because it was not my issue.

15 **Q.** Well, is it the case that the company is
16 saying that for certain categories of costs it's
17 appropriate to look outside the utility industry, but
18 for other categories of cost, such as executive
19 compensation, it's not appropriate to look outside of
20 the industry?

21 **A.** No. I mean, I don't think there's, there's
22 any apples to apples comparison. When you're looking at
23 investors' required returns, investors have dollars that
24 they can put in risk return bundles in utilities or they
25 can put them into nonutilities. Mr. Baudino talks about

1 having to compete with mutual funds, for example.

2 Mutual funds typically diversify beyond utilities.

3 So from an investor perspective, utilities
4 have to compete with nonutilities for capital. That's
5 why I looked at the nonutility group. It had nothing to
6 do with executive compensation.

7 Q. And but you would agree that from, that
8 executives have talent that they can invest in either
9 the utility sector or the nonutility sector. And when a
10 utility company is competing for executive talent, it
11 has to compete with other utility companies and
12 nonutility companies to attract that talent. Wouldn't
13 you agree with that?

14 A. Mr. Mendiola, you're getting beyond my scope.
15 I did serve on the board of a utility for seven years.

16 Q. Uh-huh.

17 A. And I know that when we were looking at the
18 compensation of our executives, we typically looked at
19 other utilities. But that's as far as I can go
20 responding to your question.

21 Q. All right. Fair enough. I'm just trying to
22 understand if it's the case that it's kind of a
23 heads-I-win-tails-you-lose situation where FP&L agrees
24 that it's appropriate to look outside the utility
25 context for certain items such as ROE, but refuses to

1 look outside for certain other items such as executive
2 compensation. Do you have any comment about that?

3 **A.** I don't think it's a heads or tails. I think
4 you look to the best information to do the analysis
5 you're doing. For the purposes of return on equity, I
6 think the reality that FPL competes with nonutilities
7 means that you should look at nonutilities.

8 The Hope and Bluefield standards talk about
9 other enterprises. I go through this in my rebuttal to
10 some extent. There is no reason to restrict the search
11 for comparable companies to utilities. And in fact, if
12 you look right after the Hope and Bluefield, people
13 excluded utilities and only looked at nonutilities to
14 find comparable companies.

15 **Q.** By the way, in talking further about the
16 nonutility proxy group and the relative risk associated
17 from an investor perspective of placing money with a
18 monopoly utility versus a company like Exxon Mobil,
19 another risk that we haven't talked about yet is the
20 risk associated with storm damage. Isn't that -- you
21 would agree that's a risk; right?

22 **A.** It is a risk, a significant risk for FPL.

23 **Q.** And also for companies in your nonutility
24 proxy group, such as Exxon Mobil or Chevron; right?

25 **A.** Yes.

1 **Q.** If a storm comes and damages an offshore
2 drilling platform, Exxon Mobil or Chevron has to pay for
3 that out of its own earnings; isn't that correct?

4 **A.** That's correct. And it can decide whether it
5 wants to rebuild there or not. We have a joint client
6 who had a refinery in Beaumont, and after Hurricane Ike
7 came through they decided not to rebuild in Beaumont.

8 **Q.** Uh-huh.

9 **A.** FPL can't decide not to rebuild in South
10 Texas.

11 **Q.** And -- South Florida.

12 **A.** Or South Florida. I'm still thinking of our
13 home state.

14 **Q.** Now -- I made the same mistake, Dr. Avera.

15 Now -- and none of those companies in your
16 nonutility proxy group have a statutory right to sell
17 securitized bonds in order to achieve immediate recovery
18 for expenses associated with storm restoration; isn't
19 that correct?

20 **A.** I don't believe they do.

21 **Q.** All right. And none of those companies in
22 your nonutility proxy group have a \$200 million reserve
23 fund funded by captive customers to guard against storm
24 restoration costs; isn't that correct?

25 **A.** These companies deal with storms in different

1 ways than having to deal with the Commission where the
2 framework allows for things like securitization, which
3 is good policy, but it serves to ameliorate a risk
4 that's there because a utility is tied to geography.
5 FPL is tied to South Florida. It cannot migrate its
6 operations to sunny climes.

7 **Q.** But it can certainly --

8 **A.** Or less, less troubled climes.

9 **Q.** Now -- but it can certainly suggest where to
10 site generation assets, isn't that right, within the
11 service territory?

12 **A.** It does with the advice and consent of this
13 Commission. It has to have a need case, and the
14 Commission and the Intervenors have a say also as to
15 what, where, what kind of fuel will be built.

16 **Q.** Now going back to the Avista case where you
17 filed testimony in Washington, you testified that --

18 **CHAIRMAN CARTER:** That would be Number 494,
19 Commissioners.

20 **MR. MENDIOLA:** Thank you, Your Honor.

21 **CHAIRMAN CARTER:** And the short title will be
22 Avista Testimony.

23 (Exhibit 494 marked for identification.)

24 You were doing real well at one time and then
25 you fell off the wagon.

1 **MR. MENDIOLA:** Blame it on my paralegal. She
2 might lose her job. No, I'm kidding.

3 **CHAIRMAN CARTER:** Okay. No, don't do that.

4 **MR. MENDIOLA:** I'm kidding. No. That's not,
5 not the case. I apologize. I move that that be
6 stricken, Your Honor.

7 **CHAIRMAN CARTER:** Yeah.

8 **BY MR. MENDIOLA:**

9 **Q.** Dr. Avera, you testified that that case had
10 been resolved through settlement; isn't that correct?

11 **A.** That's correct.

12 **Q.** Do you know what the return on equity was that
13 was settled upon in that case?

14 **A.** I do not.

15 **Q.** Let me --

16 **MR. MENDIOLA:** May I approach, Your Honor?

17 **CHAIRMAN CARTER:** You may approach.

