BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

DOCKET NO. 120015-EI

PETITION FOR INCREASE IN RATES
BY FLORIDA POWER & LIGHT COMPANY.
_____/

VOLUME 13

Pages 1579 through 1734

PROCEEDINGS:	HEARING
COMMISSIONERS PARTICIPATING:	CHAIRMAN RONALD A. BRISE COMMISSIONER LISA POLAK EDGAR COMMISSIONER ART GRAHAM COMMISSIONER EDUARDO E. BALBIS COMMISSIONER JULIE I. BROWN
DATE:	Thursday, August 23, 2012
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	LAURA MOUNTAIN, RPR Wilkinson & Associates (850) 224-0127
APPEARANCES:	(As heretofore noted.)

I N D E X

WITNESSES

EXHIBITS

P R O C E E D I N G S

(The transcript follows in sequence from Volume 12.)

THE COURT: All right, Staff.

MS. BROWN: Good afternoon, Ms. Slattery. I'm Martha Carter Brown. We spoke earlier this month at your deposition. I have handed out four documents, that include a transcript of your deposition, which has been marked for identification in the exhibit list as Number 111. I'd like to ask if any parties have any objection to that deposition at this time, specific objections.

CHAIRMAN BRISE: Okay. Are there any objections to the deposition?

MS. CLARK: Are you doing the errata sheet separately?

MS. BROWN: I'm sorry, the errata sheet is included with the deposition.

MS. CLARK: Okay.

MR. REHWINKEL: Mr. Chairman, I generally don't have an objection to the -- I was assuming that the exhibit would be kind of a composite of the depo, the errata, and then the three late filed deposition exhibits.

MS. BROWN: That's perfectly fine if everyone is amenable to that.

MR. REHWINKEL: Well, the one thing I -- and

Mr. Young indicated that I generally don't have an objection to this. I would just ask, if we could be given some leeway. This deposition was taken August 10th, I believe, and I'm actually not quite sure exactly when the late filed were filed. I haven't had an opportunity to look at them.

I'm not disputing them, but if it would be appropriate to have very limited opportunity on the rebuttal phase to inquire about the late filed, or information on the late filed, would that be a problem?

MS. CLARK: Mr. Chairman, I would suggest we wait and have it identified and moved into the record during the rebuttal testimony.

CHAIRMAN BRISE: Okay.

MS. CLARK: If that's acceptable.

MS. BROWN: Do you want to include the deposition, as well, later? I have some questions to ask about one of these late fileds, but we could identify them and then move them in at rebuttal. Do you want to include the deposition, as well?

MS. CLARK: Maybe I'm confused. The deposition?

MS. BROWN: The way I've set this up is the deposition exhibit includes the errata sheet, but I have separate exhibits for each of the late filed exhibits.

MS. CLARK: I don't think we have any objection to

handling it that way. I would like to point out that -- I want to inquire whether or not you have the updated errata sheet. We filed one last night.

MS. BROWN: I don't think so.

MS. CLARK: Okay.

MS. BROWN: If you can provide it to us, we can amend the exhibit, the deposition exhibit, to include that. If I may have -- why don't we just mark these late filed exhibits for the record and then we can determine when we want to move them in and that would give Mr. Rehwinkel time to look at them.

CHAIRMAN BRISE: You want to mark them individually?

MS. BROWN: Yes, I do.

CHAIRMAN BRISE: Okay. So we're at 540.

MR. LITCHFIELD: Is that the depo transcript?

CHAIRMAN BRISE: No, we're dealing with the late filed.

MS. BROWN: The deposition transcript is Exhibit 111. That would be FPL's Late Filed Exhibit 1 for Kathleen Slattery.

CHAIRMAN BRISE: Yes, that would be 540.

MS. BROWN: Late filed Exhibit 2 for Kathleen Slattery.

CHAIRMAN BRISE: 541.

MS. BROWN: And Late Filed Exhibit 3 for Kathleen Slattery.

CHAIRMAN BRISE: Okay, 543.

MR. SAPORITO: Mr. Chairman, the errata sheet, does that follow as 111, also?

MS. BROWN: Yes, we'll amend Exhibit 111 to include the updated errata sheet.

CHAIRMAN BRISE: Okay, so I misspoke. So it's 540, and that's the Late Filed Number 1. 541 is the Late Filed Number 2, and 542 is the Late Filed Number 3.

MS. CLARK: No objection, Mr. Chairman.

(Exhibits 540, 541 and 542 marked for identification.)

CROSS EXAMINATION

BY MS. BROWN:

Q Now, Ms. Slattery, I have a series of documents I want to pass around and pass out to you for your convenience. They are already in the record, either to be admitted at the end of your testimony, or they are already in as discovery exhibits, but I have some questions I want to ask you about.

You already have a copy of OPC's Second Set of Interrogatories, number 37, FPL's response. It has been marked for identification as Exhibit 531. Then also in the little packet I handed out to you there is the document FPL's Response to Staff's Fifteenth Set of Interrogatories, number 438. That's been entered into the record as Exhibit 52. And

finally, Staff's Ninth Set of Interrogatories, number 314, has been entered into the record as Exhibit 46.

And I think you also have Schedule C-2 from your MFRs that have been entered into the record and Schedule C-35 that other parties asked you questions about earlier. Do you have all that?

A Yes, I do.

Q Okay. Well, if you'd refer to Exhibit 531, the table included there shows wage rate increases for non-bargaining and bargaining employees for 2009 through 2012, correct?

A Yes.

Q There are wage rate increases built into the projected 2013 test year for executive, non-executive, non-bargaining and bargaining employees, correct?

A That's correct.

Q What are those wage rate increases included in the 2013 test year for each of those categories, executive, non-executive, non-bargaining and bargaining employees?

A For non-bargaining employees, it's 3 percent. And I don't recall the bargaining unit wage rate increase under the collective bargaining agreement for 2013.

Q Well, would it be okay if I asked you that same question on your rebuttal testimony and you could get the answer for me then?

A Yes, thank you.
Q Okay. And what about executive -- so the 3 percent is for executive and non-executive non-bargaining?
A Yes, that's correct.
Q And the wage rate increases included in the 2013 test year for each of those executive categories, can you tell me what those are?
MS. CLARK: Would you tell us where you are?
BY MS. BROWN:
Q I'm going to withdraw that question. It's really repetitive of the one I just asked. Sorry. All right, referring to Staff's Fifteenth Set of Interrogatories, that was Exhibit 52. It's number 438, your response.
Your response states that the base salary for non-executive non-bargaining employees net of allocations to affiliates will be decreasing 7,545,000 and change, or 1.4 percent from 2012 to 2013. Is that correct?
A That's correct.
Q The amount described is decreasing, even though there is a wage rate increase included in the 2013 test year, correct?
A That's correct. And that's related to the forecasted decrease in total head count as shown on MFR C-35, including decreases in the bargaining unit head count.
Q Okay. Now referring to Staff's Ninth Set of

Interrogatories, number 314, which is Exhibit 46, the table included shows an increase in executive base salary on a jurisdictional basis of $578,140. Has this amount been excluded as part of the adjustment included on MFR C-2, column seven?

A No, it has not been excluded.

Q Why not?

A Because the adjustment on that MFR is related to executive incentive compensation and a portion of stock-based non-executive compensation, and this dollar amount is in regards to base salary and our FPL officers -- FPL portions of base salaries are included in the O&M request.

Q Now, on to MFR C-35. The average number of employees is projected to decline from 10,312 in year 2012 to 10,147 in year 2013, correct?

A Yes.

Q If you would refer to your Late Filed Exhibit Number 1, and tell me why the average enrolled head counts are the same for 2012 projected and 2013 projected for medical, dental, and defined contribution, and show increases for short-term disability and life insurance if average employees are projected to decline based on C-35.

A Okay. Well, for medical and dental, the enrolled head count includes not only active employees but also those on long-term disability and COBRA continuance. And because

we have planned some reductions in force for our meter readers in 2012 and 2013 related to the AMI project, we are presuming that there will be an increase in the number of COBRA continuance. And that explains the assumption of kind of a flat enrolled head count year over year.

With regard to the 401(k), this is a little bit more difficult to predict, because as you can see, the participation is less than the total active employee population, and it's an individual employee election that occurs pay period by pay period.

But FPL has an active communication campaign in 2012, including scheduled monthly communications to employees, to encourage participation and increase participation. So we are assuming that we will have flat participation year over year because we're hoping to actually encourage employees to give a little more from their base salaries to fund their retirement.

And with regards to short-term disability and life insurance, again, those are different reasons. Life insurance also includes long-term disability continuance. And the short-term disability number is just slightly less than the forecasted total number of employees in 2013, because as a general rule most employees, active employees, are eligible for short-term disability.

MS. BROWN: All right, thank you. That's all we

have.

CHAIRMAN BRISE: All right, Commissioners? Commissioner Brown.

COMMISSIONER BROWN: Thank you. And thank you, Ms. Slattery, for your testimony today. I just have a few questions. I've kind of narrowed them down throughout the various cross examination.

So, first, how much does the total compensation cost, excluding the executive compensation, represent from a percentage standpoint of the total O&M costs for the test year? I was trying to find it, and I couldn't find it anywhere.

THE WITNESS: I have the net O&M payroll in the filing. What I don't have with me is the total O&M request. So I know that the net O&M payroll and filing after all of the adjustments is 740,842,000, but I don't have the MFRs with me to give you the total O&M request.

MS. CLARK: Mr. Chairman, Ms. Slattery is coming back on rebuttal, and we'd be happy to provide that at that time.

COMMISSIONER BROWN: That would be great. Thank you. Your KS-2 exhibit --

THE WITNESS: Yes.

COMMISSIONER BROWN: -- on your direct, it says -- and I know FIPUG touched on this a little bit. But it

says the average base salary organization-wide is 78,000. Of the total employees -- and I don't know if you have this categorized somewhere, but do you know how many are skilled workers versus professional versus administrative?

THE WITNESS: I don't have the employee population broken down quite that way. I know that we do try to keep track of degrees. Of our salaried employees, 33 percent have an engineering degree, 83 percent have an engineering or professional degree, and 24 percent have an advanced degree. And those are statistics we keep on our roughly 4,400 salaried employees. I don't have comparable statistics for the hourly employees.

COMMISSIONER BROWN: No, that's good. I appreciate that, though. Of the -- how many former employees currently receive that post-employment medical and life benefits?

THE WITNESS: I do not know the number of retired employees who are currently receiving that.

COMMISSIONER BROWN: Do you have the amount?

THE WITNESS: It's in the test year. It's on C-35. Let me get that amount for you. I don't have a number of people on it, I just have a dollar figure for post-employment.

COMMISSIONER BROWN: That's okay, just the dollar.

THE WITNESS: So the gross amount for post-retirement benefits, as shown on C-35 in the test year, is 16,200,000.

COMMISSIONER BROWN: Do they -- do those post-employment benefits, do they ever -- is there an age when they stop?

THE WITNESS: No. However, it is somewhat a scaled expense in that our retirees under the age of 65 who are eligible for post-retirement medical insurance are FPL primaries, we would say. And when they become Medicare entitled, we require them to become Medicare primary, so the expense is different and the actuarial expense is calculated separately for the two groups.

But they are eligible to remain on it for, you know, the rest of their life, but they receive only the difference between what FPL benefits would provide and Medicare.

COMMISSIONER BROWN: Okay. And again, I know this is probably an exhibit somewhere, and I was trying to find it and I couldn't get my hands on it. How much does the portion of non-executive incentive compensation that is being excluded, what is the total amount for this test year, 2013? I think it was on Exhibit 533.

THE WITNESS: Yes, I do have a figure for that. So for the non-executive stock-based incentive

compensation, the adjustment for that is 1,044,900. And that is FPL per book O&M remaining after the -- oh, I'm sorry, that's what remains after the adjustment. I apologize, Commissioner. The adjustment portion is actually higher than that. It's 1,361,000. So more of it is excluded than is included.

COMMISSIONER BROWN: Okay. Thank you. Of the total compensation FPL is requesting for the test year, what is the rate impact on a typical customer's bill at 1,000 kilowatts an hour?

THE WITNESS: I do not know, Commissioner. As I said before, I know that the total compensation expense included in the O&M is 740 million, but I don't -- I haven't calculated the impact on customers. I can do that before I come back for rebuttal.

COMMISSIONER BROWN: That would be great. Thank you. And that's all.

CHAIRMAN BRISE: Commissioner Balbis.

COMMISSIONER BALBIS: Thank you, Mr. Chairman. I have a few questions to follow up on Commissioner Brown's questions. How many total budgeted positions does FPL have for 2013?

THE WITNESS: For 2013 it is 10,147, as shown on MFR C-35.

COMMISSIONER BALBIS: Okay. And how many are

budgeted for the current year?

THE WITNESS: 10,312.

COMMISSIONER BALBIS: How many of those are vacant currently?

THE WITNESS: Vacant? There was a late filed exhibit which shows our current head count. So currently, as of July 31st, the total number of FPL employees is 10,230, and that includes temporaries, as all of these figures do. And by temporary, I don't mean contractors, Commissioners, I mean people on FPL payroll who are working on a time-bound or project-bound basis, generally related to nuclear extended power upgrade outages.

COMMISSIONER BALBIS: Okay. Amd does that ratio -- does that number of vacancies, as far as a percentage, is that typical year to year? Well, let me ask you this. What is your typical vacancy rate year to year, from a percentage standpoint?

THE WITNESS: That's a question that is of some debate among the Intervenors and myself, actually. Although FPL will always have some vacant positions as a result of normal, healthy turnover -- which, for example, last year turnover was seven percent for the year -- we're constantly incurring the payroll expense related to getting the job done.

So we budgeted optimal staffing levels. We will have healthy turnover. Sometimes we have hiring lags that make it a long, complicated process to fill certain positions where we need skilled labor, but we still have to get the work done, so we use our existing employees on an overtime basis, which is why for every historical year, on another exhibit that I have, it shows that we've been slightly over budget in payroll from the overtime perspective. Not total payroll, but overtime.

So we're always going to have some vacancies and it's going to vary from month-to-month, year-to-year, but we're still incurring the payroll expense in the form of overtime and temporary labor to get the work done.

COMMISSIONER BALBIS: Okay. Don't you budget -- isn't there a budget line item for overtime and a budget line item for temporary labor?

THE WITNESS: Yes, there is.

COMMISSIONER BALBIS: Okay. Let me change gears a little bit. You mention on page eight of your testimony the aging workforce as your justification for FPL's compensation package, is that correct?

THE WITNESS: Well, the aging workforce is not a justification for the compensation package, rather the fact that we have a philosophy of providing market

competitive total compensation and benefits is the basis for the fact that we say we have a reasonable, appropriate, and necessary level of comp and benefits. We make sure that we benchmark that in a robust annual benchmarking process to validate that we're at or below median of the market.

The aging workforce is a variable that impacts our -- the necessity of us providing the market competitive total compensation and benefits package, because we are competing for resources in a marketplace where, in many jobs, the demand exceeds the supply. And so we cannot afford to pay less than market or we will lose our employees that we have and we won't be able to attract new ones.

COMMISSIONER BALBIS: Okay. And then just below that you cite an organization, the Center for Energy Workforce Development. And they state a percentage of skilled technicians and power engineers will need to be replaced. What percentage of the 10,000 employees are skilled technicians or power engineers?

THE WITNESS: Well, as I was telling Commissioner Brown earlier, I don't have those statistics for the hourly employees, but 83 percent of our salaried employees have engineering or professional degrees.

COMMISSIONER BALBIS: Right, but they -- okay,

I understand. I'm not sure if I ask you -- are the engineers -- are they all nuclear engineers or are they considered power engineers, or do you have a variety of different engineering fields you employ?

THE WITNESS: Right, we have a variety of engineering degrees in there.

COMMISSIONER BALBIS: Okay. But the salary increases that you're proposing are for all the employees, correct?

THE WITNESS: It's a salary increase budget that would not be applied as an across-the-board cost of living increase to non-bargaining employees. Rather the awards are provided based on performance against stated objectives for the prior year and our need to remain, you know, market competitive with our salaries. So there's variability among the distribution of awards but it is a budget that applies to all levels of the non-bargaining organization.

COMMISSIONER BALBIS: Okay, because some employee positions would be easier to fill than others, such as administrative staff would probably be easier to fill versus a nuclear engineer position, correct?

THE WITNESS: I do agree with you that it is easier to fill those positions, and that's why we benchmark them based on regional administrative positions rather

than national utility industry jobs. And Exhibit KS-3 separates out, you know, the hourly workers from the salaried to show that we make sure that we're paying appropriately, based on the market, for each job, including the fact that it is easier to fill an administrative position than a nuclear engineer.

COMMISSIONER BALBIS: Right. Okay. Well, then, let's focus on the collective bargaining employees. What percentage or what roundabout number of the 10,000 employees are covered under a collective bargaining agreement?

THE WITNESS: The most current figure I have for bargaining is that we have 3,087 bargaining unit employees as of July 31st.

COMMISSIONER BALBIS: Okay, because I think that's important, because on page five of your testimony you indicate that the total rewards package -- and I think I'm quoting -- but emphasizing pay for performance has served the company and customer well.

But then in this FIPUG exhibit -- I think it's 534 -- interrogatory number eight, at the bottom, you note that please also note that the bargaining unit employee base increases are contractual and are not performance based.

THE WITNESS: That's correct.

COMMISSIONER BALBIS: So how -- what benefit is the customer getting for a pay increase that is not based on performance?

THE WITNESS: Well, you know, for this reason we would always prefer to be able to deal directly with our employees rather than go through a third party such as a labor union, because we do feel that a pay for performance philosophy drives performance for the benefit of the customer and it is best for customers.

But we do need our -- you know, our line workers, they do a fantastic job for our customers and we have to deal with the labor union that represents them, and we negotiate hard. So we do the best we can to control costs.

And then, of course, it is the non-bargaining unit employees that set the strategic direction for the company, set the performance goals, and essentially set out the priorities for the bargaining unit, and, you know, supervise that work in such a way that we are able to deliver industry leading performance to our customers.

COMMISSIONER BALBIS: Okay, I'm glad you explained that, because I'm just trying to put my arms around -- I think you indicated a 14.65 percent total increase over a period of time for collective bargaining employees, so

I appreciate you explaining that.

Has FPL entered into collective bargaining agreements that included increases -- we'll just call them increases -- since the last rate case?

THE WITNESS: Yes.

COMMISSIONER BALBIS: Okay. And was there ever any discussion during the negotiation process -- well, let me back up. Were you part of the negotiation process?

