981390-EI

State of Florida

Public Service Commission

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Tallahassee, Florida 32399-0850

FACSIMILE TRANSMITTAL COVER SHEET

DATE: November 18, 1998

TO: MICHAEL B. TWOMEY
Phone No. (850) 421-9530
Facsimile No. (850) 421-8543

FROM: BOB ELIAS
Phone No. (850) 413-6189
Facsimile No. (850) 413-6250

RE: Florida Power & Light Company Equity Investigation Docket.

MESSAGE: Per your November 12, 1998, request to Beth Salak

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FPSC-RECORDS/REPORTING

MEETING AGENDA

Date: 11/16/98	Place: 307 G[illegible]	Time: 1:00 p.m.
Topic Discussed:		

Persons Attending

Name:	Representing:	Phone Number:
Beth [illegible]	FPSC / AFAD	850 413-[illegible]
M. Childs	FPL	850 222-2300
Bill Walker	FPL	850 . 224-7517
Don Baeta	FPL	305-552-47[illegible]
[illegible]	"	850 . [illegible]
Terry Keith	"	305-552-4334
David Draper	FPSC - AFAD	850-413-708[illegible]
[illegible]	OPC	(850) 488-93[illegible]
Dale Mailhot	FPSC-AFAD	850-413-6418
John Slemkewicz	FPSC AFAD	850-413-6420
Andy Bertron	Fla. Alert	850.224.7091
Vicki Gordon Kaufman	FIPUG	850-222-2525
Andrew Maurey	FPSC	(850) 413-6465
Pete Lester	FPSC	(850) 413-6467
Bob Elias	"	850-413-6189
Tom [illegible]		
[illegible] Cox	Equi[illegible]	
Joel Rosenblatt		
Rod [illegible]		

[illegible]
Robert Taylor
Agri[illegible] & [illegible]
Harris
R. [illegible] Zimmerman
Fl. Alert
New [illegible]
[illegible]
[illegible]

APPENDIX

Staff's Analysis of FPL's Presentation

At the November 3, 1998 Agenda Conference, FPL presented many arguments opposing staff's recommendation. Throughout its presentation, FPL argued that the Commission should take the "longer view" and characterized staff's recommendation as "a short-term perspective." The longer view stated by FPL is that it has a plan and is in the middle of the plan. The Commission should not consider changing the equity ratio and ROE in the middle of the plan. Staff believes this recommendation does not disrupt the plan and that a review of FPL's capital structure and ROE are within the scope of the plan. The plan does not exclude these issues from review.

EQUITY RATIO ARGUMENTS

Argument 1: Staff focuses on the common equity ratio whereas Standard & Poor's (S & P) focuses on the debt ratio adjusted for the off-balance sheet obligation. S & P does not publish an adjusted common equity ratio.

Staff Response: On page 2 of the staff recommendation, staff defines the equity ratio as a firm's common equity divided by total-investor supplied capital, which includes common equity, preferred stock, long-term debt, and short-term debt. Staff believes the Commission should focus on the common equity ratio in analyzing FPL's capital structure. Common equity is the highest cost source of capital and the level of FPL's common equity can be controlled by its parent company, FPL Group, Inc. Also, the return on common equity has an associated tax impact, which significantly affects utility revenues.

FPL's common equity ratio as of March 31, 1998 is a conspicuous 64.1%. For the same March 31, 1998 data, of all electric utilities that have bond ratings of AA+, AA, or AA-, only FPL has an equity ratio above 60%.

Staff's calculation of FPL's equity ratio and adjusted equity ratio is presented below:

FPL's Capital Structure Ratios As of March 31, 1998 $ in millions				
	Equity Ratio		Adjusted Equity Ratio	
	Amounts	Ratios	Amounts	Ratios
OBSO*	- - -	- - -	$1,261	
				42.50%**
Total Debt	$2,474	32.90%	$2,474	
Preferred Stock	$ 226	3.00%	$ 226	2.60%
Common Equity	$4,823	64.10%	$4,823	54.90%
Total	$7,523	100.00%	$8,784	100.00%

* OBSO - Off-balance Sheet Obligation **42.5% is the adjusted debt ratio.