18 **BY MR. MENDIOLA:**

19 **Q.** Can you agree, sir, that that case in which
20 you filed testimony in the State of Washington was
21 settled with a cost of common equity at 10.2 percent?

22 **A.** That's what this document says, and I have no
23 reason to dispute it.

24 **Q.** All right. And what was the percentage of
25 common equity in the capital structure, if you know?

1 **A.** 46.3 percent.

2 **Q.** All right. Now --

3 **MR. ANDERSON:** Counsel, could we have a copy
4 of what you gave the witness?

5 **MR. MENDIOLA:** Yes. Let me bring that back to
6 you.

7 **MR. ANDERSON:** All right.

8 **MR. WRIGHT:** Mr. Chairman?

9 **CHAIRMAN CARTER:** Yes, sir, Mr. Wright.

10 **MR. WRIGHT:** I would like you to ask
11 Mr. Mendiola to identify the document that he just
12 showed the witness.

13 **MR. MENDIOLA:** Can I borrow that? That's my
14 only copy.

15 **CHAIRMAN CARTER:** He only had one copy.
16 Mr. Mendiola, for the record.

17 **MR. WRIGHT:** If it's an order of the
18 Washington PUC, that's great.

19 **CHAIRMAN CARTER:** For the record, Mr.
20 Mendiola.

21 **MR. WRIGHT:** I'd just like to know what it is.

22 **MR. MENDIOLA:** Mr. Wright, thank you for that
23 question. And it is entitled The Multiparty Settlement
24 Stipulation in Docket UE-080416 and Docket UG-080417
25 before the Washington Utilities and Transportation

1 Commission. The case is styled *Washington Utilities and*
2 *Transportation Commission v. Avista Corporation d/b/a*
3 *Avista Utilities.*

4 And if the record would be aided by me making
5 copies and marking this, I'll be glad to do that during,
6 during a break.

7 **CHAIRMAN CARTER:** Mr. Wright?

8 **MR. WRIGHT:** I would appreciate that, Mr.
9 Chairman. Thank you.

10 **CHAIRMAN CARTER:** Okay. We'll do that in the
11 break.

12 **MR. MENDIOLA:** I'll do that. In the meantime,
13 let me hand this back to Mr. Anderson.

14 **BY MR. MENDIOLA:**

15 **Q.** Now, Dr. Avera, you mentioned a couple of
16 times flotation costs, have you not?

17 **A.** Yes.

18 **Q.** And you I think testified that it would be
19 appropriate to allow FP&L to recover 25 basis points in
20 its cost of equity for flotation costs; is that correct?

21 **A.** Yes, sir.

22 **Q.** And using our rule of thumb that 100 basis
23 points is \$130 million annually, 25 basis points would
24 be one-fourth of that, or approximately 65 million; is
25 that correct? No, that -- 32.5 million?

1 **A.** Approximately. If we need numbers, I have my
2 calculator.

3 **Q.** So your testimony is that for flotation costs
4 this company should be allowed to recover and ratepayers
5 should be required to pay \$32.5 million every year in
6 annual revenue requirement?

7 **A.** I believe the number might be 33.25. But some
8 amount of money, yes.

9 **Q.** Around 33.25. Thank you for that.

10 **A.** Yes.

11 **Q.** All right. And you cite to a FERC case known
12 as the Pepco case, isn't that correct, in support of the
13 flotation cost?

14 **A.** I'm -- do I? In terms of -- you'll have to
15 point that out to me. I know that I cite to Pepco for
16 some issues, but I'm not sure I did for that one.

17 **Q.** I think you might be right. I think you cited
18 to Pepco for proxy group issues.

19 **A.** Yes.

20 **Q.** Yes. Thank you for that.

21 Nevertheless, I wanted to show you the Pepco
22 case.

23 **MR. MENDIOLA:** And, Mr. Chairman, I'd like to
24 have a number for this, please.

25 **CHAIRMAN CARTER:** Next, Commissioners, will be

1 495. 495.

2 A short title, Mr. Mendiola?

3 **MR. MENDIOLA:** Well, let's call it Pepco
4 Holdings, Inc.

5 **CHAIRMAN CARTER:** Okay. Pepco Holdings, Inc.

6 **MR. MENDIOLA:** That way we can just strike
7 through the remaining three lines on my previous title.

8 **CHAIRMAN CARTER:** Excellent.

9 (Exhibit 495 marked for identification.)

10 **MR. MENDIOLA:** Sorry about that, Mr. Chairman.

11 **CHAIRMAN CARTER:** One second.

12 **MR. MENDIOLA:** May I proceed, Mr. Chairman?

13 **CHAIRMAN CARTER:** Let's see. Do all the
14 parties have a copy?

15 **MR. ANDERSON:** We haven't had a chance to
16 glance at it yet. And as the, as the witness noted, he
17 did not refer to this or use this exhibit for this
18 particular purpose.

19 **CHAIRMAN CARTER:** Just one sec. Just one sec.

20 (Pause.)

21 Mr. Anderson?

22 **MR. ANDERSON:** I think it's fine to proceed
23 with the question, and we'll listen and see if there's
24 any relevance problem.

25 **CHAIRMAN CARTER:** Mr. Mendiola, you may

1 proceed.

2 **MR. MENDIOLA:** Thank you, Mr. Chairman.

3 **BY CHAIRMAN CARTER:**

4 **Q.** Now, Dr. Avera, this is an order that you have
5 reviewed from the Federal Energy Regulatory Commission;
6 isn't that correct?

7 **A.** Yes.

8 **Q.** And in fact you cite to it in your testimony,
9 do you not?

10 **A.** Yes.

11 **Q.** And you also address flotation costs and
12 flotation cost recovery in your testimony, do you not?

13 **A.** Yes.

14 **Q.** Although you don't cite this particular order
15 for the flotation cost support in your testimony; is
16 that correct?

17 **A.** That's correct.