THE WITNESS: No, I was not.

COMMISSIONER BALBIS: Okay. So I'm not sure if you can answer this or not. But my question is, was there ever a discussion, before, during or after the negotiation process, as to whether or not this Commission would approve the revenue requirements associated with these increases?

THE WITNESS: No, I'm not aware of those -- that being part of the discussions, no. One thing I would like to add, though, Commissioner, is that part of these negotiations over the past four years have included some very tough negotiations around benefits, which are not shown on this schedule of wage rate increases.

Our bargaining unit employees have higher medical costs on a per employee basis than non-bargaining unit employees. And a lot of the cost containment efforts we were able to implement for non-bargaining employees

through plan design changes and better health incentives we were limited from implementing for the bargaining unit employees.

So the thing that's not shown here is the benefit side of the equation and how hard our labor relations staff worked to convince the union to allow some change in that regard in a way that will provide cost containment for our customers on a go-forward basis.

COMMISSIONER BALBIS: So the benefits portion of the compensation part of the collective bargaining agreement went down? I mean, those were decreases?

THE WITNESS: We were able to implement some of the same plans that we had for non-bargaining employees, which will lower costs over time.

COMMISSIONER BALBIS: Okay. And then I have one more question. It's concerning pensions, because I want to make sure I understand the pension plan that you have because in one of the exhibits you indicated participation in a 401(k) type program. And I assume that is a defined contribution plan versus a defined benefit plan.

THE WITNESS: Yes, it is.

COMMISSIONER BALBIS: So can you explain the pension program? Is it a defined contribution plan like other private companies do and local governments are

going toward now, or is it a defined benefit plan like one of the older pension type plans?

THE WITNESS: Well, the pension plan that we have is technically a defined benefit plan under accounting rules. But when I describe to you how it works, it looks a lot like a defined contribution plan in that the benefits accrue for an employee based on a percent of annual salary.

So for a non-bargaining employee, for the first five years of employment, it's four-and-a-half percent of salary that accrues in a cash balance style account. And after five years of employment it's six years -- six percent, rather, of base salary.

And each year that account also accrues interest at a rate of about four percent on the balance of the account. So that would kind of look and feel to an employee more like a defined contribution plan, but under accounting rules it is a defined benefit plan.

Our 401(k) is, you know, a plan that if the employee defers a portion of base salary through an elective, an election, then the company will match up to 4.75 percent.

When we benchmark our defined benefit and defined contribution plans, we make sure to do it as a combined total retirement savings value, because it would not be

appropriate to just benchmark them separately. So when we benchmark against other utilities as --

COMMISSIONER BALBIS: Well, I'm not -- I understand your benchmarking process and I think you do a very good job of benchmarking, so I'm very comfortable with your benchmarking. I just want to make sure I understand the pension plan.

So you said for the employee it seems more like a 401(k) plan. So the company matches a certain percentage based on the tenure of the employee and then those dollars get invested, I assume, into some program.

Is the company at risk if the performance of those investments falters, or is the employee at risk? Who takes on that risk? Because then, in my mind, that would shift more from more of a defined benefits plan than a defined contribution plan.

THE WITNESS: You've really hit the nail right on the head, Commissioner Balbis, because that is the difference between the defined benefit and the defined contribution plan. In the defined contribution plan, the 401(k), the employee bears the risk of investment. They select their investments with the exception of certain limitations on moving out of the employee stock fund for the company match.

But in the defined benefit pension plan, there is

no investment by the employee in any kind of group of funds, it's simply you're going to get interest credit at the end of the year on your account, and the employer is investing the pension fund asset, and that expense is recognized in our budget. So that's a significant difference between the two.

COMMISSIONER BALBIS: Okay, thank you. That's all I have.

CHAIRMAN BRISE: Commissioner Graham.

COMMISSIONER GRAHAM: Thank you, Mr. Chair. Welcome, Ms. Slattery. One of the benefits of being last is most of my questions get asked before it comes to me. I have about two left, though.

Are you aware that this Commission, for about the last two years, hasn't given any salary increases for your non-bargaining employees or executives short of -- short of settlements or stipulations?

THE WITNESS: No, I was not aware of that.

COMMISSIONER GRAHAM: Okay. I'm looking at the Exhibit 531. I think it's OPC's Second Set of Interrogatories, number 37.

THE WITNESS: Yes.

COMMISSIONER GRAHAM: And somebody added these up earlier where the non-bargaining was 10 percent since first quarter '09 and bargaining was 14.65; do you

recall that?

THE WITNESS: That's correct.

COMMISSIONER GRAHAM: I guess the question I have, this Commission, my understanding from talking to Staff, for at least the last 25 years, has always given the companies anything that was negotiated on the bargaining table. Those salary increases, for lack of a better word, were just passed through.

My question is, what motivates Florida Power & Light to get to the bargaining table and fight hard to make sure that those numbers are down and just basically not give away the farm?

THE WITNESS: Well, we're highly motivated to ensure that although we're fair to the bargaining unit, we would not want to essentially provide motivation for additional unionization of the work force. We feel it's best to deal directly with our employees. We think that that's always the best way. And that, furthermore, our ability to provide variable performance-based compensation to our non-bargaining employees directly benefits our customers.

So we do not want to incent additional portions of our workforce to unionize, so we would never be incented to give a better deal to the bargaining unit than we do to the non-bargaining unit. And the

percentages reflected for '09 are a factor of the length of time that the bargaining unit went without an increase during a period of extended negotiations with the company in '08 and 09. I hope that gives you some comfort around our motivation to work hard to ensure we don't give more than we have to.

COMMISSIONER GRAHAM: To follow up on that question, what's happened since first quarter '09 to the end of this chart?

THE WITNESS: This reflects negotiations with the bargaining unit that we feel are appropriate based on information we receive, particularly through surveys such as Ed Powell, which provides a lot of information about the hourly workforce that we have and what the market value of their jobs are.

Additionally, with this chart, Commissioner, I want to assure you that we have provided, through the discovery process, evidence that we are in receipt of a number of market surveys from very well-respected third-party survey companies which aggregate data from around the United States, such as WorldatWork, which every year surveys more than 4,300 employers.

And it shows that for WorldatWork, Mercer, Hewitt, M-sight (phonetic) and other sources, that 3 percent salary increases are market median for the utility

industry and general industry for 2013, 2012 and 2011. That 2.7 percent was the market median for 2010, and 2.5 percent was the market median for 2009.

COMMISSIONER GRAHAM: Okay, that's all I have.

CHAIRMAN BRISE: Commissioner Balbis.

COMMISSIONER BALBIS: Thank you. I just wanted to follow up on Commissioner Graham's questioning. That brought something up that I did not ask. And I think I have the same concerns, at least it sounds like, of Commissioner Graham, that the time frame on that chart just happens to coincide when this state and the country has been going through a severe recession. So that's why I'm glad you were able to explain some of the situation associated with 14.65 percent pay raises over that period and 10 percent for the other employees.

But my question is about the merit adjustments in this FIPUG's First Set of Interrogatories. I think it's 535, the exhibit, but I might have missed one or two numbers.

Your answer to the question where the paragraph is indented, is that from -- are those guidelines, are those the only published guidelines associated with the merit adjustments?

THE WITNESS: I apologize, Commissioner Balbis, I want to make sure I have the right exhibit. Can you

please tell me which interrogatory response this is?

COMMISSIONER BALBIS: It's FIPUG's First Set of Interrogatories, interrogatory number 9, page one of two.

THE WITNESS: I have it. Regarding --

MS. CLARK: Is there an exhibit number so I --

COMMISSIONER BALBIS: I thought it was 535, but maybe --

CHAIRMAN BRISE: It is 535.

MS. CLARK: Got it. Thank you.

COMMISSIONER BALBIS: My question, again, the merit adjustment that's listed, is that the only published document or guidelines for managers to use in assigning the merit -- any merit pay?

THE WITNESS: No, every year in advance of merit we have leadership training for merit that's applicable to that year, and we hand out guidelines which include suggested base salary merit increase percentages for each category of employee performance, whether they outperform their goals -- we have a one through five scale for employees.

So we suggest stratifying the awards based on the performance rating, but we also recognize that the supervisor needs to take into consideration that employee's position to market, based on their market

reference point. So we want to make sure that we are providing market competitive salaries; we don't want to be too high, we don't want to be too low. We have to take into account internal equity, as well.

COMMISSIONER BALBIS: Okay. The reason why I'm asking is I just want to ask you, how does this Commission know that the performance goals that are associated with this merit program benefit the customers?

THE WITNESS: Well, we've provided through discovery a description of our corporate goals on an annual basis, which include customer satisfaction, survey ratings, generation availability, service reliability, safety, environmental compliance, hitting our O&M budget targets and capital budget targets, and these are all very customer-focused operating metrics.

We've also provided through discovery a description of how we -- how our business units align; there are business unit goals each year to those corporate goals. And then supervisors are responsible for ensuring that each individual employee aligns to their business unit goals. So in this way we have line of sight to these customer-focused metrics.

And it may also give you some comfort to know that my staff and I perform a thorough audit of all of the

merit awards that are entered into the system prior to running them through payroll. So we want to make sure that we have an appropriate distribution of awards by a performance rating of employee before we actually let it flow through payroll. And we go looking for explanations of outliers.

COMMISSIONER BALBIS: Okay, I think that answers my question. I guess my last follow-up question to that, are any of the company's goals that provide that line of sight, as you said, have anything to do with the financial performance of the company or NextEra?

THE WITNESS: No, they do not.

COMMISSIONER BALBIS: Okay. Thank you, that's all I have.

CHAIRMAN BRISE: Okay. Any further questions, Commissioners? Seeing none, redirect?

MS. CLARK: I have a few.

REDIRECT EXAMINATION

BY MS. CLARK:

Q I think I want to touch first on a question that you got from Commissioner Brown regarding post-retirement medical benefits. Has there been a change in that? In other words, are current employees eligible for that?

A No, no employee hired since April 1st, 1997 has been eligible for post-retirement medical coverage.

Q And Commissioner Balbis asked you some questions regarding temporary labor, I think, and you also talked about temporary employees. Could you make -- distinguish between the two?

A Temporary labor and temporary employees, as I've used that term today, is an FPL employee on FPL payroll who has been hired on a project-bound or time-bound basis for a duration of six months or less.

It's primarily used for our nuclear business unit, so they can have a scaleable workforce for outages. So it's been heavily utilized for the last several years for the extended power uprates project and will be through 2013, as well. I did not mean to use the term in reference to contract labor or folks that come in through third-party vendors and are not on FPL payroll.

Q You were asked some questions by Mr. Saporito that had reference to unemployment statistics. Do you remember that?

A Yes, I do.

Q Do you have some information about the level of employment in the utility industry?

A I do not have any specific data, but unemployment in the utility industry is less than Florida average or national average. It is an industry where there is a documented shortage of skilled replacement workers for our

aging workforce, and so for the majority of our positions we are competing in the market for skills that are in short supply. And frequently these skills are not transferable from other industries where unemployment is higher.

Q Early on I think you were asked a question about the goal setting process. Could you explain how that goal setting is done and how those goals are communicated to the employees?

A Yes. The corporate goals for the organization are determined in the fall of each year in advance of the coming year so that there's time to communicate them across the organization. They are determined by senior leadership and are set based on industry benchmarks.

We want our goals to be challenging yet achievable because we don't want to make them too easy but yet we don't want to demotivate the workforce, either. So our industry benchmarks, we generally look for top quartile or top decile performance as our goal. And then, after we've set those goals and senior leadership has approved them, they're communicated to the business units, who in turn set business unit goals which are to align to them.

And then, in turn, in January of each year every supervisor in the company must sit down with each non-bargaining employee and set individual goals which align to the business unit goals, which, again, in turn, align to

the corporate goals.

Q Could you give us an example of the goals? In other words, are there goals that are tied to availability of units, reliability standards?

A Yes, the corporate goals for Florida Power & Light Company generally include operations and maintenance costs and capital costs. In other words, hitting budget targets, which is, you know, something that throughout our culture is emphasized as important; fossil generation availability; nuclear industry composite rating -- usually we use the invo (phonetic) index -- service reliability in minutes, and also average frequency of customer interruptions and average number of momentary interruptions per customer.

We always have an employee safety goal, which we usually use OSHA recordables per 200,000 hours worked. And customer satisfaction survey scores for residential and business customers, as well as compliance with environmental FERC and NERC requirements.

Q You were also asked a question -- and this is with regard to Exhibit 536 -- and this is titled incentive compensation. You were asked a question about the last paragraph of that answer. Are you there?

A Yes.

Q It is -- I'm sorry -- it's OPC's Second, interrogatory 40.

A Yes, I have that.

Q Could you give us some idea of the magnitude of the limited participation project specific incentive program?

MR. REHWINKEL: Mr. Chairman, before we continue with this, I kind of want to interpose an objection. It seems to me the purpose of redirect is to kind of give the witness an opportunity to address a point that was made in cross examination in an adversarial sense. And I'm just not sure what the question was that is being redirected, specifically, and whether this is soliciting just supplemental direct testimony. And I'm just kind of struggling with what the redirect is at this point.

MS. CLARK: Mr. Chairman, she was asked a direct question about this paragraph regarding this incentive program. I'm just asking her to explain the magnitude of the dollars in it.

CHAIRMAN BRISE: Okay, I'll allow it.

THE WITNESS: The dollars are very small because we don't use limited participation project specific incentive programs very often. We may have one or two going at any -- in any year, with less than $500,000 in them.

BY MS. CLARK:

Q You were asked a number of questions about the determination of market comparable pay, and I think you were

directed to page 12 and 13 of your testimony, the bottom of page 12 and top of 13. And you mentioned the fact that you use third-party compensation surveys both with regard to national surveys and regional surveys.

Are these the type of surveys professionals in your position rely on to determine market --

MR. URBAN: Mr. Chair, I'm going to have to object. It's leading the witness.

MS. CLARK: I think I can do that on redirect. Well, fine, I'll rephrase it.

BY MS. CLARK:

Q Could you describe these salary surveys that you use in determining market-based pay?

MR. REHWINKEL: Mr. Chairman, I want to renew my objection. I asked the question about this, and I basically just asked her if that was her testimony. There's no issue that needs to be redirected. I think it is, again, soliciting supplemental direct testimony.

MS. CLARK: May I respond, Mr. Chairman?

CHAIRMAN BRISE: Sure, you may respond.

MS. CLARK: My inquiry along these lines is with respect to the questions by the attorney for FEA, and the suggestion that the people who prepared those surveys are not here or that in the last case we had a person here to testify as to the reasonableness of that

salary.

Ms. Slattery has been presented as an expert in compensation. And as an expert she is entitled to rely on market data, surveys, or information that individuals in her profession routinely rely on. And for that reason I am cross examining -- I am redirecting her to ask her whether or not these are the type of information that professionals in her position rely on.

In other words, Mr. Chairman, FEA has made a suggestion that by not producing those people who may have compiled the surveys, that Ms. Slattery cannot rely on them in terms of determining market position. The evidence code allows professionals in her position to rely on such surveys, and I'm just establishing that point.

CHAIRMAN BRISE: Okay.

MR. URBAN: If that was their position, then they should have put that in their direct testimony, Mr. Chairman.

MS. CLARK: Well --

CHAIRMAN BRISE: I'm going to go ahead and rule. You have one question on this, right?

MS. CLARK: I would just ask her with regard to the third-party compensation survey sources, are they the sources people in her profession rely on in determining

market salaries.

CHAIRMAN BRISE: Okay. I think that's a fair question.

THE WITNESS: Yes, they are. We must rely on salary surveys that provide aggregated data compiled by well-respected national survey companies because we cannot, under antitrust law, benchmark directly with one another in our industry, so this is the way that we benchmark it. All professionals in compensation do it this way.

BY MS. CLARK:

Q And you resorted to those same surveys in determining the percentages of merit pay increases, is that right?

MR. LaVIA: Leading, Your Honor.

CHAIRMAN BRISE: Ms. Clark, I provided you some latitude.

BY MS. CLARK:

Q Ms. Slattery, would you describe the process that you went through in determining appropriate salary increases for FPL employees?

A Yes, we purchased the market surveys --

MR. MOYLE: I'm going to object to that. I mean, that's a direct question that should have been in the direct testimony, and here it is, you know, tell us

about the process you went through to determine the salaries. I mean, you know, that's wide open, you know, soliciting live direct testimony. I mean, that's improper.

MS. CLARK: Mr. Chairman, I'm just reinforcing what is in the direct testimony based on what was asked in cross. And I believe if you look at page 12 and 13 you will find a reference to that process of determining market-based pay. He asked questions about it on cross. I'm simply asking her to explain again the process.

CHAIRMAN BRISE: Mary Anne?

MS. HELTON: Mr. Chairman, if we're explaining again, Chapter 120 says that irrelevant, immaterial or unduly repetitious evidence shall be excluded. So it seems to me that we are getting into the repetition arena.

CHAIRMAN BRISE: Okay. Okay. So we will -- if you can deal with questions that need specific clarification from questions that were posed during cross examination.

MS. CLARK: Yes, Mr. Chairman.

CHAIRMAN BRISE: Thank you.

BY MS. CLARK:

Q You had some questions from Mr. Moyle regarding employee salaries. Do you recall that?

A Yes, I do.

Q And are you aware that Mr. Moyle represents some of the large industrial customers in Florida?

A Yes.

Q And would they employ a number of professionals such as the engineers and accountants?

MR. MOYLE: I'm going to -- objection, relevancy, beyond the scope of the -- of the cross.

MS. CLARK: I'll ask -- I'll rephrase the question.

CHAIRMAN BRISE: Please do.

BY MS. CLARK:

Q Given the customers that Mr. Moyle represents, would you expect the average compensation for those employees to be below the Florida per capita income?

MR. MOYLE: Same objection.

MR. LaVIA: Leading.

MR. MOYLE: Relevancy, leading, and, you know, my clients and their salaries are not at issue in this case.

CHAIRMAN BRISE: Yeah, I think I agree with that.

MS. CLARK: I'll move on.

BY MS. CLARK:

Q Ms. Slattery, I want to refer you to questions you had about FP&L's total compensation. And I want to be clear that FPL's total compensation, including incentive compensation, is included in O&M expenses, is that correct?

A Could you please rephrase that?

Q Yes. Can you tell me what of FPL's compensation is included in O&M expenses?

A So the net O&M payroll amount in the filing?

Q I just want to establish that that is included in O&M expenses, is that correct?

A Yes, it is.