Though S & P publishes the equity ratios of electric utilities, it does not publish the adjusted equity ratio. It does publish the adjusted debt ratio, which is 42.5% for FPL as of March 31, 1998. However, as shown on the preceding chart, the complement of the adjusted debt ratio is the adjusted common equity ratio and preferred stock ratio. As presented on Attachment 7 (attached to this appendix), FPL's adjusted debt ratio is at the low end of the range for the peer group. FPL's adjusted debt ratio is significantly lower than the respective median and average for the peer group. Therefore, a review of FPL's adjusted debt ratio, as suggested by the utility, reveals the same problem as the review of FPL's adjusted equity ratio.

When staff began discussing the equity ratio issue with FPL in June 1998, FPL explained that its equity ratio should be considered in light of its off-balance sheet obligation related to its purchased power contracts. Therefore, for comparability, staff has calculated FPL's actual and adjusted equity ratios and compared these with the same ratios of other electric utilities, as presented on Attachments 4 and 5 of the recommendation.

From a regulatory perspective, the equity ratio and ROE are what drive the cost of capital. As shown on Attachment 5, FPL has a higher cost of capital than other investor-owned electric utilities in Florida. Therefore, the Commission should focus on FPL's equity ratio and adjusted equity ratio in reviewing the utility's capital structure and cost of capital.

__Argument 2__: Staff ignores the effect of preferred stock. This makes a difference in the comparison when preferred stock is added to the equity ratio.

__Staff Response__: Attachment 7 (attached to this appendix) shows the ratio of preferred and common equity to total investor capital for FPL and each utility in the peer group. When adjusted for the effect of the off-balance sheet obligations, this ratio is simply the complement of the adjusted debt ratio. With the adjustment for off-balance sheet obligations, FPL's adjusted preferred and common equity ratio, 57.5%, is near the high end of the range for the peer group and is significantly above the average and median for the peer group. FPL's actual preferred and common equity ratio, 67.1%, is significantly above the ratios of the peer group.

Typically, preferred stock represents a small percentage of investor capital. In addition, the cost rate for preferred stock is similar to the cost rate for debt and is much lower than the cost rate for common equity. Therefore, including preferred stock in the equity ratio calculation provides nothing to the analysis not previously revealed when only common equity is analyzed.

__Argument 3__: Staff's peer group of electric utilities excludes companies that do not have off-balance sheet obligations.

__Staff Response__: As noted above, FPL explained in meetings with staff and OPC that its equity ratio should be reviewed in light of the off-balance sheet obligations related to its purchased power contracts. Staff selected its peer group of electric utilities using the following criteria: the utilities had to have bond rating of AA or AA- and the companies had to have off-balance sheet obligations. These 12 companies have situations similar to FPL's. Adding utilities that do not have off-balance sheet obligations detracts from the main issue - off-balance sheet debt equivalents -

that FPL offers as the reason for its actual equity ratio being 65.7% for forecasted 1998.

FPL's argument is that it should be allowed a higher equity ratio than is typical for the industry because of its off-balance sheet obligations, which are related to its purchased power contracts. To test the validity of this argument, it is necessary to isolate a group of utilities that truly represent FPL's position, namely, AA rated electric utilities with off-balance sheet obligations. Initially, FPL pointed out that staff should recognize S & P's view of the off-balance sheet obligations when comparing FPL's equity ratio with those of other electric utilities. Now that staff is focusing on those utilities with off-balance sheet obligations FPL argues that staff is not using a comparable group.

FPL cannot have it both ways. Staff believes its current analysis and the resulting peer group of electric utilities is appropriate for reviewing FPL's equity ratio.

Argument 4: If FPL were to reduce its common equity ratio to 57.13%, it would have to pay approximately $600 million in dividends to its parent company. According to FPL, "The only way you're going to get that money is to either stop your amortization substantially and issue debt, or issue all debt and dividend it out." FPL states it would have to issue debt and pay the proceeds as a dividend to the parent.

Staff Response: For regulatory purposes, the Commission has adjusted the equity ratios of United Telephone Company of Florida (See Docket No. 910980-TL, Order No. PSC-92-0708-FOF-TL, issued July 24, 1992) and Tampa Electric Company (See Docket No. 950379-EI, Order No. PSC-98-0802-FOF-EI, issued June 9, 1998). The key here is that the company can maintain whatever level of common equity it wants to maintain. However, for regulatory purposes, such as measuring earnings, the Commission can adjust the equity ratio to a reasonable level. With such an adjustment, ratepayers will bear only the cost associated with a reasonable equity ratio. If FPL issues debt, the cost of capital the ratepayers must pay will decrease.