18 **Q.** All right. But if you turn with me to
19 Paragraph 117, that's at Page 38 of the order, and let
20 me know when you're there, sir.

21 In this particular case the Federal Energy
22 Regulatory Commission rejected flotation costs; isn't
23 that correct?

24 **A.** Yes.

25 **Q.** And one of the reasons that it rejected the

1 flotation costs is because it had not been demonstrated
2 that a new stock issuance is imminent; isn't that
3 correct?

4 **A.** That's correct.

5 **Q.** And do you know, sir, whether FP&L -- not FPL
6 Group, but FP&L -- has a new stock issuance imminent?

7 **A.** Well, FPL does not issue stock.

8 **Q.** All right.

9 **A.** It is a wholly-owned subsidiary of FPL Group.
10 FPL Group definitely plans to issue stock. They
11 disclosed it in their 2008 10K and it's also indicated
12 on their Value Line sheet.

13 **Q.** And my question was whether FP&L, not FPL
14 Group, plans to issue stock or whether a stock issuance
15 is imminent?

16 **A.** Well, my understanding that FPL does not issue
17 stock, but it is expected to be cash-flow negative, as
18 it has been for the last several years because of its
19 huge capital investment. So FPL Group is having to put
20 money into FPL, and some of that money is equity money.

21 **Q.** And furthermore, have you conducted any
22 studies to demonstrate or to calculate the actual cost
23 of flotation for FPL Group or FP&L?

24 **A.** The studies I presented in my testimony are
25 general studies that Morgan Stanley did for utilities

1 generally issuing stock of about 3.6 percent.

2 Q. And you haven't done any analysis that's
3 particular to FPL Group or FP&L; is that correct?

4 A. No. I think it, there's no reason to believe
5 that that number doesn't apply to FPL Group.

6 Q. Now you also conducted an expected earnings
7 analysis; isn't that correct?

8 A. Yes, sir.

9 Q. And the result of that, as demonstrated on
10 WEA-13, is 11.7 percent; isn't that right?

11 A. That's correct.

12 MR. MENDIOLA: All right. Now I want to --
13 Mr. Chairman, I spoke with Chris earlier. May I
14 approach the, the white board and --

15 CHAIRMAN CARTER: Do you need a portable mike?

16 MR. MENDIOLA: Yes, sir.

17 CHAIRMAN CARTER: Chris.

18 MR. MENDIOLA: Is that appropriate?

19 CHAIRMAN CARTER: You may approach.

20 MR. MENDIOLA: Thank you.

21 THE WITNESS: You may have misspoke,
22 Mr. Mendiola. The expected earnings is on WEA-13. Is
23 that what you said?

24 MR. MENDIOLA: That's what I think I said,
25 yes, sir.

1 **CHAIRMAN CARTER:** Do you need a marker? I
2 guess you have your own marker; right?

3 Is there one there, Chris? Yes, there is a
4 marker there.

5 **MR. MENDIOLA:** (Speaker not on microphone).

6 **CHAIRMAN CARTER:** Wait until you get there.

7 **MR. MENDIOLA:** Thank you. Does this work, Mr.
8 Chairman?

9 **CHAIRMAN CARTER:** Yes, sir. You may proceed.

10 **BY MR. MENDIOLA:**

11 **Q.** Dr. Avera, I wanted to summarize your results
12 from your various analyses, and I wanted to call it, if
13 you don't mind, Dr. Avera's Utility Proxy Group
14 Analysis. All right?

15 First of all, with respect to your DCF
16 analysis of the utility proxy group as demonstrated on
17 Exhibit WEA-7, the DCF results were 10.6 percent to
18 11.5 percent; is that correct?

19 **A.** Those are the averages. As you pointed out,
20 some are above 12.5, especially FPL Group.

21 **Q.** That's right. But this is the average of the
22 DCF results for the utility proxy group?

23 **A.** Yes, sir.

24 **Q.** All right. Thank you. Then you conducted an
25 expected earnings analysis, and the result, as we just

1 discussed, was 11.7 percent on WEA-13; is that correct?

2 **A.** Yes.

3 **Q.** All right. And then finally you conducted a
4 forward CAPM analysis, again for the utility proxy
5 group, that resulted in 10.5 percent, is that correct,
6 from WEA-11?

7 **A.** And let me double-check that number and make
8 sure it's --

9 **Q.** Please.

10 **A.** Yes, that is correct. It was 11.2 for FPL.

11 **Q.** All right. Now your range for the, for the
12 utility proxy group based on all of these analyses is
13 10.5 to 11.7 percent ROE; is that correct?

14 **A.** That's the range of those numbers.

15 **Q.** That's right. And that is without
16 considering, as we discussed in your cross-examination,
17 dividend growth rates or historical CAPM; isn't that
18 correct?

19 **A.** That is correct. For the reasons I explained
20 in my testimony and explained here, I didn't think those
21 were reliable guides to the cost of equity.

22 **Q.** All right. And that range, 10.5 to 11.7, is
23 80 basis points. The top end of that range is 80 basis
24 points below the recommended ROE of 12.5; is that
25 correct?

1 **A.** Yes. Now that doesn't include flotation
2 costs.

3 **Q.** That does not include flotation costs and it
4 does not include your nonutility proxy group?

5 **A.** Right.

6 **Q.** Thank you.

7 **CHAIRMAN CARTER:** I hope you have that written
8 down someplace else.

9 **MR. MENDIOLA:** Mr. Chairman --

10 **CHAIRMAN CARTER:** Yes, sir.

11 **MR. MENDIOLA:** -- Mr. McGlothlin is kind
12 enough to pass around this exact report exhibit.

13 **CHAIRMAN CARTER:** It would be 496,
14 Commissioners. 496.

15 Short title?

16 **MR. MENDIOLA:** Utility Proxy Group Analysis.

17 **CHAIRMAN CARTER:** Utility Proxy Group
18 Analysis.

19 (Exhibit 496 marked for identification.)