Q With regard -- if you know -- do you recall that Mr. Reed did some O&M benchmarking and in that do you know if FPL, in benchmarking relative to its peers, did -- was there an amount included for compensation, if you know?

A I do recall from --

MR. URBAN: I'm going to have to object, Mr. Chairman. This is another leading question. She's continuing to ask leading questions here on redirect and this is a real abuse of the process. Furthermore, it's outside the scope of the testimony.

CHAIRMAN BRISE: Ms. Clark, if you could restate the question, please?

BY MS. CLARK:

Q I will. Thank you. Ms. Slattery, you are familiar, are you not, with the benchmarking that Mr. Reed did and provided in this proceeding?

A Yes, I am.

Q And in that he -- are you aware that -- let me ask

that --

MR. URBAN: I'm going to have to object, Mr. Chairman. Once again, this is beyond the scope of her testimony. She's asking leading question after leading question. This -- this -- this needs to stop.

MS. CLARK: I apologize, Mr. Chairman. I was just trying to hurry this up a little bit.

BY MS. CLARK:

Q With regard to Mr. Reed, again -- and I'll be quick about this. With regard to peer groups, was there -- can you tell us what he did in comparison with total compensation? Was there a comparison there?

MR. URBAN: Mr. Chairman, I don't -- I have no idea what this is tied to, which cross examine question she's actually redirecting on.

MS. CLARK: I think I've gotten the answer to my question, and my question was, does she know if incentive comp is included in total comp and is that included in O&M.

CHAIRMAN BRISE: Okay. So that was an actual question, right?

MS. CLARK: Let me ask it again, Mr. Chairman. I apologize.

BY MS. CLARK:

Q Does FPL's total compensation include incentive

compensation in the amount that is included in O&M?

MR. URBAN: Objection, leading.

BY MS. CLARK:

Q Let me ask, what does total compensation consist of?

A The total compensation expense included in the O&M request does include 100 percent of non-executive performance-based variable compensation. It excludes 100 percent of executive incentive compensation and a portion of non-executive stock-based compensation.

MS. CLARK: Thank you, Mr. Chairman.

CHAIRMAN BRISE: Thank you. Exhibits.

MS. BROWN: Mr. Chairman, if I might pass out what FP&L has told me is the most current errata sheet to Ms. Slattery's deposition. And then I think we'll be copasetic on the deposition.

CHAIRMAN BRISE: Sure. That would go with 111?

MS. BROWN: Yes.

CHAIRMAN BRISE: Okay. Yes, Mr. Moyle?

MR. MOYLE: So I'm just not particularly clear where we are right now, process and procedure-wise, with respect to this witness and the exhibits. Mr. Rehwinkel raised a concern about some of the late filed exhibits and that he had just seen them and he wants some latitude to ask questions on them. We're getting

another exhibit handed out now.

And I -- in the discussion that was had with this witness, she was asked some questions and provided testimony on information that was not, I do not believe, in her direct testimony. And so she's provided additional information that -- we can handle it on rebuttal if there's latitude given to do so.

But some of the -- you know, the exhibits and the testimony that she provided in response to questions from the bench has prompted some further questions on behalf of FIPUG. We're happy to hold them, but I don't want to be, you know, confronted with objections to that if we're going to hold them for rebuttal. So I was really just kind of seeking clarification on that point.

CHAIRMAN BRISE: All right. Well, the document that is being offered right now was one that we discussed at the beginning of this witness coming up when Staff offered their deposition. And there was a question about an errata sheet, and this is the errata sheet that is following Exhibit 111. So that's what this is.

MR. MOYLE: Okay.

CHAIRMAN BRISE: We had some discussion about some late filed documents -- late filed exhibits, and there was the request for latitude with respect to those

exhibits -- I mean, those exhibits under rebuttal to deal with some of the issues that were brought up within those exhibits. So we recognize that, and we'll probably allow some latitude with respect to that.

With respect to the redirect, I think there was one question that it took -- I don't know -- maybe five or six times to get to the right posture to actually ask the question so that it could be answered. And there was a lot of objections without an actual answer being offered to the question. So if latitude needs to be provided, it will be provided on rebuttal so that issues can be dealt with there.

MR. MOYLE: Okay, thank you, I appreciate that. Just so we're clear, some of what I intend to ask was raised in response to questions from Commissioner Balbis. So as long as I have the latitude to -- she talked about a pension --

CHAIRMAN BRISE: No, let's be clear. The only latitude that will be provided is latitude based upon if you felt that some of the questions that were posed during redirect led to new issues. Questions raised from the bench are questions raised from the bench, and that's that. So you wouldn't have an opportunity after that to pose those questions. So that's the only latitude that would be provided in rebuttal.

MR. MOYLE: Okay. So I guess -- I mean, just the question -- just so the record is clear, the questions I was going to ask relate to her testimony with respect to the pension and how it's calculated and the details of that. I didn't find that in her direct testimony. I was going to do some follow-up, given the questions from the bench. You've overruled that, so we'll move on.

MR. LITCHFIELD: Mr. Chairman, I thought that, yes, that we had identified three late fileds and there was an initial objection -- or not necessarily an objection, but a qualification request for clarification from OPC that they would be entitled to review those and then take up any questions on those three late fileds on rebuttal.

CHAIRMAN BRISE: On rebuttal.

MR. LITCHFIELD: And that's acceptable to us, and we're indifferent as to whether those are marked and -- or, excuse me, they've been marked -- moved now or later. We are really indifferent on that point.

MS. BROWN: We can move them in later. We do want to move in the deposition and the errata sheet today.

MR. REHWINKEL: Mr. Chairman, with the clarification and the latitude that you've recognized, I have no problem with all four -- five documents going in as one package, because they do all relate to the same

deposition. So I'm comfortable with that as long as I have some limited opportunity on rebuttal, if need be.

MS. BROWN: Well, then, at the appropriate time we'll move all those documents.

CHAIRMAN BRISE: All right. Thank you. Back to exhibits. FPL, what do we have for Ms. Slattery?

MS. CLARK: Thank you, Mr. Chairman. FPL would move Exhibits 185 to 192.

CHAIRMAN BRISE: Okay, 185 through 192. Any objections? Okay, seeing none, we'll move 185 through 192 into the record.

(Exhibits 185, 186, 187, 188, 189, 190, 191 and 192 admitted in evidence.)

MR. MOYLE: FIPUG would offer 531 and 532.

CHAIRMAN BRISE: Okay, 531 and 532 by FIPUG. Any objections? Okay, seeing none, we'll move 531 and 532 into the record.

(Exhibits 531 and 532 admitted in evidence.)

CHAIRMAN BRISE: South Florida Hospital Association?

MR. URBAN: Yes, we would like to move exhibits marked 533 to 537 into the record.

CHAIRMAN BRISE: Okay, we will move 533 through 537 into the record. Are there any objections?

MS. CLARK: No objections.

CHAIRMAN BRISE: Okay, seeing none. Mr. Saporito?

(Exhibits 533, 534, 535, 536 and 537 admitted in evidence.)

MR. SAPORITO: Yes, Mr. Chairman, I would like to move 538 and 539 into the record.

MS. CLARK: No objection.

CHAIRMAN BRISE: Okay. Any objection? Seeing none, we'll move 538 and 539 into the record.

(Exhibits 538 and 539 admitted in evidence.)

CHAIRMAN BRISE: Staff?

MS. BROWN: Yes, Mr. Chairman, Staff would move Exhibit 111, as amended with the errata sheet, and Exhibits 540, 541 and 542 as the late filed exhibits to the deposition.

CHAIRMAN BRISE: Okay. So we will move into the record Exhibit 111, with the latest errata sheet, 541, and 542. Any objections?

MS. BROWN: And 540.

CHAIRMAN BRISE: And 540. Thank you.

MS. CLARK: No objection.

CHAIRMAN BRISE: Okay, seeing no objections, 111, 540, 541 and 542 will be moved into the record.

(Exhibits 111, 540, 541 and 542 admitted in evidence.)

MS. CLARK: Ms. Slattery will come back on rebuttal, Mr. Chairman.

CHAIRMAN BRISE: Rebuttal? So do we need to excuse her from direct?

MS. CLARK: If that's the current process, yes, could you please excuse her from direct.

CHAIRMAN BRISE: All right, you may be excused from direct. Thank you.

MR. YOUNG: Mr. Chairman?

CHAIRMAN BRISE: Yes, sir.

MR. YOUNG: If I can beg the Court's indulgence to take a five-minute break to set up the Avera -- Staff's questions on Avera and everything else, to talk to the parties.

CHAIRMAN BRISE: Okay.

MR. YOUNG: Maybe four.

CHAIRMAN BRISE: Okay. All right. It is 4:25, so we'll -- 5:30 -- I mean, 4:30, we'll got to 4:30.

(Brief recess)

CHAIRMAN BRISE: We're going to go ahead and reconvene at this time. Mr. Young?

MR. YOUNG: Yes, sir. It is my understanding that FEA has a possible request. I think all the parties have agreed to possibly stipulating their witness, Stephens.

CAPT. MILLER: That's correct.

CHAIRMAN BRISE: Okay. Is that everybody's desire

to stipulate witness Stephens? I need to hear affirmative.

MR. MOYLE: No objection from FIPUG.

CHAIRMAN BRISE: Okay.

MR. LITCHFIELD: No objection.

MR. SUNDBACK: No objection from the hospitals, Mr. Chairman.

CHAIRMAN BRISE: Okay.

MR. HENDRICKS: No objection.

MR. SAPORITO: I will stipulate to whatever OPC stipulates to.

MR. LaVIA: No objection.

MR. McGLOTHLIN: We do not object to stipulating that witness.

CHAIRMAN BRISE: Okay, thank you. Mr. Young, anything else that we need to take care of?

MR. YOUNG: No, sir, not at this time.

MR. LITCHFIELD: FPL calls Dr. Avera to the stand. I don't believe he's previously been been sworn.

Thereupon,

WILLIAM E. AVERA

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

DIRECT EXAMINATION

BY MR. GUYTON:

Q Please state your name and business address.

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

Q And by whom are you employed and in what capacity?

A I'm the President of FINCAP, Incorporated.

Q And have you prepared and caused to be filed 90 pages of direct testimony in this proceeding?

A Yes, sir.

Q Do you have any changes or corrections to your prefiled direct testimony?

A No, sir.

Q If I were to ask you the same questions today as are contained in your prefiled direct testimony, would your answers be the same?

A They would.

MR. LITCHFIELD: Mr. Chairman, we ask that Dr. Avera's direct testimony be inserted into the record as though read.

CHAIRMAN BRISE: Okay, we will insert Dr. Avera's testimony into the record as those read.

Q. Please state your name and business address.

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

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

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

I. OVERVIEW

Q. What is the purpose of your testimony?

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

Q. Are you sponsoring any exhibits in this case?

A. Yes. I am sponsoring Exhibits WEA-1 through WEA-18, which are attached to my direct testimony.

- WEA-1, Qualifications of William E. Avera
- WEA-2, Interest Rate Trends
- WEA-3, Comparison of Proxy Group Risk Indicators
- WEA-4, DCF Model – Utility Proxy Group
- WEA-5, Sustainable Growth Rate – Utility Proxy Group

- WEA-6, Implied Utility Bond Yields
- WEA-7, DCF Model – Non-Utility Proxy Group
- WEA-8, Sustainable Growth Rate – Non-Utility Proxy Group
- WEA-9, CAPM – Utility Proxy Group
- WEA-10, Yield spreads
- WEA-11, Electric Utility Risk Premium
- WEA-12, Expected Earnings Approach
- WEA-13, Summary of Cost of Equity Estimates
- WEA-14, FPL Adjusted Capital Structure
- WEA-15, Capital Structure – Electric Utility Operating Cos.
- WEA-16, Capital Structure – Utility Proxy Group
- WEA-17, Market Value Capital Structure – Utility Proxy Group
- WEA-18, Endnotes to Direct Testimony of William E. Avera

Q. Are you sponsoring or co-sponsoring any Minimum Filing Requirements ("MFRs")?

A. No.

Q. Please describe your educational background and professional experience.

A. A description of my background and qualifications, including a resume containing the details of my experience, is attached as Exhibit WEA-1.

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

A. I am familiar with the organization, finances, and operations of FPL from my participation in prior proceedings before the FPSC. In connection with the

present filing, I considered and relied upon corporate disclosures, publicly available financial reports and filings, and other published information relating to FPL, including bond rating agency reports, financial filings, and prior regulatory proceedings and orders. I also reviewed information relating generally to current capital market conditions and specifically to current investor perceptions, requirements, and expectations for FPL. These sources, coupled with my experience in the fields of finance and utility regulation, have given me a working knowledge of the issues relevant to investors' required return for FPL, and they form the basis of my analyses and conclusions.

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

A. I determined that 11.25% represents a fair ROE for FPL, which falls at the middle of my recommended range of 10.25% to 12.25%. This conclusion is based on several factors. I applied four accepted methods of estimating ROE to a proxy group of fourteen other utilities with comparable investment risks. Consistent with the fact that utilities must compete for capital with firms outside their own industry, I also referenced a proxy group of companies selected from the least risky, most stable and mature participants in the non-utility sectors of the economy. In addition, my testimony examines the unique financial challenges facing FPL that must be considered in evaluating a fair ROE range from within the proxy group results, and in order to recognize FPL's requirements for financial strength and benefit customers.

I also present the regulatory precedent supporting the 25 basis point adder to recognize FPL's excellence in management, superior service, and its achievement of low rates for its customers. Other FPL witnesses document FPL's accomplishments, while my testimony demonstrates how the proposed adder is consistent with FPSC regulatory policy and objectives. Finally, my testimony demonstrates that FPL's capital structure is consistent with my fair ROE range and necessary to meet the financial challenges facing FPL.

Q. Is the requested ROE a reasonable cost for FPL's customers to pay?

A. Yes. Investors have many options vying for their money. They make investment capital available to FPL only if the expected returns justify the risk. Customers will enjoy reliable and efficient electric service so long as investors are willing to make the huge capital investments necessary to maintain and improve FPL's electric system. Providing an adequate return to investors is a necessary cost to ensure that capital is available to FPL now and in the future. If regulatory decisions increase risk or limit returns to levels that are insufficient to justify the risk, investors will look elsewhere to invest capital. The availability of capital is particularly important to FPL's customers because of the need for financial strength inherent in FPL's location and characteristics.

Q. Have customers benefited from FPL's past financial strength?

A. Yes. The shocks that have roiled the capital markets in recent years have made investors wary of putting their money into anything other than the safest investments. During the credit crisis, for example, utilities were forced to draw on short-term credit lines to meet debt retirement obligations because of

uncertainties regarding the availability of long-term capital,[1] while others were effectively shut out of the commercial paper market altogether.

In contrast to the experience of many other utilities, FPL has been able to raise funds on reasonable terms, even in times of financial turmoil. The FPSC Staff in its December 23, 2009 Memorandum for Docket Nos. 080677-EI and 09130-EI ("Staff Memorandum") observed:

> FPL's position of financial strength has served it and its customers by holding down the Company's cost of capital. During the recent volatility in the capital markets, many companies experienced sharp spikes in their cost to borrow. In some instances, companies had to accept rates as high as 10% to issue bonds. In the case of FPL, however, due to its strong financial position it was able to sell 30-year bonds at rates under 6% during 2008 and 2009 despite significant disruption in the credit markets.[2]

Unfortunately, the market uncertainties that began in 2008 have lingered as domestic political shocks and foreign financial difficulties have continued to buffet investors. Yet FPL must continue to make significant new capital investments to keep its system efficient and reliable for the customers it serves. If FPL can raise private capital for these vital infrastructure investments, both its customers and the economy of Florida will benefit. In the past, FPL's financial strength, fostered by the support of this Commission, has served customers well

as the Company has been able to raise capital on a reasonable and timely basis to meet past challenges such as devastating storms. To maintain its position of strength and navigate through the current financial shoals, FPL needs the FPSC's support. FPL must be in a position of financial strength to attract private capital on reasonable terms from investors whose first instinct is to rush to the safety of U.S. Treasury securities.

Q. Has the FPSC Staff recognized that customers save money in the long-run if they are served by a financially strong utility?

A. Yes. The Staff Memorandum in FPL's 2009 rate case cited evidence to demonstrate that FPL customers would pay a lower capital cost in their rates than the Commission had ordered for Tampa Electric Company ("TECO") *even if the Commission had approved FPL's requested ROE and capital structure*:

> The goal of an appropriate equity ratio and capital structure is to minimize the overall weighted average cost of capital and to maintain consistent access to capital on reasonable terms. This is an important consideration in that it's the overall cost of capital that is used to determine revenue requirements and ultimately customer rates. The overall cost of capital of 8.29 percent approved in the TECO rate case was based on an ROE of 11.25 percent and an equity ratio of 54.0 percent as a percentage of investor capital. Due to its ability to raise capital from a position of financial strength, even at the proposed ROE of 12.5 percent

and an equity ratio 59.1 percent, FPL's requested overall cost of capital is 7.85 percent.[3]

The FPSC Staff was observing the fundamental truth that it is FPL's customers that ultimately benefit when the utility providing service has a strong credit rating, supportive regulation, and excellent management.

Q. What role does FPSC regulation play in saving FPL's customers money through supporting investor confidence and rewarding superior performance?

A. Regulatory signals are a major driver of investors' risk assessment for utilities. Security analysts study commission orders and regulatory policy statements to advise investors where to put their money. If FPSC actions instill confidence that the regulatory environment is supportive, investors make capital available to Florida's utilities on more reasonable terms. As FPL's past experience indicates, when investors are confident that a utility has supportive regulation, they will make funds available even in times of turmoil in the financial markets. Moreover, suppliers of fuel, replacement power, equipment, and the other goods and services necessary to keep the lights on in Florida will offer more favorable terms to a financially strong utility operating under constructive regulation than to a utility whose financial wherewithal is suspect. Since the FPSC is FPL's primary utility regulator, investors and suppliers look to the FPSC to assess regulatory support behind FPL's financial and contractual obligations. When FPL can negotiate from a position of financial strength it will get a better deal for its customers.

Q. What is the danger to FPL's customers when investors and suppliers doubt the FPSC's regulatory support of the Company?