Argument 5: Referring to Attachment 4, staff states that FPL's equity ratio and an adjusted equity ratio increased significantly from 1994 to March 31, 1998. Staff states "whereas the averages for the peer group do not show a corresponding increase." However, FPL's adjusted equity ratio for 1994 is 11% lower than the average for those companies for the prior year. According to FPL, this is not a fair comparison.

Staff Response: The growth in FPL's equity ratio, as presented on Attachment 4, is significant. FPL's equity ratio and adjusted equity ratio have grown significantly - 31.9% from 1994 to March 31, 1998 - from below average to above average. No other company in the peer group experienced this amount of growth. This growth has resulted in FPL having a comparably high equity ratio. Much of this growth has occurred since the utility's bond rating was upgraded from A+ to AA- and without significant additions to purchased power commitments. FPL's equity ratio continued to increase beyond the average. It increased by 9.6% from the end of 1996 to March 31, 1998.

Argument 6: Also on Attachment 4, for 1996 and 1997, Florida Power Corporation's (FPC) adjusted equity ratio declined from 51.9% to 42.3%. This was due to FPC's write-offs of costs. Staff did not take into account how this affects the average for the group of companies to which it compares FPL.

Staff Response: Undoubtably, FPC's equity ratio declined due to write-offs of costs. Still, it is only one of twelve companies in the peer group, so the effect on the average is not great. Moreover, even with the lower level of equity, the bond rating agencies did not downgrade FPC's rating. FPC still supports an AA- bond rating with an equity ratio lower than the average for the peer group and much lower than the level forecasted by FPL.

ROE PROBLEMS

Argument 7: Earlier documentation provided by staff showed that AA companies, which are now being used as the comparable for FPL, had allowed returns of 12.3% for one and 12.5% for another.

Staff Response: The ROEs mentioned are not current. In the documentation provided by staff, the two highest ROEs were set in the mid-1980s. Staff's recommendation asks the Commission to go to hearing to decide an appropriate ROE for FPL under **current** market conditions.

Argument 8: On pages 10 and 11 of the recommendation, staff refers to recent allowed ROE's. One of those companies, Empire, is a distribution-only company, has less than 5,000 customers, and it was a settled case. Pacificorp is a distribution-only case and its 10% ROE had a range of up to 12.5%. Some of these distribution-only cases result from various reorganizations. Concord said its 10% return had been challenged because there was no evidence to support it.

Staff Response: On page 11 of the recommendation, staff lists recent ROEs set by other state regulatory commissions. This chart has a limited purpose in that it shows the downward trend in ROEs, consistent with the decline in interest rates. FPL criticizes several decisions as settlements or for distribution-only companies. Circumstances vary from case to case but the trend toward lower ROEs is obvious. In addition, the utilities in the chart have lower bond ratings than FPL's. These utilities should receive ROEs higher than that set for FPL, all other things being equal.

Argument 9: While the cost of capital has increased in percentage terms, as shown on Attachment 5 of the recommendation, FPL's rate base has declined. Therefore, as shown on the FPL handout distributed at the agenda conference, FPL's cost of capital in dollar terms has decreased.

Staff Response: This is a valid point. In large part, due to the plan ordered by the Commission and executed by FPL, rate base has decreased. However, the decrease in rate base should not exempt the utility from a review of its cost of capital. The issue is not whether the cost of capital in dollar terms went up or down. The reasonableness of the capital costs is the issue. To address that issue, the Commission should review the utility's capital structure and cost rates, the most important components of which are the equity ratio and ROE.

Argument 10: S & P says FPL's bond rating is stable. Changing the equity ratio might affect the bond rating.

Staff Response: S & P defines the rating outlook as follows:

> A Standard & Poor's Rating Outlook assesses the potential direction of a long-term credit rating over the intermediate to longer term. In determining a Rating Outlook, consideration is given to any changes in the economic and/or fundamental business conditions. An Outlook is not necessarily a precursor of a rating change or future CreditWatch action. Standard & Poor's, Financial Statistics, March 31, 1998, Global Utilities Rating Service.