20 **MR. MENDIOLA:** Thank you, Mr. Chairman.

21 **THE WITNESS:** Mr. Mendiola, could we add
22 Flotation Number 3 without considering three flotation
23 costs down here?

24 **BY MR. MENDIOLA:**

25 **Q.** That's fine with me. On number three

1 without -- in other words, without considering one, two,
2 and then there would be three?

3 **A.** Flotation, right. Flotation costs.

4 **Q.** Flotation costs. That's appropriate. Thank
5 you, Dr. Avera.

6 **MR. MENDIOLA:** Did you get that, Mr. Anderson?
7 All right.

8 **CHAIRMAN CARTER:** Let's do this. The one that
9 you gave to the court reporter, make sure you have that
10 written on there so we'll have --

11 **MR. MENDIOLA:** I'll do that during the break.

12 **CHAIRMAN CARTER:** Okay. Good.

13 **MR. MENDIOLA:** Yes.

14 **CHAIRMAN CARTER:** You may proceed.

15 **MR. MENDIOLA:** Thank you, Mr. Chairman.

16 **BY MR. MENDIOLA:**

17 **Q.** Now would you agree with me, Dr. Avera,
18 switching topics now to capital structure, that all
19 other things being equal, more debt in a capital
20 structure equals more financial risk?

21 **A.** All else being equal, yes. And all is big.

22 **Q.** And so the converse would also be true: All
23 other things being equal, less debt equals less
24 financial risk.

25 **A.** Again, yes, with the understanding that all is

1 very comprehensive.

2 Q. Would you also agree with me that in a given
3 capital structure, setting aside hybrid securities, the
4 investor supplied capital is comprised of debt and
5 equity?

6 A. For this company. I mean, there are other
7 forms: Preferred stock and trust certificates. But for
8 FPL Group, what we have is debt/equity, and then there
9 are those hybrid securities, which have an important
10 role, but we can talk about that later.

11 Q. All right. Now would you also agree with me
12 that the more business risk, okay, the more business
13 risk a company has, the less willing investors are to
14 supply debt capital to that business, all other things
15 being equal?

16 A. Well, they're willing to supply it at a price.
17 I mean, generally, the more business risk, especially as
18 viewed from the perspective of debt holders -- because
19 debt holders are saying, "I've got a stream of
20 contractual payments. Are those going to be made on
21 time and in full?" So they're looking at the business
22 risk from a slightly different perspective than the
23 equity holders do.

24 Q. And my question is really going to, the more
25 risky a business is, the more equity is generally found

1 in the capital structure. For example, a high tech
2 startup that is perceived by investors to be risky is
3 generally capitalized with predominantly equity capital
4 as opposed to debt capital. Would you agree with that?

5 **A.** No, I really wouldn't. In the very example
6 you mentioned, very often startups are largely debt
7 because the geeks who start them don't have the capital
8 for equity.

9 **Q.** Well, for example -- well, you would agree
10 with me that as a company becomes more mature and a, and
11 its revenue stream becomes more stable, it's more able
12 to attract debt capital at a lower cost?

13 **A.** Yes. Generally as a company becomes more
14 substantial, larger, has a track record, then it finds
15 the traditional debt markets more available to them. In
16 the younger stages companies have to rely on venture
17 capital or private equity firms or people like that.
18 But the only people that can access the public debt
19 market are generally established companies of size and
20 substance.

21 **Q.** Fair enough. That's what I'm trying to
22 establish. And as a reminder, debt capital is generally
23 less expensive than equity capital; right?

24 **A.** That is generally the case. Debt capital for
25 the same company, because the debt holders have a senior

1 claim on assets and earnings.

2 Q. All right. So the more debt capital found in
3 a given company's capital structure, the lower the
4 overall return will be required. Let me rephrase that.

5 The more debt capital that's found in a given
6 company's capital structure, the lower the overall cost
7 of capital for that company.

8 A. That is not necessarily so. And there's a lot
9 of financial literature and corporate finance practice
10 about whether the, the, the point at which having more
11 debt actually increases your cost of capital because of
12 the increased bankruptcy risk and agency risk that goes
13 with having a lot of debt.

14 Q. The increased financial risk?

15 A. Well, there's more than financial risk.
16 There's what's called agency risks. There's the
17 bankruptcy cost. So financial risk generally talks
18 about the variability of return and how it's shared
19 between debt holders and equity holders. But as you get
20 into relatively high levels of debt, given a significant
21 business risk, then there are other issues that come
22 into play.

23 Q. You would agree with me that -- well, let me,
24 let me rephrase that.

25 We've established that debt is cheaper than,

1 than equity from a, for the same company; right?

2 **A.** For the same company at the same time, yes.

3 **Q.** And you would agree with me that there is an
4 optimal capital structure with an optimal amount of debt
5 for a given company at some point before you get to that
6 tipping point where the cost of capital goes up if you
7 have too much debt?

8 **A.** No. I mean --

9 **Q.** You don't agree that there's an optimal
10 capital structure?

11 **A.** I think there may be a zone of optimality, but
12 I think, as I've taught corporate finance and studied
13 corporate finance, you know, the notion that there is a
14 fine point that balances the increased risk with the
15 lower cost of debt, I think most authorities now are
16 saying that probably if it exists, it's not for humans
17 to know.

18 **Q.** All right. But you --

19 **A.** So, so generally it's thought that there's a
20 general range where there's a trade-off between the
21 debt/equity ratio and the ultimate cost.

22 **Q.** All right. You would agree that there's an
23 optimal range of debt and equity relationship in a
24 capital structure?

25 **A.** Yes.

1 **Q.** All right. And you would also agree -- we
2 talked earlier about the fact that, generally speaking,
3 regulated monopolies are less risky than companies that
4 operate in the unregulated competitive industries in our
5 economy; right?

6 **A.** General.

7 **Q.** Generally.