A. FPL's customers become exposed to less reliable and more expensive electric service. Consider the effect of the FPSC's 2010 rate order in Docket Nos. 080677-EI and 09130-EI. The 10% ROE was unsettling to investors because it was such a low ROE for an electric utility in Florida and the decision was viewed as a departure from the FPSC's tradition of supportive regulation protected from political influence. As described in FPL witness Dewhurst's testimony, the bond rating agencies responded with negative assessments, including downgrades of FPL's bond rating by Moody's Investors Service ("Moody's") and Standard & Poor's Corporation ("S&P"). When the parties reached a settlement that allowed FPL to earn an ROE of 11%, investors reacted with relief that the previous decision may have been a temporary deviation from FPSC tradition of regulatory support.

Q. Do customers benefit when investors have confidence that the regulatory environment is constructive?

A. Yes. The challenging capital market environment highlights the benefits of the ability in attracting the capital needed to secure reliable service at a lower cost for customers. Changing course from the path of financial strength would be extremely short-sighted. Customers and the economy of Florida have benefited from FPL's financial flexibility and ability to raise capital on reasonable terms. If investors perceived that the Commission was withdrawing its support for FPL's financial strength at this crucial juncture, then it would likely take a long time to

re-establish the well-deserved reputation that this Commission had earned among investors. By helping sustain FPL's financial strength, the FPSC will facilitate the flow of capital on reasonable terms that is required for the Company to maintain and improve the electric infrastructure so vital to Florida's economic recovery and future growth.

Q. Is the ROE in this case an important signal to investors?

A. Yes. In setting the ROE in this case, the FPSC has an opportunity to show that it recognizes the importance of financial strength and it will reward superior performance by a utility. A constructive outcome will confirm that the FPSC has returned to the regulatory policy of supportive regulation and that the investors should not expect that the 10% ROE in the last case signals a change in the regulatory climate in Florida. By allowing an ROE in this case that reflects capital market realities and FPL's unique financial challenges while providing justified ROE adder for superior performance, the FPSC will reassure investors of the regulation in Florida has returned to its tradition of fairness and innovation.

Q. Does FPL have any unique characteristics that make it more important to maintain financial strength and regulatory support?

A. Indeed it does. FPL's location and fuel mix give its customers a larger stake in the Company's financial strength and regulatory support compared to other electric utilities in Florida and the rest of the nation. FPL's exposure to devastating storms requires that FPL mount huge recovery efforts that require ready availability of money and credit. FPL's nuclear generation, while saving customers significant energy costs, can necessitate huge unexpected expenditures.

FPL's dependence on natural gas, while having economic, environmental, and operational advantages benefiting customers, has volatile prices and exposure to transportation disruptions. FPL's unique location at the end of the Florida Peninsula increases the challenges of accessing the nation's energy infrastructure. In addition, FPL's service area is exposed to economic fluctuations and requires large capital investments to support customer growth. FPL must be prepared to meet these challenges even when confronting capital market conditions that might restrict access for utilities with weaker financial profiles or lacking effective regulatory support.

Q. Can the FPSC be confident that allowing an ROE in the 10.25% to 12.25% range represents a reasonable cost for FPL's customers?

A. Yes. The ROE compensates common equity investors for the use of their capital to finance the plant and equipment necessary to provide utility service. Investors commit capital only if they expect to earn a return on their investment commensurate with returns available from alternative investments with comparable risks. To be consistent with sound regulatory economics and the standards set forth by the Supreme Court in the *Bluefield*[4] and *Hope*[5] cases, a utility's allowed ROE should be sufficient to: (1) fairly compensate investors for capital invested in the utility, (2) enable the utility to offer a return adequate to attract new capital on reasonable terms, and (3) maintain the utility's financial integrity.

I have developed the range by first estimating investors' required return for a proxy group of comparable risk utilities and a low-risk group of non-utility enterprises using four accepted methods: the discounted cash flow ("DCF") model, Capital Asset Pricing Model ("CAPM"), risk premium method, and the expected earnings approach. In evaluating a reasonable ROE for FPL from within the range of these results, I considered the impact of flotation costs and the imperative of recognizing the unique risk exposures and financial challenges faced by FPL. An ROE in the 10.25% to 12.25% range represents a reasonable and necessary cost to attract investors' funds and to maintain FPL's financial strength.

Q. Is it appropriate to consider customers' stake in FPL's financial strength and encourage effective management and low rates when setting a fair ROE?

A. Yes. The purpose of regulation is to achieve the best possible long-term outcome for customers in terms of economical rates and reliable service. Florida has led the way in innovative and effective regulation. During the early days of the Public Utility Commission of Texas ("PUCT"), I traveled with the chair of that commission to Florida to interview the FPSC commissioners and senior staff about the forward-looking actions of this commission, particularly its use of incentives in regulation. Since that time regulatory agencies around the nation have followed with measures to encourage and support utilities in building financial strength and encouraging effective management.

The Federal Energy Regulatory Commission ("FERC"), over the last decade has effectively supported utilities in attracting capital and encouraging the improvement of the open access transmission grid by allowing ROE's from the upper end of the reasonable range. For example, FERC has allowed an increment of 50 basis points above the base ROE level for membership in a regional transmission organization. Utilities can qualify for additional ROE adders if they demonstrate that they need a higher ROE to attract sufficient capital or they are bringing other benefits to their customers.

A law passed several years ago in Virginia established a new regulatory framework that allows utilities to request an ROE adder of 50 basis points over and above the cost of equity found by the Virginia State Corporation Commission as an incentive for the utility to meet renewable energy goals. In its recent case, Appalachian Power Company was granted the 50 basis point ROE adder in recognition of its achievements.

Similarly, the Florida Legislature has provided the FPSC with the statutory authority to make adjustments to the ROE to recognize a utility's relative performance. Consistent with this statutory guidance, the FPSC has used the ROE as a lever to recognize a utility's effective management, and on occasion signal dissatisfaction with utility behavior. If the FPSC finds that consumers in FPL's service area have benefited from efficient and cost-effective operations, excellent customer service, and relatively low rates, considering the Company's

exemplary performance through a higher ROE is entirely consistent with sound regulatory policy. FPL's customers will clearly benefit in the long run if the ROE in this case reflects the cost of attracting investors' funds and sends a clear signal that the FPSC understands the importance of supporting investors' confidence and encouraging efficient management and low rates. Given FPL's unique characteristics and recent investor concerns about the FPSC's regulatory support, FPL's customers have a stake in a constructive outcome in this case. Just as customers in the free enterprise system win because companies that provide the best value also have the opportunity to earn higher returns, so also do utility customers benefit when regulators allow utilities that provide superior value the opportunity to earn an increment of return.

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

A. Based on my evaluation, I concluded that FPL's projected equity ratio of 59.6% based on investor sources described in the testimony of FPL witness Dewhurst represents a reasonable mix of capital sources from which to calculate FPL's overall rate of return. My analyses demonstrate that while FPL's adjusted common equity ratio falls somewhat above the average maintained by the electric utilities in the proxy group, it is well within the range of individual results for these firms and in-line with the lower leverage expected for the industry going forward. In addition, FPL's regulatory capital structure contains less equity than the market value capital structures relevant to investors for the electric utilities in the proxy group used to estimate the cost of equity.

Absent its relatively conservative capital structure, FPL's financial strength would suffer and its debt rating would undoubtedly be lower than present levels. The resulting greater investment risk would imply an increase in investors' required rate of return for FPL's securities and ultimately higher costs for FPL's customers. Given FPL's need for financial strength due to its exposure to devastating storms, nuclear generation, reliance on natural gas, location at the end of the Florida Peninsula, and economic vulnerability and growth of its service area, FPL customers benefit from a more secure capital structure.

Sensitivity to financial market and regulatory uncertainties has increased dramatically and investors recognize that constructive regulation is a key ingredient in supporting utility credit standing and financial integrity. For a utility with an obligation to provide reliable service, investors' increased reticence to supply additional capital during times of financial turmoil highlights the necessity of preserving the flexibility necessary to overcome periods of adverse capital market conditions.

II. RISKS AND FINANCIAL REQUIREMENTS OF FPL

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

A. As a predicate to my capital market analyses, this section briefly reviews FPL's operations and finances. In addition, it examines the risks that investors take into account in evaluating their required rate of return for FPL, the unique financial

requirements that should be considered in establishing a fair ROE for FPL, and conditions in the capital markets and the general economy.

A. Operations and Finances

Q. Please briefly describe FPL and its parent, NextEra Energy, Inc.

A. Headquartered in Juno Beach, Florida, FPL is engaged in the generation, transmission, and distribution of electric power throughout 35 counties located principally along the east and lower west coasts of Florida. FPL is one of the largest rate-regulated utilities in the U.S., and its service territory includes a population of nearly 8.9 million, with service being provided to approximately 4.6 million customers. FPL is a wholly owned subsidiary of NextEra Energy, Inc. ("NextEra").

NextEra Energy is a leading energy company with over 41,000 megawatts ("MW") of generating capacity, and approximately 14,800 employees in 24 states and Canada. NextEra Energy's principal subsidiaries are FPL and NextEra Energy Resources, LLC, which together with its affiliated entities is the largest generator in North America of renewable energy from the wind and the sun. Through its subsidiaries, NextEra Energy collectively operates the third largest U.S. nuclear power generation fleet.

Q. Please describe FPL's electric utility operations.

A. During 2011, approximately 51% of electric sales were attributable to residential customers, with 42% from commercial and 7% from industrial and other users. With a combined capacity of approximately 24,460 MW, FPL's generating facilities include four nuclear units at the St. Lucie and Turkey Point generating stations, with a total capacity of 2,970 MW. In 2011, nuclear generation accounted for 20% of the electric energy provided by FPL, with natural gas at 65%, oil at 1%, and coal at 5%.

The remaining 9% of FPL's 2011 energy requirements were obtained through purchased power contracts. Take-or-pay purchased power contracts with the Jacksonville Electric Authority and with subsidiaries of The Southern Company provide approximately 1,330 MW of power through 2015 and 375 MW thereafter through 2021. FPL also has various firm contracts to purchase approximately 705 MW of capacity and energy from certain cogenerators and qualifying facilities. FPL estimates that capacity and minimum payments under these agreements will exceed approximately $400 million annually through 2015.

FPL's transmission and distribution facilities consist of over 580 substations and include over 48,000 miles of overhead lines and approximately 25,000 miles of underground and submarine cables. As of December 31, 2011, FPL's investment in utility assets was approximately $31.8 billion. FPL's retail electric operations are subject to the jurisdiction of the FPSC, with the interstate jurisdiction

regulated by FERC. Additionally, FPL's nuclear facilities are subject to licensing and oversight by the Nuclear Regulatory Commission. FPL's latest decommissioning studies indicate that FPL's portion of the cost of decommissioning its four nuclear units, including costs associated with spent fuel storage, to be $6.2 billion. As of December 31, 2011, the accumulated provision for nuclear decommissioning totaled approximately $2.8 billion.

Q. What credit ratings have been assigned to FPL?

A. FPL has been assigned a corporate credit rating of "A-" by S&P and an issuer rating of "A2" by Moody's. Fitch Ratings Ltd. ("Fitch") has assigned an issuer default rating of "A" to FPL.

B. Risks and Financial Requirements

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

A. Implementation of structural change and related events caused investors to rethink their assessment of the relative risks associated with the utility industry. There has been steady erosion in credit quality throughout the utility industry for more than a decade, both as a result of revised perceptions of the risks in the industry and the weakened finances of the utilities themselves. In December 2009, S&P observed with respect to the industry's future that:

> Looming costs associated with environmental compliance, slack demand caused by economic weakness, the potential for permanent demand destruction caused by changes in consumer behavior and

> closing of manufacturing facilities, and numerous regulatory filings seeking recovery of costs are some of the significant challenges the industry has to deal with.[6]

Similarly, Moody's noted:

> [A] sustained period of sluggish economic growth, characterized by high unemployment, could stress the sector's recovery prospects, financial performance, and credit ratings. The quality of the sector's cash flows are already showing signs of decline, partly because of higher operating costs and investments.[7]

More recently, Moody's concluded, "we also see the sector's overall business and operating risks increasing."[8]

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

A. Yes. FPL will require capital investment to meet customer growth, provide for necessary maintenance and replacements, and fund new investment in the facilities needed to generate, transmit and distribute electricity. As discussed in greater detail by FPL witness Dewhurst, over the 2011-2013 period alone, FPL plans to invest approximately $9 billion to strengthen and improve Florida's electric generation and delivery system.

Continued support for FPL's financial integrity and flexibility will be instrumental in attracting the long-term capital necessary to fund these projects in an effective manner. In addition, FPL must meet short-term liquidity needs

arising from seasonal cash flows and ongoing construction programs. FPL's exposure to storm restoration activities and the substantial liquidity requirements necessary to support its fuel hedging program magnify the importance of maintaining financial flexibility, which is essential to guarantee access to the cash resources and interim financing required to cover operating cash flows and fund required investments in the utility system.

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

A. Yes on both counts. In recent years utilities and their customers have had to contend with dramatic fluctuations in fuel costs due to ongoing price volatility in the spot markets, and investors recognize the potential for further turmoil in energy markets. In times of extreme volatility, utilities can quickly find themselves in a significant under-recovery position with respect to power costs, which can severely stress liquidity. The power industry and its customers have had to contend with dramatic fluctuations in gas costs due to ongoing price volatility in the spot markets. Similarly, the Energy Information Administration ("EIA"), which is a statistical agency of the U.S. Department of Energy ("DOE"), reported that the weighted-average price paid for uranium oxide equivalent in 2008 was $45.88 per pound, representing an increase of 40% compared to 2007 price levels and coming on the heels of a 76% price increase during the previous year.[9]

While current expectations for significantly lower power prices reflect weaker fundamentals affecting current load and fuel prices, investors recognize the potential that such trends could quickly reverse. For example, recurring political crises in the Middle East have led to sharp increases in petroleum prices. Moody's concluded that utilities remain exposed to fluctuations in energy prices, observing, "This view, that commodity prices remain low, could easily be proved incorrect, due to the evidence of historical volatility."[10] Fitch recently observed that market conditions will likely result in higher natural gas prices, and noted the utility industry's potential exposure to future price shocks.[11]

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

A. Yes. In order to meet rising demand for electricity across its service territory, FPL has sought to acquire additional power resources to ensure its ability to maintain adequate reserve margins and provide reliable service. The expansion of gas-fired generation has resulted in this fuel representing over 60% of FPL's fuel mix. Exposure to fluctuations in natural gas prices or supply interruption is a significant concern, with S&P noting that, "a large and growing reliance on natural gas to fuel utility generation could over time turn from an advantage (because of its environmental status) to a weakness if gas prices continue to fluctuate and trend up."[12] FPL's significant exposure to natural gas detracts from the Company's credit quality and should be considered in evaluating a fair ROE. While FPL has stated that it continues to explore alternative fuel sources and technologies, the potential for a continuation of the extreme price volatility experienced in the market for natural gas means that FPL must be able to fund

fuel under-recoveries and have the financial strength to effectively hedge price risks.

Q. Do the Commission's adjustment mechanisms protect FPL from exposure to fluctuations in power supply costs?

A. To a limited extent, yes. The investment community views FPL's ability to periodically adjust retail rates to accommodate fluctuations in fuel and purchased power as an important source of support for FPL's financial integrity. Nevertheless, they also recognize that there can be a lag between the time FPL actually incurs the expenditure and when it is recovered from ratepayers. As a result, FPL is not insulated from the need to finance deferred power production and supply costs and support the substantial liquidity requirements related to its fuel hedging program. Indeed, despite the significant investment of resources to manage fuel procurement, investors are aware that the best FPL can do is to recover its actual costs. In other words, FPL earns no return on fuel costs and is exposed to substantial short-term financing responsibilities, regulatory lag, and the potential for disallowances for imprudence in its fuel procurement.

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

A. Investors are aware of the financial and regulatory pressures faced by utilities associated with rising costs and the need to undertake significant capital investments. S&P noted that cost increases and capital projects, along with uncertain load growth, were a significant challenge to the utility industry.[13] As Moody's observed:

> [W]e also see the sector's overall business risk and operating risks increasing, owing primarily to rising costs associated with upgrading and expanding the nation's trillion dollar electric infrastructure.[14]

As noted earlier, investors anticipate that FPL will undertake significant electric utility capital expenditures. While providing the infrastructure necessary to meet the electricity needs of customers is certainly desirable, it imposes additional financial responsibilities on the Company.

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

A. Yes. Although FPL's exposure is moderated through the Company's reliance on natural gas and nuclear generation, and the environmental compliance cost recovery clause established by the FPSC, utilities are confronting increased environmental pressures that impose significant uncertainties and costs. Moody's noted that, "the prospect for new environmental emission legislation – particularly concerning carbon dioxide – represents the biggest emerging issue for electric utilities."[15] While the momentum for carbon emissions legislation has slowed, expectations for eventual regulations continue to pose uncertainty.

Q. Please discuss the impact that FPL's nuclear operations have on its financial requirements?

A. Approximately 20% of FPL's total energy requirements are provided by its four nuclear units located at the St. Lucie and Turkey Point generating stations.

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

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

> Operating and maintaining [nuclear plants] is more complex compared with fossil plants because of safety considerations and the additional safety equipment and operational controls required.[16]

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

These concerns have been exacerbated by the events at the Fukushima Daiichi nuclear complex in Japan, as S&P recently noted:

> Standard & Poor's Ratings Service believes that the failure of the back-up safety systems will heighten scrutiny of the systematic

> risks for U.S. nuclear power generators. We aren't taking any rating actions at this time. Still, the failures and their consequences raise the likelihood of greater costs and enhanced regulatory oversight for existing U.S. facilities. A renewed public focus on the inherent risks of nuclear power will demand as much. This could result in delays in license-extension approvals and deteriorating economics for new plant construction. At the same time, closure of nuclear power plants, either due to increased costs or regulatory action, might significantly affect U.S. electricity supply and have substantial capital spending implications for utilities.[18]

As Moody's noted, "[O]ne of the biggest risks associated with nuclear generation is an unanticipated extended outage," concluding that "an extended outage can significantly stress an owner's liquidity and over-all financial profile."[19] In addition, longer-term uncertainties regarding the disposal of spent fuel and the ultimate costs of decommissioning continue to accompany any investment in nuclear generating facilities. In order to mitigate these potential exposures, Moody's cited the importance of a constructive regulatory relationship and "a need to establish financial policies over the near-term aimed at producing very strong financial credit ratios in order to maintain a given rating."[20]

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

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

> Given the location of the company's service territory at the extreme southern end of the Florida peninsula, there are limits on the ability to import power.[21]

Apart from its relative isolation, FPL's service territory has extreme exposure to the catastrophic damage of tropical storms. While the investment community recognizes that the FPSC has been generally supportive in permitting recovery of the costs of storm damage, FPL nonetheless must maintain the financial strength and liquidity necessary to effect a rapid and far-reaching response in the likely event of a future hurricane strike.

