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**Sent:** Friday, September 21, 2012 4:15 PM
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**Subject:** Hendricks' Post Hearing Statement of Issues and Positions and Post-Hearing Brief
**Attachments:** Hendricks Post-Hearing Brief & Positions.docx

Electronic Filing

a. Person responsible for this electronic filing:

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b. Docket No. 120015-EI

In re: Petition for rate increase by Florida Power & Light Company

c. Documents being filed on behalf of John W Hendricks

d. There are a total of 2 pages, plus 2 pages for the Certificate of Service.

e. The document attached for electronic filing is: Electronic Filing

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b. Docket No. 120015-EI

In re: Petition for rate increase by Florida Power & Light Company

c. Documents being filed on behalf of John W Hendricks

d. There are a total of 12 pages, plus 2 pages for the Certificate of Service.

e. The document attached for electronic filing is: HENDRICKS' POST-HEARING STATEMENT OF ISSUES AND POSITIONS AND POST-HEARING BRIEF

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06390 SEP 21 ≌
FPSC-COMMISSION CLERK

Thank you for your attention to this request.

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**BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**

| In re: Petition for increase in rates by Florida Power & Light Company. | DOCKET NO. 120015-EI<br><br>FILED: September 21, 2012 |
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John W. Hendricks, pursuant to Order No. PSC-12-0143-PCO-EI and ORDER No. PSC-12-0439-PCO-EI, files this Post-Hearing Statement of Issues and Positions and Post-Hearing Brief.

## BASIC POSITION

This case offers the Commission a real opportunity to go beyond just balancing the competing positions of FPL and the representatives of its various ratepayers. Certainly the Commission is responsible for making decisions where stakeholder interests are in conflict, but some combinations of choices can be more efficient than others. An innovative commission can actively favor balancing the sometimes competing interests of FPL and its ratepayers in ways that are more efficient, and therefore provide a net gain, increasing the size of the pie to be shared instead of just carving it up differently. The capital structure issues in this case present the commission with a substantial opportunity to improve the economic efficiency of the results of this rate case.

The evidence in this case supports the conclusion that the regulatory capital structure requested by FPL is unnecessarily costly, but can be adjusted to better serve ratepayers without harming investors, for both the short and longer term. There is widespread understanding of the importance of ROE in driving the cost of ratepayer bills, but the effects of capital structure are

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more complex and less widely understood by the public and some policymakers. There are four elements to this position recommending changes to the regulatory capital structure: tax efficiency, taking advantage of low debt costs, reducing ratepayer risk, and transparency and cost effectiveness.

**Tax Efficiency**

The revenue requirement and rate structure in this case are driven by a requested regulatory equity ratio and ROE that burdens ratepayers with an effective 13.2% cost of investor capital (defined as including only equity and long term debt for all of the following analysis). This includes about $680 million per year (about 4.1%) just to "gross up" the equity returns to compensate for a 35% federal and 5% state corporate income tax.[1] Each reduction of the equity ratio by 1% would reduce ratepayer costs to gross up equity returns and the total revenue requirement by about $8 million per year, based on the reasonable assumption that incremental changes in the equity ratio do not either raise or lower the overall cost of investor capital, but do marginally increase the required ROE on a shrinking percentage of equity (as illustrated in Exhibit JWH-6)[2].

Even if the equity ratio is reduced by 15%, it would still be within a reasonable range for a large electric utility operating company and very near the actual equity ratio reported for FPL's parent NextEra Energy and the average of the utility proxy group presented by FPL's witness Dr. Avera and graphed in my exhibit JWH-3[3]. <u>With a 45% equity ratio the "equity tax gross up" savings to ratepayers would be about $120 million each year.</u>[4] Please note that this assessment assumes that the total returns to FPL (equity and bond) investors remain the same; it does not depend on arbitrarily reducing the regulatory ROE. These ratepayer savings are exclusively from

[1] Based on $21,820 Revised Jurisdictional Adjusted Rate Base from Schedule A-Sum for year 2013, Line 17.
[2] Ex. 378
[3] Ex. 375
[4] Based on $21,820 Revised Jurisdictional Adjusted Rate Base from Schedule A-Sum for year 2013, Line 17.

the equity "gross up" costs that are applied through the revenue multiplier and include accounting for incremental increases in ROE as the equity ratio decreases. The only loser is the taxman.