8 **A.** Over, over the broad population. Which is not
9 to say that some nonutilities aren't less risky than
10 many, if not all, utilities.

11 **Q.** Right. And so you would agree with me that,
12 generally speaking, regulated monopoly electric
13 investor-owned utilities that have captive ratepayers
14 have a greater capacity to maintain debt in the capital
15 structure than a nonregulated company that operates in
16 the competitive market selling widgets?

17 **A.** I would -- I'm troubled by the term "captive
18 ratepayers." I, I think customers have power and they
19 have choices and they have the Commission to protect
20 them. So having, being a graduate of the SERE school
21 and having been in a simulated prison camp, I don't
22 think "captive" is the right word for the relationship
23 between FPL and its customers.

24 But let me say that as to levels of debt,
25 there's a recent Moody's article that points out that

1 utilities of a given level of risk are able to carry
2 more, more debt than other companies and industries that
3 have some similar characteristics. And they make the
4 point that if you put, compared the metrics, most
5 utilities would be downgraded if they were in any other
6 business other than utilities.

7 Q. All right. So is that a long way of saying
8 that you agree that, generally speaking, regulated
9 monopoly utilities can carry more debt in the capital
10 structure than companies that operate in the competitive
11 industries?

12 A. Yes, all else being equal.

13 Q. Thank you. Now we've talked before several
14 times that you're from the great state of Texas. And
15 you have testified numerous times before the Texas
16 Public Utility Commission, have you not?

17 A. Yes.

18 Q. And the Texas Public Utility Commission has
19 adopted a standard regulatory capital structure for its
20 utilities; isn't that correct?

21 A. I think it's adopted it for those that are in
22 ERCOT that are doing transmission and distribution
23 services. I don't think that applies to SPS and Energy
24 Texas that are outside of ERCOT.

25 Q. Well, let's talk first of all about the T&D

1 utility companies within ERCOT. What is the standard
2 regulatory capital structure that the Texas Public
3 Utility Commission has adopted? Should I remind you?

4 **A.** Please do. I know there is one and I used to
5 know it, but I don't want to speculate.

6 **Q.** Would you agree, subject to check, that for
7 the utilities within ERCOT it's 60 percent debt,
8 40 percent equity?

9 **A.** That is correct. You refreshed my
10 recollection.

11 **MR. MENDIOLA:** Mr. Chairman, can I have just a
12 moment?

13 **CHAIRMAN CARTER:** Absolutely. Take a moment.

14 **MR. MENDIOLA:** Thank you.

15 **CHAIRMAN CARTER:** Are you getting your second
16 wind now, Mr. Mendiola?

17 **MR. MENDIOLA:** I'm just -- I may be finished,
18 Your Honor.

19 (Pause.)

20 Your Honor, those are all the questions I have
21 for this witness at this time. Thank you.

22 **CHAIRMAN CARTER:** Thank you.

23 Mr. McGlothlin?

24 **CROSS EXAMINATION**

25 **BY MR. MCGLOTHLIN:**

1 **Q.** Dr. Avera, I want to begin with a few
2 questions to follow up the earlier questions.

3 In response to one series of questions you
4 referred to, by analogy to the company that makes
5 widgets in an unregulated environment. And your point
6 was that, unlike Florida Power & Light Company, that
7 widget company doesn't have to go to a regulator to get
8 approval for a price change. Do you recall that
9 question and answer?

10 **A.** That's correct. And in addition it has the
11 freedom to move its production, to choose its customers.
12 It has many freedoms that a utility that operates under
13 an obligation to serve does not have.

14 **Q.** I want you to follow a simple hypothetical for
15 me. Envision an intersection that has four corners, and
16 on each corner there's an outlet for a company that
17 manufactures and sells widgets, Company A, B, C and D.
18 And the widgets are like burgers or laptops or standard
19 grade gasoline, largely interchangeable, a customer can
20 be served by any of the widgets. The four companies
21 have roughly the same market share and the prices of the
22 widgets range from \$6 to \$6.10 to \$6.20 to \$6.50. And
23 Company C executive says, "Well, Dr. Avera says I don't
24 have to have anybody's permission to raise my prices.
25 Starting tomorrow, my widgets cost \$12.50."

1 In an unregulated environment, what do you
2 think would happen if you try to charge 12.50?

3 **A.** Well, actually, Mr. McGlothlin, there is an
4 economic literature that says there can be price
5 differences in an intersection, and this is observed for
6 gasoline based on the relative traffic because customers
7 don't want to make left turns to go get fuel. So you
8 will observe the gasoline, regular, which is uniform,
9 the prices in a given intersection are not always the
10 same if there are differences in traffic flow. But
11 besides that, if, if a widget company wants to get more
12 than \$6 or \$6.50, they call themselves the Starbucks
13 Widget Company and they sell it for \$12.

14 See, a company in free enterprise will migrate
15 away from commodities. If you look at these low-risk
16 companies like Johnson & Johnson and Coca-Cola and
17 Brown-Forman, they don't sell commodity products. So
18 one of the things that a company in free enterprise can
19 do is differentiate their product, and by
20 differentiating their product they can establish a
21 customer base that's willing to pay whatever they can
22 charge.

23 **Q.** Well, sir, you've largely changed the
24 hypothetical presented to you. If you'll recall, I said
25 that a customer can be served by A, B, C or D

1 satisfactorily if they were largely interchangeable or
2 fungible, and you've added the left turn.

3 But isn't it a fact, sir, that in a truly
4 competitive environment there are some competitive
5 forces that discipline and restrain the ability of a
6 company to raise its prices at will?

7 **A.** That's right. In the theory of perfect
8 competition where you have a uniform product, cost
9 curves are well behaved, you will achieve a result where
10 each of the participants is earning a fair rate of
11 return. If they aren't earning a fair rate of return,
12 you have migration out of the industry, supply goes
13 down, demand stays the same, price goes up, until all
14 the participants are earning a fair return.