Staff does not believe that a hearing regarding the equity ratio and ROE will cause a change in FPL's Rating Outlook or in its bond rating. Also, a stable outlook means that a rating is not likely to change. Staff believes that S & P understands the regulatory process.

FPL's suggestion that a regulatory adjustment to its equity ratio would jeopardize its bond rating is contradicted by experience. Tampa Electric Company's bond rating was not downgraded after the Commission adjusted the equity ratio for purposes of measuring earnings subject to the earnings sharing plan. In addition, FPC's bond rating was not downgraded when the utility recognized write-offs that reduced its actual equity ratio from 59.4% in 1996 to 47.4% in 1997.

DOCKET NO. 981390-EI
DATE: November 19, 1998

ATTACHMENT 7

FLORIDA POWER & LIGHT COMPANY
EQUITY RATIO AS OF MARCH 31, 1998

					Includes Preferred Stock in the Numerator		
S&P Bond Rating	Electric Company	OBS	Equity Ratio	Adj. Equity Ratio	Equity Ratio	Adj. Equity Ratio	Adj. Total Debt
AA	Madison G & E	10.40	57.0%	55.2%	57.0%	55.2%	44.8%
	Tampa Electric Co.	41.30	59.8%	58.7%	59.8%	58.7%	41.3%
AA-	Central Illinois Light Co.	13.70	48.7%	47.8%	58.5%	57.3%	42.7%
	Florida Power Corp.	450.30	47.2%	42.1%	48.1%	42.9%	57.1%
	Indianapolis Power & Light	60.10	53.8%	51.7%	57.8%	55.5%	44.5%
	Kentucky Utilities	138.50	51.4%	46.1%	54.7%	49.1%	50.9%
	Louisville G & E	16.80	48.0%	47.5%	54.7%	54.1%	45.9%
	Northern State Power (MN)	229.50	47.7%	45.6%	51.8%	49.6%	50.4%
	Oklahoma G & E	136.80	54.3%	49.8%	54.3%	49.8%	50.2%
	Otter Tail Power	31.10	46.4%	43.4%	54.9%	51.4%	48.6%
	Union Electric Co.	35.40	52.6%	52.2%	56.1%	55.7%	44.3%
	Wisconsin P & L	144.60	53.1%	47.0%	58.5%	51.8%	48.2%
	Average	109.04	51.7%	48.9%	55.5%	52.6%	47.4%
	Median	50.70	52.0%	47.6%	55.5%	52.9%	47.1%
	Florida Power & Light	1,261.10	64.1%	54.9%	67.1%	57.5%	42.5%

Source: S & P Financial Statistics, Global Utilities Rating Service, March 31, 1998

State of Florida

ORIGINAL

Public Service Commission

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

DATE: November 23, 1998

TO: Mr. Bill Walker
Mr. Matthew M. Childs, Esquire
Mr. John Roger Howe, Esquire
Ms. Vicki Gordon Kaufman, Esquire
Mr. Richard Salem, Esquire
Mr. Tom Pennavaria
Mr. Richard Zambo, Esquire
Mr. Jay Brew, Esquire
Mr. Andy Bertron, Esquire

FROM: Robert V. Elias, Chief of Electric & Gas, Division of Legal Services RVE
Wm. Cochran Keating, IV, Senior Attorney, Division of Legal Services WCK

RE: Docket No. 981390-EI - Investigation into the equity ratio and return on equity of Florida Power & Light Company.

Via Facsimile

MEETING NOTICE

The continuation of the discussion begun on Wednesday, November 18, 1998, in the above-referenced docket will be held at the following time and place:

10:00 a.m., Tuesday, November 24, 1998
Florida Public Service Commission
2540 Shumard Oak Boulevard, Room 262
Tallahassee, Florida

Two hours have been reserved for this meeting. Please note that no meet-me conference call has been arranged. If you have any questions about the meeting, please call Pete Lester at (850) 413-6467 or Cochran Keating at (850) 413-6193.

RVE/js

cc: Blanca Bayo, Pete Lester, David Draper, John Slemkewicz, Tim Devlin, Beth Salak, Andrew Maurey, Mike Haff

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