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

A. Past experience indicates that the economy in FPL's service territory can be highly vulnerable, especially to conditions that cause a decline in tourism. And while the Florida economy has achieved a degree of diversification that was not present during the tourism-led slump of the 1970s, Floridians are aware that the combined effect of a general business slowdown and a plunge in tourism can result in a particularly severe economic double-whammy, which heightens the risks that an economic downturn poses for FPL's investors and customers. More recently, the economy of FPL's service territory has been the epicenter for the

monumental collapse in real estate values that precipitated a global financial crisis. As Fitch recently noted, "FPL's south Florida service territory still has above average unemployment and a weak housing market,"[22] S&P recently recognized, "Maintaining financial strength despite regulatory setbacks and a moribund economy has been challenging."[23] While the long-term outlook for Florida's economy may remain positive, investors nonetheless recognize the exposure introduced by current uncertainties.

C. Impact of Capital Market Conditions

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

A. As The Value Line Investment Survey ("Value Line") recently recognized, "It has been a turbulent year for the financial markets, to say the least."[24] Investors have faced a myriad of challenges and uncertainties, including the threat of a U.S. government default, political brinkmanship over raising the federal debt ceiling, and S&P's subsequent downgrade of its U.S. sovereign debt rating. The sovereign debt crisis in Europe has also dealt a harsh blow to investor confidence, and concerns over potential exposure to a Euro-zone default has again undermined confidence in the financial and banking sector. Meanwhile, speculation that the economy remains exposed to a potential "double-dip" recession persists, with unemployment remaining stubbornly high, rising petroleum prices, lackluster consumer confidence, and continued weakness plaguing the real estate sector.

Investors have had to confront ongoing fluctuations in share prices and stress in the credit markets.[25] In response, investors have repeatedly fled to the safety of U.S. Treasury bonds, and stock prices have experienced renewed volatility. As the *Wall Street Journal* noted in August 2011:

> Stocks spiraled downward Thursday as investors buckled under the strain of the global economic slowdown and the failure of policy makers to stabilize financial markets.... The nervousness among investors is being reflected in an extraordinary rally in U.S. Treasury bonds, regarded as a safe haven for investors in time of turmoil.... The Dow's decline was its biggest point drop since the market was plunging amid a crisis of confidence in banks in late 2008. On Thursday, the focus shifted to world governments, which are laboring under mountains of debt and have diminished ability to prop up the financial system.[26]

The dramatic rise in the price of gold and other commodities also attests to investors' heightened concerns over prospective challenges and risks, including the overhanging threat of inflation, a double-dip recession, and renewed economic turmoil. With respect to utilities, Moody's noted the dangers to credit availability associated with exposure to European banks,[27] and concluded:

> Over the past few months, we have been reminded that global financial markets, which are still receiving extraordinary intervention benefits by sovereign governments, are exposed to

turmoil. Access to the capital markets could therefore become intermittent, even for safer, more defensive sectors like the power industry.[28]

Uncertainties surrounding economic and capital market conditions heighten the risks faced by utilities, which, as described earlier, face a variety of operating and financial challenges.

Q. How do interest rates on long-term bonds compare with those projected for the next few years?

A. Exhibit WEA-2 compares current interest rates on 30-year Treasury bonds, triple-A rated corporate bonds, and double-A rated utility bonds with near-term projections from Value Line, IHS Global Insight, Blue Chip Financial Forecasts ("Blue Chip"), S&P, and the EIA.

As shown on Exhibit WEA-2, there is a clear consensus that the cost of permanent capital will be higher in the 2012-2016 timeframe than it is currently. As a result, current cost of capital estimates are conservative, because they are likely to understate investors' requirements at the time the rates set in this proceeding become effective.

Q. What do these events imply with respect to the ROE for FPL?

A. No one knows the future of our complex global economy. We know that the financial crisis had been building for a long time, and few predicted that the economy would fall as rapidly as it did, or that corporate bond yields would

fluctuate as dramatically as they have. While conditions in the economy and capital markets appear to have stabilized significantly since 2009, investors continue to react swiftly and negatively to any signs of future trouble in the financial system or economy. Given the importance of reliable utility service, it would be unwise to ignore investors' increased sensitivity to risk and future capital market trends in evaluating a fair ROE in this case.

Q Does the prospect for continued turmoil in capital markets also influence the appropriate capital structure for FPL?

A Yes. Financial flexibility plays a crucial role in ensuring the wherewithal to meet funding needs, and utilities with higher financial leverage may be foreclosed from additional borrowing, especially during times of stress. Fitch recently highlighted this exposure:

> **Capital Markets Freeze:** Significant tightening or loss of capital markets and bank access would have a deleterious affect on sector creditworthiness in the face of high capex budgets.[29]

As a result, the Company's capital structure must maintain an equity "cushion" that preserves the flexibility necessary to maintain continuous access to capital even during times of unfavorable market conditions.

III. CAPITAL MARKET ESTIMATES

Q. What is the purpose of this section?

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

A. Economic Standards

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

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

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

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

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

$$k_i = R_f + RP_i$$

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

RP_i = Risk premium required to hold riskier asset i.

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

Q. Is the cost of equity observable in the capital markets?

A. No. Unlike debt capital, there is no contractually guaranteed return on common equity capital since shareholders are the residual owners of the utility. Because it is not readily observable, the cost of equity for a particular utility must be estimated by analyzing information about capital market conditions generally, assessing the relative risks of the company specifically, and employing various quantitative methods that focus on investors' required rates of return. These

various quantitative methods typically attempt to infer investors' required rates of return from stock prices, interest rates, or other capital market data.

B. Comparable Risk Proxy Groups

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

A. Application of the DCF model and other quantitative methods to estimate the cost of equity requires observable capital market data, such as stock prices. However, even for a firm with publicly traded stock, the cost of equity can only be estimated. As a result, applying quantitative models using observable market data only produces an estimate that inherently includes some degree of observation error. Thus, the accepted approach to increase confidence in the results is to apply the DCF model and other quantitative methods to a proxy group of publicly traded companies that investors regard as risk-comparable.

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

A. In order to reflect the risks and prospects associated with FPL's jurisdictional utility operations, my DCF analyses focused on a reference group of other utilities composed of those companies classified by Value Line as electric utilities with: (1) an S&P corporate credit rating of "BBB+" to "A", (2) a Value Line Safety Rank of "1" or "2", (3) a Value Line Financial Strength Rating of "B++" or better, and (4) a market capitalization of approximately $1.8 billion or greater. In addition, I eliminated two utilities that otherwise would have been in the proxy

group, but are not appropriate for inclusion because they are currently involved in a major merger or acquisition. These criteria resulted in a proxy group composed of fourteen companies, which I will refer to as the "Utility Proxy Group."

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

A. Under the regulatory standards established by *Hope* and *Bluefield*, the salient criterion in establishing a meaningful benchmark to evaluate a fair ROE is relative risk, not the particular business activity or degree of regulation. With regulation taking the place of competitive market forces, required returns for utilities should be in line with those of non-utility firms of comparable risk operating under the constraints of free competition. Consistent with this accepted regulatory standard, I also applied the DCF model to a reference group of low-risk companies in the non-utility sectors of the economy. I refer to this group as the "Non-Utility Proxy Group."

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

A. Yes. The cost of capital is an opportunity cost based on the returns that investors could realize by putting their money in other alternatives. Clearly, the total capital invested in utility stocks is only the tip of the iceberg of total common stock investment, and there are a plethora of other enterprises available to investors beyond those in the utility industry. Utilities must compete for capital, not just against firms in their own industry, but with other investment opportunities of comparable risk. Indeed, modern portfolio theory is built on the assumption that rational investors will hold a diverse portfolio of stocks, not just companies in a single industry.

Q. Is it consistent with the *Bluefield* and *Hope* cases to consider required returns for non-utility companies?

A. Yes. Returns in the competitive sector of the economy form the very underpinning for utility ROEs because regulation purports to serve as a substitute for the actions of competitive markets. The Supreme Court has recognized that it is the degree of risk, not the nature of the business, which is relevant in evaluating an allowed ROE for a utility. The *Bluefield* case refers to, "business undertakings attended with comparable risks and uncertainties."[30] It does not restrict consideration to other utilities. Similarly, the *Hope* case states:

> By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.[31]

As in the *Bluefield* decision, there is nothing to restrict "other enterprises" solely to the utility industry.

Indeed, in teaching regulatory policy I usually observe that in the early applications of the comparable earnings approach, utilities were explicitly eliminated due to a concern about circularity. In other words, soon after the *Hope* decision, regulatory commissions did not want to get involved in circular logic by looking to the returns of utilities that were established by the same or similar regulatory commissions in the same geographic region. To avoid circularity, regulators looked only to the returns of non-utility companies.

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

A. Yes. The estimates of growth from the DCF model depend on analysts' forecasts. It is possible for utility growth rates to be distorted by short-term trends in the industry or the industry being in temporary favor or disfavor by analysts. The result of such distortions would be to bias the DCF estimates for electric utilities.

Because the Non-Utility Proxy Group includes low risk companies from many industries, it diversifies away any distortion that may be caused by the ebb and flow of enthusiasm for a particular sector.

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

A. My comparable risk proxy group of non-utility firms was composed of those U.S. companies followed by Value Line that: (1) pay common dividends, (2) have a Safety Rank of "1", (3) have a Financial Strength Rating of "B++" or greater; (4) have a beta of 0.60 or less, and, (5) have investment grade credit ratings from S&P.

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

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

normally considered important in assessing a firm's relative credit standing, corporate credit ratings provide a broad, objective measure of overall investment risk that is readily available to investors. Although the credit rating agencies are not immune to criticism, their rankings and analyses are widely cited in the investment community and referenced by investors. Investment restrictions tied to credit ratings continue to influence capital flows, and credit ratings are also frequently used as a primary risk indicator in establishing proxy groups to estimate the cost of common equity.

While credit ratings provide the most widely referenced benchmark for investment risks, other quality rankings published by investment advisory services also provide relative assessments of risks that are considered by investors in forming their expectations for common stocks. Value Line's primary risk indicator is its Safety Rank, which ranges from "1" (Safest) to "5" (Riskiest). This overall risk measure is intended to capture the total risk of a stock, and incorporates elements of stock price stability and financial strength. Given that Value Line is perhaps the most widely available source of investment advisory information, its Safety Rank provides useful guidance regarding the risk perceptions of investors.

The Financial Strength Rating is designed as a guide to overall financial strength and creditworthiness, with the key inputs including financial leverage, business volatility measures, and company size. Value Line's Financial Strength Ratings

range from "A++" (strongest) down to "C" (weakest) in nine steps. Finally, Value Line's beta measures the volatility of a security's price relative to the market as a whole. A stock that tends to respond less to market movements has a beta less than 1.00, while stocks that tend to move more than the market have betas greater than 1.00.

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

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

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

A. Yes. As shown in Exhibit WEA-3, the average corporate credit rating for the Utility Proxy Group is "BBB+", with ratings for the individual firms ranging from "BBB+" to "A", while the Non-Utility Proxy Group's average credit rating is slightly higher at "A". These average ratings for the Utility and Non-Utility Proxy Groups bracket FPL's "A-"corporate credit rating.

Meanwhile, the average Value Line Safety Rank and Financial Strength Rating for the Utility Proxy Group are identical to the values corresponding to FPL, while the average beta value of 0.70 indicates less risk than for FPL. With respect to the Non-Utility Proxy Group, its average Safety Rank, Financial Strength Rating and beta all indicate less risk than the values corresponding to FPL.

Considered together, a comparison of these objective measures, which consider of a broad spectrum of risks, including financial and business position, relative size, and exposure to company specific factors, indicates that investors would likely conclude that the overall investment risks for FPL are comparable to those of the firms in the Utility and Non-Utility Proxy Groups.

While the impact of differences in regulation is reflected in objective risk measures, my analyses conservatively focus on a lower-risk group of non-utility firms. The 13 companies that make up the Non-Utility Proxy Group are representative of the pinnacle of corporate America. These firms, which include household names such as Coca-Cola, Colgate-Palmolive, Proctor & Gamble, and Wal-Mart, have long corporate histories, well-established track records, and exceedingly conservative risk profiles. The companies in my Non-Utility Proxy Group have a stable track record of dividend payments, with the average dividend yield for the group approaching 3%. Moreover, because of their significance and name recognition, these companies receive intense scrutiny by the investment community, which increases confidence that published growth estimates are representative of the consensus expectations reflected in common stock prices.

C. Discounted Cash Flow Analyses

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

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

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:[32]

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

where: P_0 = Current price per share;

D_1 = Expected dividend per share in the coming year;

k_e = Cost of equity; and

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.

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

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

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

A. Estimates of dividends to be paid by each of these utilities over the next 12

months, obtained from Value Line, served as D_1. This annual dividend was then divided by the average stock price for the 30 days ended November 28, 2011 to arrive at the expected dividend yield for each utility. The stock prices, expected dividends, and resulting dividend yields for the firms in the Utility Proxy Group are presented on page 1 of Exhibit WEA-4. As shown there, dividend yields for the firms in the Utility Proxy Group ranged from 2.0% to 5.3%, and averaged 4.1%.

Q. Do the dividend yields incorporated in your DCF analyses reflect the quarterly timing of dividend payments?

A. No. The traditional annual form of the constant growth DCF model applied in my testimony is based on the assumption that dividends are received as a lump sum payment at the end of the year, when in fact most utilities pay dividends on a quarterly basis. Because of the time value of money, a stock that pays quarterly dividends will command a higher price than a stock that pays the same amount as a lump sum at year-end. As a result, the annual model that is most frequently relied on in regulatory proceedings understates investors' required rate of return because it ignores the quarterly timing of dividend cash flows.

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

A. The next step is to evaluate long-term growth expectations, or "*g*", for the firm in question. In constant growth DCF theory, earnings, dividends, book value, and market price are all assumed to grow in lockstep, and the growth horizon of the DCF model is infinite. But implementation of the DCF model is more than just a theoretical exercise; it is an attempt to replicate the mechanism investors used to

arrive at observable stock prices. A wide variety of techniques can be used to derive growth rates, but the only "*g*" that matters in applying the DCF model is the value that investors expect.

Q. Are historical growth rates likely to be representative of investors' expectations for utilities?

A. No. If past trends in earnings, dividends, and book value are to be representative of investors' expectations for the future, then the historical conditions giving rise to these growth rates should be expected to continue. That is clearly not the case for utilities, where structural and industry changes have led to declining growth in dividends, earnings pressure, and, in many cases, significant write-offs. While these conditions serve to distort historical growth measures, they are not representative of long-term expectations for the utility industry or the forward-looking expectations that investors have incorporated into current market prices. As a result, historical growth measures for utilities do not currently meet the requirements of the DCF model.

Q. Do the growth rate projections of security analysts nonetheless consider historical trends?

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

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

A. While the DCF model is technically concerned with growth in dividend cash flows, implementation of this DCF model is solely concerned with replicating the forward-looking evaluation of real-world investors. In the case of utilities, dividend growth rates are not likely to provide a meaningful guide to investors' current growth expectations. This is because utilities have significantly altered their dividend policies in response to more accentuated business risks in the industry.[33] As a result of this trend towards a more conservative payout ratio, dividend growth in the utility industry has remained largely stagnant as utilities conserve financial resources to provide a hedge against heightened uncertainties.

As payout ratios for firms in the utility industry trended downward, investors' focus has increasingly shifted from dividends to earnings as a measure of long-term growth. Future trends in earnings per share ("EPS"), which provide the source for future dividends and ultimately support share prices, play a pivotal role in determining investors' long-term growth expectations. The importance of earnings in evaluating investors' expectations and requirements is well accepted in the investment community, and surveys of analytical techniques relied on by professional analysts indicate that growth in earnings is far more influential that trends in dividends per share ("DPS"). Apart from Value Line, investment advisory services do not generally publish comprehensive DPS growth projections, and this scarcity of dividend growth rates relative to the abundance of

earnings forecasts attests to their relative influence. The fact that securities analysts focus on EPS growth, and that dividend growth rates are not routinely published, indicates that projected EPS growth rates are likely to provide a superior indicator of the future long-term growth expected by investors.

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

A. The projected EPS growth rates for each of the firms in the Utility Proxy Group reported by Value Line, Thomson Reuters ("IBES"), and Zacks Investment Research ("Zacks") are displayed on page 2 of Exhibit WEA-4.[34]

Q. Some argue that analysts' growth rates are biased. Do you believe these projections are inappropriate for estimating investors' required return using the DCF model?

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

Any claims that analysts' estimates are not relied upon by investors are unfounded given the reality of a competitive market for investment advice. The market for investment advice is intensely competitive, and securities analysts are personally

and professionally motivated to provide the most accurate assessment possible of future growth trends. If financial analysts' forecasts do not add value to investors' decision making, then it is irrational for investors to pay for these estimates. Those financial analysts who fail to provide reliable forecasts will lose out in competitive markets relative to those analysts whose forecasts investors find more credible. The reality that analyst estimates are routinely referenced in the financial media and in investment advisory publications (*e.g.*, Value Line) strongly suggests that investors use them as a basis for their expectations.

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

> Because of the dominance of institutional investors and their influence on individual investors, analysts' forecasts of long-run growth rates provide a sound basis for estimating required returns.

> Financial analysts exert a strong influence on the expectations of many investors who do not possess the resources to make their own forecasts, that is, they are a cause of *g* [growth]. The accuracy of these forecasts in the sense of whether they turn out to be correct is not an issue here, as long as they reflect widely held expectations.[35]

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

A. In constant growth theory, growth in book equity will be equal to the product of the earnings retention ratio (one minus the dividend payout ratio) and the earned rate of return on book equity. Furthermore, if the earned rate of return and the payout ratio are constant over time, growth in earnings and dividends will be equal to growth in book value. Despite the fact that these conditions are seldom, if ever, met in practice, this "sustainable growth" approach may provide a rough guide for evaluating a firm's growth prospects and is frequently proposed in regulatory proceedings.

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

accretion rate.