15 **Q.** I think I heard you say yes to my question,
16 which was there are some forces, competitive forces that
17 restrain and limit the ability of a company in a truly
18 competitive market to raise its prices at will; correct?

19 **A.** Yes. And they will restrain the companies so
20 that they will earn a fair rate of return. If they earn
21 less than a fair rate of return, there will be migration
22 out of the industry, supply will go down. If demand
23 doesn't change, price and quantity will adjust so the
24 price is higher and all remaining participants earn a
25 fair rate of return.

1 **Q.** You're familiar with the term or the concept
2 of competing on the basis of price?

3 **A.** Yes, sir, Mr. McGlothlin.

4 **Q.** Does that imply to you that in order to be
5 competitive an entity in the unregulated market would
6 try to have the lowest price available?

7 **A.** No. Again, I think the rational strategy in
8 an unregulated market is differentiate your product and
9 be able to sell on the basis of quality and service. Or
10 some participants do sell on price, like Wal-Mart, but
11 they've found they've had to respond with quality and
12 service as well.

13 **Q.** Well, again, you've changed the hypothetical
14 and the nature of the question. The question leading up
15 to this one was the concept of competing based on price.
16 And if you compete on price, you don't try to increase
17 the price, you try to lower price; correct?

18 **A.** But the only reason you would compete on
19 price, Mr. McGlothlin, is if you have a totally uniform
20 product, no differentiation in quality and service, and
21 that's not the real world. It's the theoretical world.

22 **Q.** In the real world do you think there's such a
23 thing as price-based competition?

24 **A.** I think there is for commodity products. But
25 I think competition usually is multidimensional,

1 involving service, advertising and customer perceptions.

2 Q. And price?

3 A. And price.

4 Q. And when one competes on price, does one raise
5 price or lower it?

6 A. It depends on, on the strategy the participant
7 is taking.

8 Q. The strategy --

9 A. And what the elasticity of demand is.

10 Q. The question --

11 A. If the elasticity is less than one, lowering
12 price will reduce total revenues. If it's greater than
13 one, it will increase it.

14 Q. I submit to you that if one intends to compete
15 based on price, one attempts to gain market share by
16 lowering the price and having the most advantageous
17 price to the customer. Do you agree or disagree?

18 A. I disagree. The rational strategy is to earn
19 a fair return. If you're not earning a fair return,
20 there's migration out of the industry. So if a company
21 can't earn a fair rate of return in the business, they
22 will leave, and supply will go down and prices will go
23 up.

24 Q. So your answer is you disagree there's
25 anything such as price-based competition?

1 **A.** No. There's price-based competition, but it's
2 constrained by the mobility of capital and resources, so
3 that the long-run equilibrium is all participants will
4 be earning a fair rate of return.

5 **Q.** So your answer is there is such a thing as
6 price-based competition in which one market participant
7 would try to offer a better price for the customer than
8 others, but there are limits on the ability to do so;
9 correct?

10 **A.** There are limits on the ability to do so and
11 there's limits on the willingness to do so because
12 nobody is in business to lose money.

13 **Q.** Now with respect to your point that Florida
14 Power & Light Company must obtain the permission of the
15 regulators before it can modify the price it charges,
16 describe to me, if you can, the nature of the mechanisms
17 in place in Florida for considering and acting on a
18 request to increase rates.

19 **A.** Well, rates are generally divided into base
20 rates and then pass-through adjustments. And I have
21 some familiarity with Florida. I'm by no means an
22 expert. I've been here quite a few times for quite a
23 few cases.

24 But for base rates you have to have a rate
25 case such as we're engaged in now. There is another set

1 of revenues for fuel, for purchased power, currently for
2 generation, for environmental, where the company can
3 make adjustments on an interim basis without having a
4 full rate case, but there are periodic reviews of those
5 costs as they're passed through.

6 Q. Tell me, if you can -- identify for me, if you
7 can, the, the pass-through mechanisms that are in place
8 in Florida and in place for Florida Power & Light
9 Company.

10 A. Florida has a fuel clause, a purchased power
11 clause that applies both to the cost of power and
12 capacity payments. There are other clauses. I would
13 have to kind of review my notes to know all of them.
14 Under the settlement there is the GBRA that FPL has and
15 is asking to be renewed in this case.

16 Q. Are those the ones that you're familiar with?

17 A. There's storm, there are adjustments for storm
18 costs, which I understand have two parts. There's a
19 certain amount of storm costs that have been securitized
20 and there's payments to support that securitization, and
21 then there's another part that is collected on a
22 continuing basis.

23 Q. Are those all the ones that you're familiar
24 with?

25 A. Let me review my notes, Mr. McGlothlin,

1 and -- Florida has a fuel cost adjustment, a demand-side
2 management conservation adjustment clause, it has an
3 environmental adjustment clause, and it has an
4 infrastructure construction cost, which is made up both
5 of the GBRA, and then there is an adjustment for nuclear
6 construction and preconstruction expenses. Then there
7 is storm recovery and then there's a property insurance
8 reserve.

9 Q. And with respect to the cost recovery clauses,
10 do you know how frequently those are modified in
11 Florida?

12 A. I don't know. I understand that with the
13 fuel, for example, which is the most money, there is an
14 annual fuel reconciliation, and then there is a
15 provision if fuel costs pass certain boundaries for an
16 interim measure.

17 Q. Do you know whether any of the cost recovery
18 clauses that you identified incorporate what in Florida
19 is called a true-up provision?

20 A. I think many involve true-up provisions, which
21 means that they're established, then the world turns and
22 the company incurs costs, and then they come back here
23 to the Commission and the Commission reviews the cost.
24 And if there's underrecovery, there's a provision for
25 them to recover. If there's overrecovery, there's a

1 provision to adjust for that overrecovery in subsequent
2 periods.