**Taking Advantage of Low Debt Costs**

The cost of long-term debt is historically low at this time and there is good reason to expect it to remain so for the reasonably foreseeable period of about three years, based on the Federal Reserve policy statements such as this excerpt from a recent press release from the Federal Open Market Committee:

> To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In particular, the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015. [5]

Fed policy is specifically targeting a reduction in the cost of long- term debt for mortgages and business investment to reduce unemployment.

This comes at a time when the average utility bond yields are already at historically low levels (lower than any other year going back to 1974) as illustrated in my Exhibit JHW-5A[6]. The average utility equity premium over bonds as a percentage of the average utility bond yield is also much higher as bond rates have decreased substantially more than equity ROE over the last 20+ years. Since 2008, the average utility equity premium has gone up from about 60% to over 100%. The rates requested by FPL in this case exhibit an equity premium over bonds of about 119%, and if the equity tax gross up costs are included, this premium becomes about 190%, which means that equity costs ratepayers almost three times as much as debt financing.[7]

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[5] Federal Reserve Press Release, Sept 12, 2012.
[6] Ex. 377.
[7] Tr. at 2279.

It is likely that debt costs would be substantially higher if the Fed were not pursuing an accommodative monetary policy, but they are, and while this policy continues it is sensible to take advantage of the unusually low cost of debt. The very high equity ratio requested by FPL might be reasonable in an environment with relatively high debt costs and a smaller equity premium over debt, but it is unnecessarily punishing for ratepayers in the low interest rate environment which currently exists and which the Federal Reserve has indicated they are likely to maintain until mid-2015.

**Reducing Ratepayer Risk**

In addition to being more costly, the excessive use of equity requested by FPL substantially increases the risk of future rate increases. Equity usually trades at a substantial, but variable, premium to debt at a given time, because it is a subordinate claim on returns. However, long-term fixed rate debt "locks in" the market rate for the issuer (and the ratepayer in this case) that is in effect at the time it is sold. This means that the buyer of the debt assumes the risk of future changes in interest rates. In contrast, the market cost of equity is based on a variable premium above the market price of debt on each trading day. The regulatory ROE does not vary daily, but it is adjusted to then current market conditions with regulatory action typically available in two to four year periods. This leaves the ratepayer exposed to much higher financing costs for equity in future years, while long-term fixed rate debt does not impose this risk on ratepayers.

When debt costs are historically low, market driven companies take advantage of this opportunity as illustrated by a recent analysis in the Financial Times.

> Companies are in a rush to lock in as much long-term debt as they can. They have sold more than $100 billion of 30-year investment grade corporate debt in the US so far this year, on pace for an annual record. Average yields on long-term corporate bonds are at 4.5%.... Who wouldn't grab 30-year financing at that price? [8]

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[8] Lex financial editors, Financial Times, September 21, 2012, p12.

Considering that one objective of regulation is to be a stand-in for market discipline in a regulated monopoly market, it is appropriate that the regulatory capital structure in this case be adjusted to direct the utility to use more debt financing, now and for at least the next several years.

**Transparency and Cost Effectiveness**

In the testimony that I filed in this case, I applied the term "customer view" to a representation of the to the cost of capital that is intended to make the effects of decisions about ROE and capital structure choices more transparent regarding their effect customer bills.[9] I observed that the frequently used metrics such as WACC and ROE represent how the utility and other businesses see capital finance, but they are misleading for the ratepayer, because they are misleading about the capital costs that customers actually pay and do not reveal any indications about the risks of future increases from market driven regulatory changes in ROE.

My objective is a view of the cost of capital that more clearly reveals the costs and risks to ratepayers of alternatives in financing investor capital, which may facilitate making incremental adjustments and more nuanced decisions that can be more efficient in delivering value. We are fortunate that the ambitious capital program that FPL is planning coincides with public policy supporting a low interest rate environment, but I am concerned that opportunities to make incremental adjustments for efficiency in this environment may be clouded by only considering the traditional views. For example, ratepayers have no interest in damaging the financial integrity of FPL, but they do have an interest in only supporting it up to a cost that is not excessive, when seen from the "customer view."

[9] Tr. at 2271.

**Process Observations**

In addition to the specific issues in this case, I would like to share a few observations about the rate hearing process. First, let me compliment the commissioners, staff and all the other parties and witnesses for their professionalism, insight and sheer hard work in this proceeding. Before participating in this hearing, I understood the role of utility regulation in the U.S. economic system but had little appreciation of how specific regulatory processes actually operate. At times I felt a bit like I had wandered into a parallel universe, but operating on the theory that sometimes an "outsider" can identify issues that are difficult for ongoing players to perceive as a problem, I will offer a few observations.