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

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

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

A. The sustainable, "br+sv" growth rates for each firm in the Utility Proxy Group are summarized on page 2 of Exhibit WEA-4, with the underlying details being presented on Exhibit WEA-5. For each firm, the expected retention ratio (b) was calculated based on Value Line's projected dividends and earnings per share. Likewise, each firm's expected earned rate of return (r) was computed by dividing projected earnings per share by projected net book value. Because Value Line reports end-of-year book values, an adjustment was incorporated to compute an average rate of return over the year, consistent with the theory underlying this approach to estimating investors' growth expectations. Meanwhile, the percent of common equity expected to be issued annually as new common stock (s) was equal to the product of the projected market-to-book ratio and growth in common

shares outstanding, while the equity accretion rate (v) was computed as 1 minus the inverse of the projected market-to-book ratio.

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

A. After combining the dividend yields and respective growth projections for each utility, the resulting cost of equity estimates are shown on page 3 of Exhibit WEA-4.

Q. In evaluating the results of the constant growth DCF model, is it appropriate to eliminate estimates that are extreme low or high outliers?

A. Yes. In applying quantitative methods to estimate the cost of equity, it is essential that the resulting values pass fundamental tests of reasonableness and economic logic. Accordingly, DCF estimates that are implausibly low or high should be eliminated when evaluating the results of this method.

Q. How did you evaluate DCF estimates at the low end of the range?

A. It is a basic economic principle that investors can be induced to hold more risky assets only if they expect to earn a return to compensate them for their risk bearing. As a result, the rate of return that investors require from a utility's common stock, the most junior and riskiest of its securities, must be considerably higher than the yield offered by senior, long-term debt. Consistent with this principle, the DCF results must be adjusted to eliminate estimates that are determined to be extreme low outliers when compared against the yields available to investors from less risky utility bonds.

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

A. As noted earlier, S&P corporate credit ratings for the firms in the Utility Proxy Group ranged from "BBB+" to "A", with Moody's monthly yields on triple-B and single-A bonds averaging approximately 5.1% and 4.3%, respectively, in December 2011.[36] It is inconceivable that investors are not requiring a substantially higher rate of return for holding common stock. Consistent with this principle, the DCF results for the Utility Proxy Group must be adjusted to eliminate estimates that are determined to be extreme low outliers when compared against the yields available to investors from less risky utility bonds.

Q. Have similar tests been applied by regulators?

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

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

> same return, this low-end return cannot be considered reliable in this case.[37]

Similarly, in its August 2006 decision in *Kern River Gas Transmission Company*, FERC noted that:

> [T]he 7.31 and 7.32 percent costs of equity for El Paso and Williams found by the ALJ are only 110 and 122 basis points above that average yield for public utility debt.[38]

The Commission upheld the opinion of Staff and the Administrative Law Judge that cost of equity estimates for these two proxy group companies "were too low to be credible."[39]

The practice of eliminating low-end outliers has been affirmed in numerous FERC proceedings,[40] and in its April 15, 2010 decision in *SoCal Edison*, FERC affirmed that, "it is reasonable to exclude any company whose low-end ROE fails to exceed the average bond yield by about 100 basis points or more."[41]

Q. What else should be considered in evaluating DCF estimates at the low end of the range?

A. As indicated earlier, while corporate bond yields have declined substantially as the worst of the financial crisis has abated, it is generally expected that long-term interest rates will rise as the recession ends and the economy returns to a more normal pattern of growth. As shown in Exhibit WEA-6, forecasts of IHS Global

Insight and the EIA imply average triple-B and single-A bond yields of approximately 6.6% and 6.0%, respectively, over the period 2012-2016.

The increase in debt yields anticipated by IHS Global Insight and EIA is also supported by the widely-referenced Blue Chip Financial Forecasts, which projects that yields on corporate bonds will climb more than 100 basis points through the period 2013-2017.[42]

Q. What does this test of logic imply with respect to the DCF estimates for the Utility Proxy Group?

A. As highlighted on page 3 of Exhibit WEA-3, the low end of the range of results was set by a 5.9% cost of equity estimate for Pacific Gas and Electric Company ("PG&E") Corporation. In light of the risk-return tradeoff principle and the test applied in *SoCal Edison*, it is inconceivable that investors are not requiring a substantially higher rate of return for holding common stock, which is the riskiest of a utility's securities. As a result, consistent with the test of economic logic applied by FERC and the upward trend expected for utility bond yields, this value provides little guidance as to the returns investors require from utility common stocks and should be excluded.

Q. Do you also recommend excluding estimates at the high end of the range of DCF results?

A. Yes. The upper end of the cost of common equity range was set by cost of equity estimates of 20.7% and 18.5%. When compared with the balance of the remaining estimates, these values are clearly implausible and should be excluded

in evaluating the results of the DCF model for the Utility Proxy Group. This is also consistent with the precedent adopted by FERC, which has established that estimates found to be "extreme outliers" should be disregarded in interpreting the results of the DCF model.[43]

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

A. As shown on page 3 of Exhibit WEA-4, after eliminating illogical low-end values, application of the constant growth DCF model resulted in an average cost of common equity estimates ranging from 9.6% to10.3%.

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

A. I applied the DCF model to the Non-Utility Proxy Group in exactly the same manner described earlier for the Utility Proxy Group. The results of my DCF analysis for the Non-Utility Proxy Group are presented in Exhibit WEA-7, with the sustainable, "br+sv" growth rates being developed on Exhibit WEA-8. As shown on Exhibit WEA-7, after eliminating illogical low- and high-end values, application of the constant growth DCF model resulted in cost of common equity estimates ranging from 11.5% to 12.3%.

Q. How can these DCF results for the Non-Utility Proxy Group be reconciled against the significantly lower estimates produced for your comparable-risk group of utilities?

A. First, it is important to be clear that the higher DCF results for the Non-Utility Proxy Group cannot be attributed to risk differences. As I documented earlier, the

risks that investors associate with the group of non-utility firms - as measured by S&P's credit ratings and Value Line's Safety Rank, Financial Strength, and Beta - are lower than the risks investors associate with the Utility Proxy Group and FPL. The objective evidence provided by these observable risk measures rules out a conclusion that the higher non-utility DCF estimates are associated with higher investment risk.

Rather, the divergence between the DCF results for these two groups of utility and non-utility firms can be attributed to the fact that DCF estimates invariably depart from the returns that investors actually require because their expectations may not be captured by the inputs to the model, particularly the assumed growth rate. Because the actual cost of equity is unobservable, and DCF results inherently incorporate a degree of error, the cost of equity estimates for the Non-Utility Proxy Group provide an important benchmark in evaluating a fair ROE for FPL. There is no basis to conclude that DCF results for a group of utilities would be inherently more reliable than those for firms in the competitive sector, and the divergence between the DCF estimates for the Utility and Non-Utility Proxy Groups suggests that both should be considered to ensure a balanced end-result.

D. Capital Asset Pricing Model

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.

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-9. In order to capture the expectations of today's investors in current capital markets, the expected market rate of return was estimated by conducting a DCF analysis on the dividend paying firms in the S&P 500. This is directly analogous to the CAPM approach previously utilized by the FPSC Staff.[44]

The dividend yield for each firm was obtained from Value Line, and the growth rate was equal to the consensus earnings growth projections for each firm

published by IBES, with each firm's dividend yield and growth rate being weighted by its proportionate share of total market value. Based on the weighted average of the projections for the 373 individual firms, current estimates imply an average growth rate over the next five years of 10.9%. Combining this average growth rate with a year-ahead dividend yield of 2.6% results in a current cost of common equity estimate for the market as a whole (R_m) of approximately 13.5%. Subtracting a 3.0% risk-free rate based on the average yield on 30-year Treasury bonds produced a market equity risk premium of 10.5%.

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

A. I relied on the beta values reported by Value Line, which in my experience is the most widely referenced source for beta in regulatory proceedings. As noted in *New Regulatory Finance*:

> Value Line is the largest and most widely circulated independent investment advisory service, and influences the expectations of a large number of institutional and individual investors.... Value Line betas are computed on a theoretically sound basis using a broadly based market index, and they are adjusted for the regression tendency of betas to converge to 1.00.[45]

Q What else should be considered in applying the CAPM?

A. As explained by *Morningstar*:

> One of the most remarkable discoveries of modern finance is that of a relationship between firm size and return. The relationship cuts across the entire size spectrum but is most evident among

smaller companies, which have higher returns on average than larger ones.[46]

Because empirical research indicates that the CAPM does not fully account for observed differences in rates of return attributable to firm size, a modification is required to account for this size effect.

According to the CAPM, the expected return on a security should consist of the riskless rate, plus a premium to compensate for the systematic risk of the particular security. The degree of systematic risk is represented by the beta coefficient. The need for the size adjustment arises because differences in investors' required rates of return that are related to firm size are not fully captured by beta. To account for this, Morningstar has developed size premiums that need to be added to the theoretical CAPM cost of equity estimates to account for the level of a firm's market capitalization in determining the CAPM cost of equity.[47] Accordingly, my CAPM analyses incorporated an adjustment to recognize the impact of size distinctions, as measured by market capitalization.

Q. What cost of equity is indicated based on this forward-looking application of the CAPM?

A. The average market capitalization of the Utility Proxy Group is $12.9 billion. Based on data from *Morningstar*, this means that the theoretical CAPM cost of equity estimate must be increased by 81 basis points to account for the industry group's relative size. As shown on page 1 of Exhibit WEA-9, adjusting the 10.4%

theoretical CAPM result to incorporate this size adjustment results in an indicated cost of common equity of 11.2%.

Q. Is it appropriate to consider anticipated capital market changes in applying the CAPM?

A. Yes. As discussed earlier, there is widespread consensus that interest rates will increase materially as the economy continues to strengthen. As a result, current bond yields are likely to understate capital market requirements at the time the outcome of this proceeding becomes effective. Accordingly, in addition to the use of current bond yields, I also applied the CAPM based on the forecasted long-term Treasury bond yields developed based on projections published by Value Line, IHS Global Insight, and Blue Chip. Incorporating projected bond yields in applying the CAPM is analogous to the approach that has been adopted by the FPSC staff in prior proceedings.[48]

Q. What cost of equity was produced by the CAPM after incorporating forecasted bond yields?

A. As shown on page 2 of Exhibit WEA-9, incorporating a forecasted Treasury bond yield for 2012-2016 implied a cost of equity of approximately 10.8% for the Utility Proxy Group, or 11.6% after adjusting for the impact of relative size.

Q. Should the CAPM approach be applied using historical rates of return?

A. No. 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 data that reflects the expectations of actual investors in the market. Applications

of the CAPM method that are based on historical data – such as realized rates of return or expected returns estimated in the past – ignore the returns that investors are currently requiring in the capital markets. As a result, they violate a fundamental requirement of the CAPM approach.

Q. Is there good reason to entirely disregard the results of historical CAPM analyses?

A. Yes. The CAPM cost of common equity estimate is calibrated from investors' required risk premium between Treasury bonds and common stocks. In response to heightened uncertainties, investors have repeatedly sought a safe haven in U.S. government bonds and this "flight to safety" has pushed Treasury yields significantly lower while yield spreads for corporate debt have widened. This distortion not only impacts the absolute level of the CAPM cost of equity estimate, but it affects estimated risk premiums. Economic logic would suggest that investors' required risk premium for common stocks over Treasury bonds has also increased.

Meanwhile, backward-looking approaches incorrectly assume that investors' assessment of the required risk premium between Treasury bonds and common stocks is constant, and equal to some historical average. At no time in recent history has the fallacy of this assumption been demonstrated more concretely than it is today. This incongruity between investors' current expectations and historical risk premiums is particularly relevant during periods of heightened uncertainty

and rapidly changing capital market conditions, such as those experienced recently.[49] As the FPSC Staff concluded:

> [R]ecognizing the impact the Federal Government's unprecedented intervention in the capital markets has had on the yields on long-term Treasury bonds, staff believes models that relate the investor-required return on equity to the yield on government securities, such as the CAPM approach, produce less reliable estimates of the ROE at this time.[50]

Q. Has the Federal Reserve continued to pursue a policy of actively managing long-term government bond yields?

A. Yes. In September 2011, the Federal Reserve announced "Operation Twist," involving the exchange of short-term Treasury instruments for longer-term government bonds, in an effort to put downward pressure on long-term interest rates. The ongoing potential for renewed turmoil in the capital markets has certainly come to a head in recent months, with common stock prices exhibiting the dramatic volatility that is indicative of heightened sensitivity to risk.

Nowhere has this been more evident than in the market for Treasury bonds, with yields being pushed significantly lower due to a global "flight to safety" in the face of rising political, economic, and capital market risks. In turn, this has led to a dramatic increase in risk premiums, as illustrated by the spreads between triple-B utility bond yields and 30-year Treasuries shown in Exhibit WEA-10. This

increase in the yield spread indicates that the additional compensation investors demand to take on higher risks has increased. As S&P observed:

> Standard & Poor's U.S. speculative-grade composite spread, which measures the extra yield above U.S. Treasury bonds that investors demand to hold the bonds of riskier companies, widened by 63% to 781 basis points (bps) from April 18, 2011, to Sept. 30, 2011. This sharp expansion reflected the bond market's increasing aversion to credit risk in an uncertain and riskier environment.... During periods of stress, correlations frequently increase among risky asset classes such as the relationship between the return on speculative-grade bonds and the return from equities.[51]

Equity risk premiums cannot be observed directly, but because common stock investors are the last in line with respect to their claim on a utility's cash flows, higher yield spreads imply an even steeper increase in the additional return required from an investment in common equity. In short, heightened capital market and economic uncertainties, and the increase in risk premiums demanded by investors, further undermine any reliance on historical studies to apply the CAPM.

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

A. No. Reference to arithmetic or geometric mean risk premiums is associated with applications of the CAPM that depend on historical data. In order to derive an

estimate of the market equity risk premium under this approach, historical average returns on Treasury bonds are typically subtracted from those for common stocks. These average rates of return based on backward-looking data for historical time periods can be derived using both arithmetic and geometric means.

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

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

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

None of these values are comparable to the risk premium, as I have applied it in my forward-looking CAPM analyses, which is based not on some generic notion

of the equity risk premium but is derived from contemporaneous projections for individual stocks in the S&P 500. Average realized risk premiums computed over some selected time period may be an accurate representation of what was actually earned in the past, but they don't answer the question as to what risk premium investors were actually expecting to earn on a forward-looking basis during these same time periods. Similarly, calculations of the equity risk premium developed at a point in history – whether based on actual returns in prior periods or contemporaneous projections – are not the same as the forward-looking expectations of today's investors, which are premised on an entirely different set of capital market and economic expectations.

The purpose of my analysis was to determine an allowed return that would meet the regulatory requirement of allowing FPL to attract capital and maintain its financial integrity. The most appropriate benchmark for a meaningful forward-looking estimate of the return investors require from FPL is what investors are currently requiring for other investments with which FPL must compete for capital. The risk premium used in my CAPM is derived from current market data and is forward-looking in the sense of using the projected earnings estimates used by investors. It does not depend on analysis of past historical data on risk premiums nor does it purport to identify what investors will actually realize in the future, or what they should reasonably expect over the long-term. Rather it is an estimate of what investors currently require when they allocate their capital to competing investments. These current forward-looking required returns are the

touchstone of whether an authorized ROE can meet the FPSC's standard of capital attraction and maintaining financial integrity.

E. Risk Premium Approach

Q. Briefly describe the risk premium method.

A. The risk premium method of estimating investors' required rate of return extends to common stocks the risk-return tradeoff observed with bonds. The cost of equity is estimated by first determining the additional return investors require to forgo the relative safety of bonds and to bear the greater risks associated with common stock, and by then adding this equity risk premium to the current yield on bonds. Like the DCF model, the risk premium method is capital market oriented. However, unlike DCF models, which indirectly impute the cost of equity, risk premium methods directly estimate investors' required rate of return by adding an equity risk premium to observable bond yields.

Q. How did you implement the risk premium method?

A. I based my estimates of equity risk premiums for electric utilities on surveys of previously authorized rates of return on common equity. Authorized returns presumably reflect regulatory commissions' best estimates of the cost of equity, however determined, at the time they issued their final order. Such returns should represent a balanced and impartial outcome that considers the need to maintain a utility's financial integrity and ability to attract capital. Moreover, allowed returns are an important consideration for investors and have the potential to influence

other observable investment parameters, including credit ratings and borrowing costs. Thus, this data provides a logical and frequently referenced basis for estimating equity risk premiums for regulated utilities. Using the survey approach avoids the assumption that the average realized returns for stocks and bonds over some historical period represent what investors expected.

Q. How did you implement the risk premium approach using surveys of allowed rates of return?

A. Surveys of previously authorized rates of return on common equity are frequently referenced as the basis for estimating equity risk premiums. The rates of return on common equity authorized utilities by regulatory commissions across the U.S. are compiled by Regulatory Research Associates and published in its *Regulatory Focus* report. In Exhibit WEA-11, the average yield on public utility bonds is subtracted from the average allowed rate of return on common equity for electric utilities to calculate equity risk premiums for each year between 1974 and 2011. Over this 38-year period, these equity risk premiums for electric utilities averaged 3.41%, and the yield on public utility bonds averaged 8.91%.

Q. Is there any capital market relationship that must be considered when implementing the risk premium method?

A. Yes. There is considerable evidence that the magnitude of equity risk premiums is not constant and that equity risk premiums tend to move inversely with interest rates. In other words, when interest rate levels are relatively high, equity risk premiums narrow, and when interest rates are relatively low, equity risk premiums widen. The implication of this inverse relationship is that the cost of equity does

not move as much as, or in lockstep with, interest rates. Accordingly, for a 1% increase or decrease in interest rates, the cost of equity may only rise or fall, say, 50 basis points. Therefore, when implementing the risk premium method, adjustments may be required to incorporate this inverse relationship if current interest rate levels have changed since the equity risk premiums were estimated.

Finally, it is important to recognize that the historical focus of the risk premium studies almost certainly ensures that they fail to fully capture the significantly greater risks that investors now associate with providing electric utility service. As a result, they are likely to understate the cost of equity for a firm operating in today's electric power industry.

Q. What cost of equity is implied by surveys of allowed rates of return on equity?

A. Based on the regression output between the interest rates and equity risk premiums displayed on page 4 of Exhibit WEA-11, the equity risk premium for electric utilities increased approximately 41 basis points for each percentage point drop in the yield on average public utility bonds. As illustrated on page 1 of Exhibit WEA-11, with the yield on average public utility bonds in December 2011 being 4.47%, this implied a current equity risk premium of 5.24% for electric utilities. Adding this equity risk premium to the yield on single-A utility bonds of 4.33% produces a current cost of equity of approximately 9.6%.