3 Q. So to recap for just a second, with respect
4 the mechanisms in place and are available to Florida
5 Power & Light Company and other regulated utilities in
6 Florida, you identified a fuel and purchased power cost
7 recovery clause with a true-up mechanism, a conservation
8 cost recovery clause with a true-up mechanism, an
9 environmental cost recovery clause with a true-up
10 mechanism, the GBRA that was a portion of the
11 settlement, and the nuclear cost recovery clause with a
12 true-up mechanism. If you know, what percentage of
13 FP&L's total revenues are collected through these
14 various cost recovery clauses with true-up mechanisms?

15 A. I saw a -- unlike many companies, FPL does set
16 out its relative recovery, and I can find it here in the
17 10K, but for present purposes about 50 percent.

18 Q. Would you accept, subject to check, it's more
19 than 60 percent?

20 A. Well, I'm not sure that I agree -- I don't
21 remember that number. But if you, if you have a
22 reference, I'll accept it.

23 Q. If you'll accept for the purposes of the
24 question, would you agree with me that the availability
25 of fuel conservation, environmental and nuclear cost

1 recovery clauses all having true-up provisions and
2 comprising 61 percent of FP&L's total annual revenues
3 goes a long way to mitigate any risk associated with
4 having to come to a regulator before modifying a price?

5 **A.** It moderates the risk associated with those
6 costs. There's still substantial risk associated with
7 the base rates. So it does moderate. It doesn't
8 eliminate, as I discuss in my testimony, and also FPL is
9 not able to earn a return, except on some like the GBRA.

10 **MR. MOYLE:** Can I just interject for just one
11 second?

12 **CHAIRMAN CARTER:** Mr. Moyle.

13 **MR. MOYLE:** Mr. McGlothlin asked the witness a
14 question about the percentage of monies recovered
15 through the clause, and he has a document in front of
16 him, he referenced it, he gave an answer of 50 percent.
17 Just so the record is clear, could the witness identify
18 the document he was referring to? I think it's the 10K
19 but --

20 **CHAIRMAN CARTER:** I think he said it was the
21 10K. Is that --

22 **THE WITNESS:** That's correct. It's the FPL
23 Group Annual Report, and attached to it is the Form 10K
24 for 2008.

25 **CHAIRMAN CARTER:** Okay. Mr. McGlothlin.

1 **MR. MOYLE:** And the date on the 10K?

2 **MR. MCGLOTHLIN:** Now --

3 **CHAIRMAN CARTER:** Hang on a second, Mr.
4 McGlothlin.

5 **THE WITNESS:** It's March.

6 **CHAIRMAN CARTER:** March of what year?

7 **THE WITNESS:** 2009. But it covers the fiscal
8 year through December 31st, 2008.

9 **CHAIRMAN CARTER:** Okay, Mr. Moyle?

10 **MR. MOYLE:** Thank you.

11 **CHAIRMAN CARTER:** Okay. Mr. McGlothlin.

12 **BY MR. MCGLOTHLIN:**

13 **Q.** Mr. Mendiola asked you a couple of questions
14 about the nature of the storm cost recovery mechanisms
15 in place and the use of financing orders to accomplish
16 that recovery. Do you recall that question and answer?

17 **A.** Yes.

18 **Q.** And so you're aware that over time Florida
19 Power & Light Company has been able to collect with the
20 Commission's approval the cost of restoring a system
21 after storm damage occurs?

22 **A.** That is correct. But from a financial
23 perspective, the important thing is that FPL has to
24 immediately respond when there's a storm to hire crews,
25 to mobilize resources to recover, and that takes

1 financial resilience. Ultimately, FPL will be able to
2 recover subject to the review of this Commission. I've
3 been involved in past storm cases, so I'm familiar that
4 there is a detailed review of those costs.

5 Q. And in one of your answers you alluded to the
6 example of a company that experienced damage in, in a
7 storm. I can't remember if it was Florida or somewhere
8 else.

9 A. No. It was Beaumont, Texas.

10 Q. Beaumont, Texas. And you said that that
11 company chose not to rebuild as a result of its storm
12 damage; is that correct?

13 A. That's correct. They switched the production
14 to other facilities in Germany and elsewhere.

15 Q. And that was because of the concern that it
16 was exposed to storm damage if it were to rebuild there?

17 A. Well, we were a consultant to the company. I
18 don't know all the things they considered. But I do
19 know that they regarded operating, continuing to operate
20 in the Texas Gulf Coast as risky and a risk they didn't
21 choose to take.

22 Q. Yes. And that's a risk that Florida Power &
23 Light Company does not have due to the fact that it can
24 come to the Commission and seek approval of a surcharge
25 with which to restore the storm damage; correct?

1 **A.** It can seek a surcharge, but that doesn't
2 eliminate the immediate risk of having a storm and
3 having to fund the recovery from the storm and the loss
4 of revenues associated with it. So the risk is still
5 there. Having a storm recovery mitigate some of the
6 risk, it doesn't eliminate the need for financial
7 resilience and it doesn't eliminate all the risk.

8 **Q.** But as between the regulated company, Florida
9 Power & Light Company, and an unregulated company, the
10 risk is greater for the unregulated company; correct?

11 **A.** I don't know. In this case, they had
12 insurance, they got insurance proceeds, and they had the
13 freedom to choose not to rebuild at that location but to
14 take their money to Germany. But I can't say that -- I
15 just, Mr. McGlothlin, I can't say whether the risk of
16 that particular exposure is greater or less.

17 **Q.** Well, you can say, however, that Florida Power
18 & Light Company can and has been able to request and
19 receive approval to surcharge its customers for this
20 storm damage, which is something that the unregulated
21 company could not do.

22 **A.** Yes, sir. Florida Power & Light cannot charge
23 its customers without this Commission's permission, and
24 they have allowed the recovery of storm restoration
25 costs.