Q. What cost of equity was produced by the risk premium approach after incorporating forecasted bond yields?

A. As shown on page 2 of Exhibit WEA-11, incorporating a forecasted yield for 2012-2016 and adjusting for changes in interest rates since the study period implied an equity risk premium of 4.56% for electric utilities.[53] Adding this equity risk premium to the average implied yield on single-A public utility bonds for 2012-2016 of 6.00% resulted in an implied cost of equity of approximately 10.6%.

F. Expected Earnings Approach

Q. What other benchmarks did you develop to evaluate the ROE for FPL?

A. As I noted earlier, I also evaluated the ROE by reference to expected rates of return for electric utilities. Reference to rates of return available from alternative investments of comparable risk can provide an important benchmark in assessing the return necessary to assure confidence in the financial integrity of a firm and its ability to attract capital. This approach is consistent with the economic underpinnings for a fair rate of return, as reflected in the comparable earnings test established by the Supreme Court in *Hope* and *Bluefield*. Moreover, it avoids the complexities and limitations of capital market methods and instead focuses on the returns earned on book equity, which are readily available to investors.

Q. What economic premise underlies the expected earnings approach?

A. The simple, but powerful concept underlying the expected earnings approach is that investors compare each investment alternative with the next best opportunity. If the utility is unable to offer a return similar to that available from other opportunities of comparable risk, investors will become unwilling to supply the capital on reasonable terms. For existing investors, denying the utility an opportunity to earn what is available from other similar risk alternatives prevents them from earning their opportunity cost of capital. In this situation the government is effectively taking the value of investors' capital without adequate compensation.

Q. How is the comparison of opportunity costs typically implemented?

A. The traditional comparable earnings test identifies a group of companies that are believed to be comparable in risk to the utility. The actual earnings of those companies on the book value of their investment are then compared to the allowed return of the utility. While the traditional comparable earnings test is implemented using historical data taken from the accounting records, it is also common to use projections of returns on book investment, such as those published by recognized investment advisory publications (*e.g.*, Value Line). Because these expected returns on book value equity are analogous to the allowed return on a utility's rate base, this measure of opportunity costs results in a direct, "apples to apples" comparison. My application of the expected earnings approach was focused exclusively on forward-looking projections, not historical data.

Moreover, regulators do not set the returns that investors earn in the capital markets – they can only establish the allowed return on the value of a utility's investment, as reflected on its accounting records. As a result, the expected earnings approach provides a direct guide to ensure that the allowed ROE is similar to what other utilities of comparable risk will earn on invested capital. This opportunity cost test does not require theoretical models to indirectly infer investors' perceptions from stock prices or other market data. As long as the proxy companies are similar in risk, their expected earned returns on invested capital provide a direct benchmark for investors' opportunity costs that is independent of fluctuating stock prices, market-to-book ratios, debates over DCF growth rates, or the limitations inherent in any theoretical model of investor behavior.

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

A. Value Line reports that its analysts anticipate an average rate of return on common equity for the electric utility industry as a whole of 10.5% over its forecast horizon.[54] While this provides a rough guide to investors' expectations, the returns on common equity projected by Value Line over its forecast horizon for the comparable-risk group of utilities are shown on Exhibit WEA-12. Consistent with the rationale underlying the development of the br+sv growth rates, these year-end values were converted to average returns using the same adjustment factor discussed earlier and developed on Exhibit WEA-5. As shown on Exhibit

WEA-12, Value Line's projections for the Utility Proxy Group suggest an average ROE of 12.0%.

G. Flotation Costs

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

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

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

A. No. While debt flotation costs are recorded on the books of the utility, amortized over the life of the issue, and thus increase the effective cost of debt capital, there is no similar accounting treatment to ensure that equity flotation costs are recorded and ultimately recognized. Alternatively, no rate of return is authorized on flotation costs necessarily incurred to obtain a portion of the equity capital used

to finance plant. In other words, equity flotation costs are not included in a utility's rate base because neither that portion of the gross proceeds from the sale of common stock used to pay flotation costs is available to invest in plant and equipment, nor are flotation costs capitalized as an intangible asset. Unless some provision is made to recognize these issuance costs, a utility's revenue requirements will not fully reflect all of the costs incurred for the use of investors' funds. Because there is no accounting convention to accumulate the flotation costs associated with equity issues, they must be accounted for indirectly, with an upward adjustment to the cost of equity being the most logical mechanism.

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

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

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

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

Applying these expense percentages to a representative dividend yield for a utility of 4.0% implies a flotation cost adjustment on the order of 14 to 40 basis points. Issuance costs are a legitimate consideration in setting the return on equity for a utility, and I recommend incorporating a minimal, 15 basis-point adjustment in determining a reasonable ROE range for FPL.[57]

IV. RETURN ON EQUITY RANGE FOR FPL

Q. What is the purpose of this section?

A. This section addresses the economic requirements for FPL's rate of return on equity. It discusses the regulatory policy reasons for avoiding a return on equity that is not sufficient to maintain FPL's financial integrity and ability to attract capital. This section also demonstrates the benefits to FPL's customers of an ROE that reflects FPL's need for financial strength and recognizes FPL's low rates and excellent service through management effectiveness. The 11.5% recommended ROE remains well below the 12.25% upper end of my range, and is a reasonable cost for FPL's customers to pay so investors will provide their money to FPL on reasonable terms. Ensuring FPL's financial flexibility and access to capital ultimately results in low cost and reliable service to customers in the long-run, while assuring that Florida has private capital to develop and maintain the vital electric infrastructure.

A. Implications for Financial Integrity

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

A. Given the importance of the utility industry to the economy and society, it is essential to maintain reliable and economical service to all consumers. While FPL remains committed to provide reliable electric service, a utility's ability to fulfill its mandate can be compromised if it is allowed a return too low to attract investors' money.

As documented earlier, the major rating agencies have warned of FPL's exposure to uncertainties associated with ongoing capital expenditure requirements, uncertain economic and financial market conditions, uncertain environmental compliance costs, and the potential for continued energy price volatility. Investors understand just how swiftly unforeseen circumstances can lead to deterioration in a utility's financial condition.

While maintaining and improving the electric infrastructure for customers is certainly desirable, it imposes additional financial responsibilities on FPL. Coupled with FPL's inherent characteristics that require financial strength, investors' fear during times of crisis requires that FPL have the flexibility necessary to overcome periods of adverse capital market conditions. Without an adequate ROE FPL will not be able to compete for investors' money at the very time it is needed most to protect customers.

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

A. Supportive regulation plays a central role in maintaining FPL's access to capital on reasonable terms. Investors recognize that regulation has its own risks, and that constructive regulation is a key ingredient in supporting utility credit ratings and financial integrity, particularly during times of adverse conditions. Fitch concluded, "[G]iven the lingering rate of unemployment and voter concerns about the economy, there could well be pockets of adverse rate decisions, and those companies with little financial cushion could suffer adverse effects."[58] Moody's has also emphasized the need for regulatory support, concluding:

> For the longer term, however, we are becoming increasingly concerned about possible changes to our fundamental assumptions about regulatory risk, particularly the prospect of a more adversarial political (and therefore regulatory) environment. A prolonged recessionary climate with high unemployment, or an intense period of inflation, could make cost recovery more uncertain.[59]

S&P noted, "the quality of regulation is at the forefront of our analysis of utility creditworthiness."[60]

With respect to Florida specifically, the investment community expressed significant concerns over the highly politicized atmosphere surrounding FPL's last

base rate proceedings. S&P acknowledged that FPL's credit fundamentals have been aided by constructive regulation and a sound service area economy, but noted:

> Both of those pillars have been shaken in recent years as Florida, and FP&L's service territory in particular, suffered during the recession, and regulators have responded in ways that reflect greater political influence over regulatory decisions.[61]

More recently, however, the rating agencies have expressed optimism that this period of regulatory and political strife has been replaced by a return to a more orderly and constructive climate. For example, the investment community noted the regulatory clarity provided by the FPSC's approval in December 2010 of the settlement agreement governing FPL's base rates. Although cautioning that deterioration in the regulatory outlook could prompt a downgrade, Moody's noted that FPL's current ratings, "reflect the stabilization of the political and regulatory environment for investor owned utilities in Florida."[62]

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

A. No. Investors recognize that FPL is exposed to significant risks associated with energy price volatility and rising costs and concerns over these risks have become increasingly pronounced in the industry. The FPSC's cost adjustment mechanisms are a valuable means of mitigating those risks, but they do not eliminate them. Of particular concern to investors is the impact of regulatory lag

and cost-recovery on the utility's ability to earn its authorized return. The adjustment mechanisms approved for FPL only serve to preserve FPL's opportunity to earn its authorized return, as required by established regulatory standards.

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

For example, PG&E also operates under numerous balancing account mechanisms that cover a significant portion of its revenue requirements and effectively dampen the impact of fluctuations in electric sales and expenses on its ability to recover the costs of providing service. Similarly, SCANA Corporation's electric and gas utilities operate under weather normalization and

revenue decoupling mechanisms, as well as the ability to implement periodic rate adjustments to reflect new nuclear construction costs. Moreover, in response to the heightened risk associated with utilities' exposure to substantial costs for environmental remediation, adjustment mechanisms designed to allow for recovery of these costs outside a general rate case have become increasingly prevalent. As a result, the mitigation in risks associated with utilities' ability to attenuate the impact of fluctuations in costs is already reflected in the cost of equity estimates developed earlier. Similarly, the firms in the Non-Utility Proxy Group also have the ability to alter prices in response to rising production costs, with the added flexibility to withdraw from the market altogether.

Q. Do the exposures inherent to FPL highlight the need for ongoing support of the company's financial strength and ability to attract capital on reasonable terms?

A. Most definitely. As discussed earlier, FPL faces a number of challenges that require the relatively swift commitment of capital in order to maintain reliable service and preserve low rates. For example, if federal agencies ordered FPL to shutdown one or more generating units (possibly in response to security threats or events far from Florida) this would impose significant reliance on wholesale power markets to meet energy shortfalls. In light of its relative geographic isolation on the Florida Peninsula, contracting for the resources necessary to keep the lights on in the FPL service area would require strong credit and ready access to cash. Similarly, weather emergencies that can devastate parts of Florida have required FPL to fund enormous recovery efforts to protect the health and safety of

its customers and restore utility service. These massive undertakings require FPL to mobilize money and credit on a scale beyond the experience of utilities elsewhere in America. In addition, it is crucial that FPL maintain its ability to meet the significant liquidity requirements necessary for its fuel hedging program.

Apart from this exposure to the vagaries of capital and energy market conditions, FPL must simultaneously meet the long-term energy needs of its service area. To continue to meet these challenges successfully and economically, it is crucial that FPL receive adequate support for its credit standing. While providing an ROE that is sufficient to maintain FPL's ability to attract capital, even under duress, is consistent with the economic requirements embodied in the Supreme Court's *Hope* and *Bluefield* decisions, it is also in customers' best interests. Ultimately, it is customers and the service area economy that enjoy the benefits that come from ensuring that the utility has the financial wherewithal to invest in infrastructure and take whatever actions are required to ensure a reliable energy supply. By the same token, customers and the service area economy suffer when the utility is unable to attract necessary capital.

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

A. FPL's ability to keep pace with the growing needs of its customers demonstrates the advantage that accrues to all stakeholders when the utility is able to maintain a strong financial position. In recent years, FPL has spent billions of dollars to add the new generation and transmission capacity dictated by the demands of a vibrant

service area and repair the devastation wrought by tropical storms. At the same time, FPL was increasing efficiency and lowering emissions from its generating facilities. Despite the associated complexities, including volatile conditions in energy and capital markets, FPL has responded to these challenges while charging relatively low rates to its customers.

As discussed in the testimony of FPL's witnesses, FPL has done an outstanding job of meeting customers' power requirements reliably, efficiently, and at rates that compare favorably with other utilities in Florida. While FPL's financial strength has benefited customers and provided a strong platform for continued success, regulatory actions that undermine financial strength or impair financial flexibility could have swift and damaging consequences. The cost of providing FPL an adequate return is small relative to the benefits of strong utility in providing reliable service and fostering economic growth. And as FPL's history demonstrates, financial strength leads to relatively low rates over the long run.

B. Return on Equity Recommendation

Q. Please summarize the results of your analyses.

A. The cost of equity estimates produced by the analyses described in my testimony are summarized in Exhibit WEA-13. As shown there, the "bare bones" cost of equity estimates (*i.e.*, excluding flotation costs) produced by the alternative approaches explained in my testimony ranged from 9.6% to 12.3%. In evaluating

a fair ROE range for FPL from within these results, I considered the relative strengths and weaknesses inherent in each method, and the implications of quarterly dividend payments and flotation costs. In addition, my assessment also reflects the specific risks and exposures faced by FPL, and the need to consider the importance of maintaining FPL's financial flexibility. Based on my evaluation of these considerations, I concluded that my analyses indicate a fair ROE for FPL in the 10.25% to 12.25% range.

Q. What then is your conclusion as to a fair ROE for FPL applicable to the 2013 Test Year?

A. After considering the potential exposures faced by FPL and the economic requirements necessary to maintain access to capital even under adverse circumstances, it is my opinion that the Commission should allow an ROE at the midpoint of my recommended range, or 11.25%, before any adder for low rates and excellent management. Apart from the results of these quantitative methods, it is crucial to recognize the importance of maintaining a strong financial position so that FPL remains prepared to respond to unforeseen events that may materialize in the future. While this imperative is reinforced by current capital market conditions, it extends well beyond the financial markets and includes the Company's ability to absorb potential shocks associated with devastating hurricanes, volatile fuel pricing, and disruptions in energy supply.

Recent challenges in the capital markets and regulatory environments, and ongoing economic uncertainties, highlight the benefits of FPL's strong credit

rating in attracting the capital needed to secure reliable service at a lower cost for customers. Changing course from the path of financial strength would be extremely short-sighted, especially considering that a combination of events could adversely impact FPL's ability to serve customers if its current financial strength were not maintained.

Q. In evaluating the fair ROE for FPL, is it also appropriate to recognize that customers have benefited from FPL's low rates?

A. Yes. As discussed in the testimony of FPL witness Dewhurst and other FPL witnesses, the Company has distinguished itself in numerous measures of operating efficiency and effectiveness while maintaining relatively low electric rates compared to other Florida utilities. As a result, consumers and the service area economy have benefited from FPL's efficient and cost-effective operations, excellent customer service, improved reliability, and prices that have declined in real terms. As S&P noted, "costs and rates are low, and reliability and customer satisfaction is high."[63] I therefore support FPL's request that the Commission approve a 25 basis point adder, or an ROE totaling 11.50%. An ROE of 11.50% remains well below the 12.25% top end of my reasonable range.

Q. Is an adjustment to recognize FPL's relative performance consistent with sound regulatory policy?

A. Yes. Considering exemplary performance when establishing a fair ROE from within my recommended range is entirely consistent with regulatory economics and past incentive mechanisms approved by the FPSC. While traditional cost of service regulation has provided a foundation for the development of an efficient

and reliable utility system, it is not without drawbacks. One of these is a lack of incentive to achieve increased efficiencies and innovate. Regulation presumably serves as a substitute for the outcome of a competitive market, but unlike firms operating under free competition, which can reap the benefits of efficiency and innovation through higher returns, the ROE for a regulated utility is generally set based on cost of equity estimates for a risk-comparable proxy group. As a result, the traditional cost of service model provides little incentive to encourage and support increased efficiencies. Frequently, the results of the regulatory process are asymmetric, with cost savings associated with innovations and exemplary management being passed on to customers, while less successful endeavors are disallowed, penalized, and absorbed by investors.

This potential inequity was specifically addressed by the Florida Legislature, which granted the FPSC the statutory authority to explicitly consider relative performance when setting rates for utility service.[64] Similarly, the Florida Supreme Court has recognized that adjustments to the ROE represent "the only incentive available" to reward efficiency or punish mismanagement.[65] Thus, including an award for exemplary management above the minimum fair ROE required by investors is entirely consistent with the current regulatory regime in Florida.

Similarly, it is also consistent with past actions of the FPSC. For example, the Commission has formerly approved agreements providing for earnings sharing between FPL's customers and shareholders, and has adjusted allowed ROEs – both upward and downward – to recognize relative performance.[66] Considering FPL's relative performance in establishing the ROE in this case would further confirm the FPSC's commitment to foster an environment in which customers are assured reliable service at reasonable rates, while stockholders are fairly treated.

V. CAPITAL STRUCTURE

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. What equity ratio is implied by FPL's requested capital structure for the 2013 Test Year?

A. As discussed in the testimony of FPL witness Dewhurst, FPL's capital structure based on investor sources results in an equity ratio of 59.6%.

Q. Does this provide a representative basis on which to evaluate FPL's capital structure?

A. No. Depending on their specific attributes, contractual agreements that obligate the utility to make specified payments may be treated as debt in evaluating a utility's financial risk. Because power purchase agreements typically obligate the utility to make specified minimum contractual payments akin to those associated with traditional debt financing, investors consider a portion of these commitments as debt in evaluating total financial risks. The implications of purchased power commitments and other off-balance-sheet obligations have been repeatedly cited by major bond rating agencies in connection with assessments of utility financial risks. Because bond ratings agencies and investors consider the debt impact of such fixed obligations in assessing a utility's financial position, they imply greater risk and reduced financial flexibility.

As discussed earlier, a significant portion of FPL's power requirements are currently obtained through purchased power contracts. These contractual payment obligations are fixed commitments with debt-like characteristics and are properly considered when evaluating the financial risks implied by FPL's capital structure. S&P reported that it adjusts FPL's current capitalization to include

approximately $949 million in imputed debt from off-balance sheet obligations.[67] Unless the Company takes action to offset this additional financial risk by maintaining a higher equity ratio, the resulting leverage will weaken FPL's creditworthiness, implying a higher required rate of return to compensate investors for the greater risks.[68]

Q. What capital structure is implied for FPL's 2013 Test Year once the off-balance sheet obligations associated with purchased power contracts are incorporated?

A. Based on S&P's quantification, an upward adjustment to long-term debt of $949 million was incorporated for 2013 to account for the debt equivalent attributed to FPL's off-balance sheet obligations. As shown in Exhibit WEA-14, this results in an adjusted common equity ratio of 56.3%.

This adjustment not only reflect the investment community's evaluation of FPL's financial risks, it is also consistent with past decisions of the FPSC, which have acknowledged that an adjustment is appropriate to address the capital structure impact associated with purchased power.