1 **Q.** Now we've covered, with respect to the
2 mechanisms available to, for a regulated utility to
3 modify its rates in Florida, we've talked about the fuel
4 and purchased power cost recovery clause, the
5 conservation cost recovery clause, the environmental
6 cost recovery clause, the nuclear cost recovery clause
7 and the storm damage provisions. I want to talk about
8 base rates for a second. Are you familiar with the
9 concept of a file-and-suspend tariff?

10 **A.** I'm familiar with the concept, yes.

11 **Q.** Are you familiar with the mechanism in place
12 in Florida for utilizing the file-and-suspend provisions
13 to change rates?

14 **A.** I'm generally familiar that there are
15 provisions, but I really haven't looked into them,
16 Mr. McGlothlin.

17 **Q.** I see. Are you familiar with any provision in
18 Florida for seeking and receiving an interim rate
19 increase pending the disposition of the full base rate
20 request?

21 **A.** I believe there are provisions. I don't know
22 the details. I mean, one of the things in my experience
23 is in some cases where you have a file-and-suspend, and
24 I think there may be reasons why you have to have them
25 for legal reasons, the obligations to file bond or to do

1 other things to effectuate that are onerous, and I just
2 don't know about Florida.

3 Q. Well, assume for a moment that a utility has
4 available to it a statutory mechanism which requires the
5 regulators to respond to requests for interim rates
6 within 60 days of filing. Would that in your estimation
7 mitigate any risk that you perceive in conjunction with
8 having to approach a regulator before modifying a rate?

9 A. No. First, Mr. McGlothlin, it's not my risk
10 that matters. It's investors' risk. And investors view
11 regulatory risk as very significant. And I have quotes
12 in my testimony that investors view the regulatory risk
13 here in Florida, as highly as they regard this
14 Commission, they, they look at the risk of regulation in
15 Florida, particularly as there are political influences
16 being played out.

17 Q. Okay. Well, let's take the investors' point
18 of view and let's say the investor looks at one
19 jurisdiction in which there is no provision for interim
20 rates, and then looks at Florida where there's a
21 statutory mechanism that says if the utility requests an
22 interim increase in rates, the Commission must act
23 within 60 days. Of the two jurisdictions, judging from
24 the investors' point of view, which would be the less
25 risky?

1 **A.** I think it depends on the facts and
2 circumstances. In many cases, in my experience, the,
3 the standard for interim rates is an almost imminence of
4 bankruptcy standard. So it is not something that gives
5 the investors very much comfort.

6 **Q.** Well, let's assume that in this particular
7 example the jurisdiction with which there is available a
8 mechanism for interim ratemaking, the standard is a
9 showing, a prima facie showing that the utility is not
10 earning its last authorized rate of return. Now if we
11 add that parameter to the other information I gave you
12 and the investors comparing one jurisdiction in which
13 there is no provision for interim ratemaking with a
14 jurisdiction in which there is a 60-day mechanism and
15 the standard I've described, from the investors'
16 perspective of the two jurisdictions, which is the least
17 risky?

18 **A.** I think it depends on the facts and
19 circumstances. Moody's in August in a document that the
20 staff is going to introduce, the global infrastructure,
21 they say, "For the longer term, however, we're becoming
22 increasingly concerned about possible changes to our
23 fundamental assumptions about regulatory risk,
24 particularly the prospect of more adversarial, political
25 and, therefore, regulatory environment." So I think

1 they look at the entire environment.

2 Q. With respect to the question I've given you,
3 the considerations are, other things being equal, one
4 jurisdiction has no provision for interim ratemaking,
5 the other jurisdiction has a 60-day time line and the
6 standard that says you have to show, make a prima facie
7 showing that you're not earning your last authorized
8 rate of return. And you're unable to say which of those
9 jurisdictions is less risky from the perspective of the
10 investor?

11 A. I think the investors would look at how the
12 regulation actually occurs. Elsewhere in this same
13 article Moody's says we don't just look at the ROE, we
14 just don't look at the allowed return, we look at the
15 whole framework from which the regulators operate.

16 Q. Okay. Again, with the questions I have given
17 you, one jurisdiction has no provision for interim
18 ratemaking, the other has a 60-day provision in the
19 standard I've described, do you think that 60-day
20 standard is something that the investor will look at?

21 A. I think investors would certainly look at it,
22 Mr. McGlothlin. And if they felt that it was
23 implemented in a way that was evenhanded and allowed the
24 utility an opportunity to maintain its financial
25 integrity and earn a fair return, they would view that

1 favorably. And so they would look at it. You know,
2 without more facts, I can't say they would automatically
3 leap to less risk.

4 Q. Well, the nature of my question was all other
5 things being equal, looking at these considerations from
6 a, from the pure standpoint. Now with respect to
7 file-and-suspend concepts, is it true that typically, in
8 the case of a file-and-suspend type of tariff, there are
9 limitations or time constraints on the time within which
10 the regulator can, can act?

11 A. In many cases they are. In my experience, a
12 lot of cases they are not very effective. For example,
13 when the Texas PUC first started, it had an 180-day
14 limit. But the Commission would strongly ask the
15 companies to waive that, and they universally did.

16 Q. What are the time constraints in Florida for
17 FP&L?

18 A. I am not sure, Mr. McGlothlin.

19 Q. So if you don't know, can we assume that's not
20 something that you factored into your risk analysis?

21 A. Well, yeah, my, my risk analysis looked at the
22 indicia that investors look at. And investors do look
23 at all aspects of the regulatory environment, and based
24 on that, they've evaluated the relative risk of FPL.

25 (Transcript continues in Volume 34.)

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

STATE OF FLORIDA)
 :
COUNTY OF LEON)

CERTIFICATE OF REPORTER

I, LINDA BOLES, RPR, CRR, Official Commission Reporter, do hereby certify that the foregoing proceeding was heard 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 constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorneys or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 21st day of September, 2009.

Linda Boles
LINDA BOLES, RPR, CRR
FPSC Official Commission Reporter
(850) 413-6734