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

A. It is generally accepted that the norms established by comparable firms provide one valid benchmark against which to evaluate the reasonableness of a utility's capital structure. The capital structure maintained by other electric utilities should reflect their collective efforts to finance themselves so as to minimize capital costs while preserving their financial integrity and ability to attract capital. Moreover,

these industry capital structures should also incorporate the requirements of investors (both debt and equity), as well as the influence of regulators.

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

A. Exhibit WEA-15 displays capital structure data at year-end 2010 for the group of electric utility operating companies owned by the firms in the Utility Proxy Group used to estimate the cost of equity. As shown there, common equity ratios for these electric utilities ranged from 44.0% to 62.9% and averaged 53.8%. Incorporating the same short-term debt ratio reflected in FPL's 2013 capitalization of approximately 2.2% results in an average common equity ratio for this group of other utilities of 52.6%.

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

A. As shown on Exhibit WEA-16, for the nineteen firms in the Utility Proxy Group, common equity ratios at December 31, 2010 ranged between 30.9% and 52.4% and averaged 45.9%. Adjusting the average capitalization to include short-term debt in the same proportion as FPL would result in an adjusted equity ratio of 44.9%.

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

A. As shown on Exhibit WEA-16, Value Line expects an average common equity ratio for the Utility Proxy Group of 48.1% for its three-to-five year forecast horizon, with the individual common equity ratios ranging from 35.0% to 54.5%.

Adjusting the average capitalization to include short-term debt in the same proportion as FPL would result in an adjusted equity ratio of 47.1%.

Q. What other benchmarks are relevant in assessing FPL's capital structure?

A. From an investor's perspective, the relevant capital structure is based on the market values of securities because investors can only buy and sell securities at market value. To be able to raise capital, companies must pay returns that are competitive at the current market prices of their securities, not the embedded book value of the mix of stocks and bonds. As a result, the market value capitalization for the firms in the Utility Proxy Group also serves as a benchmark in evaluating FPL's capital structure.

As shown on Exhibit WEA-17, at year-end 2010, the market value capitalization for the firms in the Utility Proxy Group implied an average common equity ratio of 59.7%, or 58.9% based on Value Line's projections for its 2014-16 forecast horizon. Adjusting these ratios to consider FPL's short-term debt balances would result in adjusted equity ratios of 58.4% and 57.6%, respectively.

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

A. As discussed earlier, utilities are facing rising cost structures, significant capital investment plans, energy market volatility, uncertainties over accommodating future environmental mandates, and ongoing regulatory risks. Coupled with the potential for turmoil in capital markets, these considerations warrant a stronger balance sheet to deal with an increasingly uncertain environment. A more

conservative financial profile, in the form of a higher common equity ratio, is consistent with increasing uncertainties and the need to maintain the continuous access to capital that is required to fund operations and necessary system investment, even during times of adverse capital market conditions.

Moody's has repeatedly warned investors of the risks associated with debt leverage and fixed obligations and advised utilities not to squander the opportunity to strengthen the balance sheet as a buffer against future uncertainties.[69] As Moody's concluded:

> From a credit perspective, we believe a strong balance sheet coupled with abundant sources of liquidity represents one of the best defenses against business and operating risk and potential negative ratings actions.[70]

Similarly, S&P noted that, "we generally consider a debt to capital level of 50% or greater to be aggressive or highly leveraged for utilities."[71] Fitch affirmed that it expects regulated utilities to employ "a judicious mix of debt and equity to finance high levels of planned investments."[72] More recently, Moody's affirmed that it expects regulated utilities to strengthen their balance sheets in order "to prepare for more challenging business conditions."[73] This is especially the case for FPL, which faces the prospect of financing significant capital expansion plans in a turbulent market while at the same time maintaining its ability to respond to other significant challenges.

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

A. Based on my evaluation, I concluded that the 59.6% common equity ratio requested by FPL represents a reasonable mix of capital sources from which to calculate FPL's overall rate of return. Although this adjusted common equity ratio is higher than the average book value equity ratio currently maintained by the group of electric utility operating companies, it is well within the range of individual results for this reference group, below the average market value equity capitalization, and consistent with the trend towards lower financial leverage expected for the industry. As discussed earlier, it is also consistent with the relatively greater financial strength required to counterbalance the various exposures faced by FPL.

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

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

Q. Does this conclude your direct testimony?

A. Yes.

BY MR. GUYTON:

Q Are you sponsoring Exhibits WEA-1 through 18, which have been identified as Exhibits 193 through 210?

A Yes, sir.

Q And is the information contained in those exhibits true and correct to the best of your knowledge and belief?

A Yes.

Q Please summarize your testimony for the Commission.

A Good afternoon, Commissioners. I'm Bill Avera. I pronounce my name Avera, even though it's an Hispanic name because my family didn't survive the name leaving Florida and going to Georgia. So I hope -- there is some confusion.

My testimony deals with return on equity, ROE, and capital structure. I present in my testimony analyses to support a reasonable range for a fair ROE of FPL from 10.25 to 12.25. And I find and give evidence to support that the midpoint of 11.25 is a reasonable and fair return for FPL.

Now, to get to that conclusion, I considered a number of factors. First, I did four standard accepted analyses on a group of comparable utilities. I chose 14 comparable utilities where the information was available and ran those analyses.

Also, recognizing that investors have choices, and they not only invest in utilities, but they invest in other

companies and hold diversified portfolios, I selected a group of 13 extremely low risk, mature, recognized blue-blue chip companies and conducted a DCF analysis on those companies.

Having conducted these analyses, I then looked to where we should position FPL in the reasonable range, and I considered the inherent risk that FPL faces and its challenges because of its unique characteristics. And then I also considered flotation costs and the quarterly payment of dividends to come up with my reasonable range.

My testimony also deals with the ROE adder. Now, my role is to give the regulatory philosophy behind the adder, how it is sound regulation, how it's consistent with what this Commission has done in other cases and how it models the way free enterprise markets work.

Others present the facts and figures to support that FPL has a record of superior customer service, low rates, efficiency and reliability, and excellence in management that support the adder.

And finally, my testimony deals with the issue of capital structure. I show that the capital structure presented by Mr. Dewhurst is the actual capital structure of the company and is an appropriate capital structure. It is reasonable and it's in the customer's interest that that capital structure be used.

Now, my suggested 11.5 ROE and the actual capital

structure is reasonable and is a good deal for customers because investors have choices. They have many places vying for their money and they will not make money available to FPL unless its return is commensurate with its risk.

We have seen that this company has been challenged by the actions of the market when in 2010 the order was disappointing and shocking. And then we saw later in 2010, when the settlement gave the company an opportunity to earn a reasonable return, the financial position stabilized. This is important to customers.

A financially strong company can get a better deal for customers. It pays less for debt, it is in a better position to negotiate with vendors, it is in a better position to get fuel, it's in a better position to hedge its fuel.

FPL is exposed to storms, it has nuclear power, it has natural gas, it's located at the end of a peninsula, and it has an economically vulnerable service area. Now, some utilities have these characteristics but FPL is unique in the interaction of these characteristics. And that's why it's so important for FPL to maintain strength.

What we saw when the market was disappointed by the Commission's actions, bond ratings went down and ultimately the customers would have suffered. Fortunately, there was an agreement which allowed the company to earn 11

percent -- actually earn 11 percent -- and that worked to the benefit of the customers. Thank you.

CHAIRMAN BRISE: Thank you, Dr. Avera.

MR. GUYTON: We tender Dr. Avera for cross.

MR. YOUNG: Mr. Chairman, the parties have graciously agreed that I can go first. And with that, Staff -- in lieu of Staff's cross, Staff is going to request that what is identified as hearing Exhibit 112 on the comprehensive exhibit list be marked and moved into the record. This will be amended to include the late filed deposition exhibits that the parties have received. And I think we are trying to locate Dr. Avera's errata sheet, which was sent out this morning or late yesterday.

CHAIRMAN BRISE: Okay, are there any objections?

MR. GUYTON: FPL has no objections. That's all part of 112?

MR. YOUNG: Yes.

MR. MOYLE: FIPUG has no objections but is unclear with respect to the deposition is 112 and then there's another exhibit. Is that part of 112 or 113, or --

MR. YOUNG: That's part of 112.

MR. MOYLE: Okay, so two 112s. Got it.

CHAIRMAN BRISE: Any further objections or questions on this exhibit? All right, seeing none,

thank you very much. So now we'll deal with the moving in a little bit later.

(Exhibit 112 marked for identification.)

CHAIRMAN BRISE: Mr. Young, is that it?

MR. YOUNG: I'm done.

CHAIRMAN BRISE: Okay. I wasn't sure with the errata if you had found it or not.

MR. GUYTON: It's in the process of being copied, Mr. Chairman.

CHAIRMAN BRISE: Okay. All right, FIPUG? Just so that you know, we'll be taking our afternoon sort of dinner break at 5:00, so manage yourself accordingly. You know, you can come back and continue your questions post that time --

MR. MOYLE: Okay.

CHAIRMAN BRISE: -- if necessary.

MR. MOYLE: Thank you. And maybe just right before the break also we can deal with the errata. FIPUG has no objection to any of the exhibits and any of that.

CROSS EXAMINATION

BY MR. MOYLE:

Q Good afternoon --

A Good afternoon, Mr. Moyle. Good to see you.

Q -- Mr. Avera. Thank you for the help on the pronunciation. I've heard it a couple of ways and I'm sure

you've heard it a lot more often a couple of ways than I have.

A Yes, sir.

Q You have not been here throughout much of this hearing, correct?

A Well, I've watched a good deal of it since Tuesday afternoon on the television.

Q Okay. There's a provision in the order that the Chairman has entered and he has repeatedly directed witnesses, if a question is phrased or posed to solicit a yes or no answer, that the witness answer the question yes or no. Can you comply with that order?

A Yes.

Q I was hoping that would be your answer, and thank you. I have some introductory questions. In your opening you talked about investors having choices and capital seeking places where it can earn the best return for the lowest risk. And you also have DCF models and a lot of ways to calculate an ROE.

And with respect to your testimony about what investors will or will not do, I am not sure whether that is testimony based on facts or theory. And if you could -- if you could -- is it based on theory?

A Yes, along with factual inputs and necessary professional judgments.

Q Okay. So when we talk about investors, then I'm correct in assuming largely that's theoretical, correct?

A No. Investors exist, they have money, and if they don't make the money available to FPL, the lights will go out.

Q On a couple of -- let me direct you to page 27, line 15. You have two places in your testimony. One you talk about -- well, let me just take them one at a time: 27, 15.

A Yes, sir.

Q You use the phrase political brinkmanship over raising the Federal debt ceiling. What are you referring to there?

A I'm referring to that period of time when Congress could not reach a conclusion to extend the debt limit, and had they not been successful, the United States of America would have defaulted on its obligations.

Q But Congress was successful, correct?

A Yes, sir, they were. Thank you, Congress.

Q And I guess successful may be with a small "S" in that in a lot of respects they've made some budgets decisions but have put a trigger in place that said they need to make further budget decisions or else certain cuts will befall the military and domestic programs; is that a fair characterization?

A Yes, it's sometimes called the fiscal cliff. And also there was a down-rating of the credit rating of the country. It's a sovereign debt in part because of that episode.

Q Okay. And I have an exhibit that I'd like to have handed out, if I could.

CHAIRMAN BRISE: This will be marked as 543. Any objections?

(Exhibit 543 marked for identification.)

MR. GUYTON: I'm a little bit hard-pressed to raise an objection until I hear the questions. This looks to be hearsay on the part of the witness, and I don't know how the exhibit is to be used, Mr. Chair.

MR. MOYLE: Sounds like he needs me to pose my question first.

CHAIRMAN BRISE: That's what it sounds like to me, too.

BY MR. MOYLE:

Q Mr. Avera, take a minute if you would and maybe just review the first few paragraphs of the exhibit. It's entitled Florida -- I'm sorry -- Federal Budget, quote, unquote, Sequestration Threatens Florida Military Bases.

A Yes, sir.

Q And the questions that I just asked you with respect to your reference to the political brinkmanship and

your relating of the actions of Congress, is it your understanding that this 1.2 billion -- I'm sorry, 1.2 trillion trigger is set to take place in January, as reflected in the second paragraph of this article?

A Yes, sir.

Q And do you have any understanding with respect to the impacts that this sequestration may have on the defense industry in the state of Florida?

A Yes, sir. I'm a retired military -- retired Naval officer, and I spent many happy years sailing ships out of Mayport. So I know that the military is important to this state.

Q And I guess the other point is are you aware that Florida is working hard to -- as it says in the article -- to make the state one of the nation's most military friendly?

A Yes, sir.

Q That's all I have. Page six, line 18 -- I'm sorry, I got that wrong. Let me refer you to page 11, line 10. You were asked the question can the Florida Public Service Commission be confident that allowing an ROE in the range of 10.25 percent to 12.25 percent range represents a reasonable cost for FPL's customers. And you say yes, correct?

A Yes.

Q Am I correct in understanding your testimony,

then, that your recommendation with respect to 11.25 is not the only number that in your judgment would be reasonable, correct?

A That is correct. It is the midpoint of a range from 10.25 to 12.25, and in my judgment that represents a reasonable range for this Commission to consider the return on equity for FPL in this case.

Q Okay. And you would likewise agree that given your testimony, all your testimony here speaks to a number that includes 10.25, correct? Yes?

A That is correct, plus if the Commission agrees with the equity adder there would be another 25 basis points.

Q All right. You -- page nine, line three, you made some comments in your opening about the last rate case. I think you said it was disappointing and shocking in your opening, correct?

A Yes, sir.

Q And I assume that that is your opinion that you're expressing, correct?

A No, sir.

Q So you don't have an opinion with respect to the rate case order?

A Well, I have an opinion but my opinion doesn't matter. What matters is how investors reacted. And those words -- disappointing, shocked -- were in Value Line. There

have been similar descriptions by S&P and Moody's when they downgraded FPL's ratings.

So Bill Avera's ideas are important to me and my family, but this Commission needs to be concerned about the investment community, because they're the ones that make capital available and decide if FPL can get capital in good times and bad. When the storms come, when the financial turmoil comes, it can get capital to save the customers money in the long run.

Q But you would agree, would you not, that this Commission also needs to be keenly concerned about the interest of Floridians who receive power from Florida Power & Light, correct?

A Absolutely. As I mention in my testimony, this Commission is the agent for the company.

MR. MOYLE: Mr. Chair, I'm only interested in the yes. I don't need the additional.

BY MR. MOYLE:

Q You state, on line three, that FPL's customers become exposed to less reliable and more expensive electric service, correct?

A Yes.

Q And you stand by that comment?

A Yes, sir. Yes, sir. In the long run, it will be more expensive if the strength goes down.

Q Okay. But with respect to -- your next sentence talks about the 2010 rate order. Am I correct in assuming that you were commenting on the 2010 decision in this answer to this question?

A Yes, sir.

Q Okay. So you say that the customers have been exposed to less reliable service. Have you read Mr. Reed's testimony? Do you know Mr. Reed?

A Yes, sir.

Q And have you read his testimony?

A Parts of it, yes, sir.

Q Are you aware that Mr. Reed provided testimony that FP&L ranks high in reliability even after the rate case?

A Yes, sir.

Q Okay. And with respect to more expensive electric service, you don't have any evidence that you can point to that FPL's ratepayers -- you use the word customers -- but that they have incurred additional cost with respect to the price -- the price of electricity following the order in the 2010 rate case, am I correct?

A Yes, sir. As we discussed in my deposition, it's the long run effect that's important. If you turn to page six of my testimony, the Staff, in their report, gave examples of customers paying more.

Q I appreciate that. And you agreed in the

deposition and you agree with me today that with respect to your statement about the customers becoming exposed to less reliable and more expensive electricity that there's no evidence, there's no facts supporting that, and that your view on that is looking down the road as to what may happen, correct?

A No, sir.

MR. GUYTON: I object. He's characterizing -- mischaracterizing testimony taken out of a deposition. We have the witness here. He can ask the witness the question that he wants to ask him rather than recharacterizing what Dr. Avera supposedly said in deposition.

MR. MOYLE: I thought he was getting to that point in his live testimony. I mean, I can clarify it, but --

CHAIRMAN BRISE: If you can clarify the question. Make it direct.

BY MR. MOYLE:

Q Mr. -- Mr. Avera -- Avera, I'm sorry -- there's no evidence, looking factually, and looking in a retrospective vantage point, that FPL's customers have had to experience less reliable electrical service following the last rate case, correct?

A No, there is no evidence. But had it extended and the settlement not been reached, then the bond ratings that

occurred, D ratings, would have likely cumulated and ultimately customers would be exposed, as I say in the testimony, to less reliable and more expensive energy.

Q And we're going to talk about what would have happened, but I just am trying to get you to agree that factually, from a retrospective basis, there's no evidence to support either customers being exposed to less reliable energy or more expensive electric service; we can agree with that, correct?

A No, we can't.

MR. GUYTON: Objection, asked and answered.

BY MR. MOYLE:

Q Well, I asked it with respect to less reliable and I thought I got an answer. I'll ask it with respect to more expensive, if we need to do it that way.

From a retrospective analysis, following the last rate case with FP&L, you have no evidence with respect to customers -- customers incurring any monetary loss in having to pay more for electric service, correct?

A Correct, for that period. But they were exposed to a scenario where reliability and cost could have deteriorated.

Q But you would agree with me that from a ratepayer's perspective -- you talk a lot about from an investor's perspective -- from a ratepayer's perspective,

being exposed to something where it doesn't take any money out of your pocket as compared to having something that takes money out of your pocket, that there's a pretty big difference between those two, correct?

A No, you and I have insurance because we're exposed to fires and traffic accidents and we want our family protected if something happens to us. So that's the reason we have insurance, to protect us from those risks.

Q All right. And just one final point on this line, and maybe we'll take a break. But with respect to the answer of the question I asked you, I thought I heard you say that your concern was -- you used the word could, and, you know, prospective -- your concerns are more prospective as compared to looking at a retroactive factual analysis, is that right?

A Yes, but it is factual. It is a fact, and I present the facts.

MR. MOYLE: Okay. Okay, that may be --

CHAIRMAN BRISE: This is a good time to break. It is 5:02 so we'll return at about 6:00.

(The transcript continues in sequence in Volume 14.)

CERTIFICATE OF REPORTER

STATE OF FLORIDA)
COUNTY OF LEON)

I, LAURA MOUNTAIN, Court Reporter, do hereby certify that I was authorized to and did stenographically report the foregoing proceedings; and that the transcript is a true record of the aforesaid 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' attorney or counsel connected with the action, nor am I financially interested in the action.

Dated this 28th day of August, 2012.

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