For orientation, I did review a sample of the record for several previous Florida rate cases and some of the relevant academic literature on regulation and finance. I was surprised how much continuity there appears to be over time and across the multiple hearing processes that determine utility rates, with many of the same issues, parties and players appearing time and time again. Even the same expert witnesses reappear with similar arguments and exhibits, but refreshed data. They are, as Dr. Avera remarked, "on the same circuit," talk to each other and testify against each other regularly in hearings around the country.[10]

This relatively constant set of experienced players combined with the adversarial nature of the proceedings seem to generate two preferred modes of communication: (1) "Gotcha" lines of inquiry that seek to show errors or inconsistencies, or at least the appearance of them, in the details of the analysis and evidence for the other side's positions, (2) Repetition of each sides "talking points" at every possible opportunity, usually cloaked in grand phrases such as public interest,

[10] Tr. At 4514.

financial integrity, etc. Both of these communication techniques serve a purpose, but they take up so much of the available time that even lengthy hearings provide little information that is relevant to understanding adjustments that could deliver a more economically efficient outcome. This lack of information about how incremental tradeoffs might perform puts a huge burden on commissioners who might want to consider outcomes other than the polar opposites of the utility's plan or the average interveners' plan, or perhaps, just splitting the difference between the two.

The archaic dependence on hundreds of paper documents also wastes much of the hearing time as voluminous documents are passed around, with controversies about numbering, different versions, pagination, and other document management issues. It also makes it unnecessarily difficult for all the parties to quickly follow document references in cross examination, and probably raises the legal costs for parties as legal teams manage and roll in and out boxes of documents on a daily basis. Most importantly, the exclusively paper format makes it almost impossible to effectively use graphs, diagrams or models to visualize relationships and the effects of incremental changes in the systems being considered. This contributes to "a take it or leave it" positioning of proposed solutions and creates an additional barrier for commissioners who want to assess and improve the economic efficiency of the available choices. Last year I was in Washington and had the opportunity to observe a day of hearings at the Presidential Oil Spill Commission, where I saw chief counsel Fred Bartlit use a series of extraordinary graphics to explain to the commission and the public the various potential causes and ways this complex accident could have developed. The decisions that the Public Service Commission must make are just too important for the economic future of Florida to be denied a similar level of analysis and communication.

If the commissioners find some merit in these observations, you might consider encouraging more probing questioning in the hearings from the staff and the commissioners,

particularly questions to elicit the incremental costs and benefits to the parties of adjusting their preferred positions. In the longer run you could consider procedural changes to the hearings, or requesting legislative changes, and an electronic document management and presentation system for PSC hearings.

## ISSUES AND POSITIONS

**Note:** "No Position" on Issues other than those listed below.

**ISSUE 5:** Does the Commission possess the power to grant a 25 basis point performance incentive to FPL?

**POSITION:** *Yes.*

**ISSUE 17:** Should FPL's adjustment to extend the amortization period of the new SAP general ledger system from 5 years to 20 years be approved?

**POSITION:** *Yes. I have not seen any specific data on this project, but offer the following general observation since I have extensive experience planning and assessing large systems projects. A complex GL implementation is a major project and should have a useful life in the 20 year range.*

**ISSUE 19:** Whether FPL's request for a base rate increase is needed to construct the poles, wires, and transformers needed to serve an anticipated 100,000 new customer accounts from the end of 2010 through the end of 2013?

**POSITION:** *Yes.*

**ISSUE 49:** What is the appropriate cost rate for long-term debt for the 2013 projected test year?

**POSITION:** *6.3%. Assuming that the Commission adopts my recommended equity ratio as specified in Issue 51 and explained in context in the response to Issue 60, the appropriate cost rate for long-term debt is approximately 6.3%. The appropriate cost rate for long-term debt for 2013 is higher than the FPL request because I am recommending a higher percentage of debt. This shifts more risk to the debt holders, reduces risk for the FPL ratepayers and will contribute to reducing

overall costs to the ratepayers. The table in the Issue 60 position indicates how this recommendation would vary with different assumptions.*

**ISSUE 51**: What is the appropriate equity ratio that should be used for FPL for ratemaking purposes in this case?

**POSITION**: *45%. If the Commission adopts my recommended ROE, the appropriate equity ratio for investor sources is approximately 45%. The table in response to Issue 60 shows my estimate that a 45% equity ratio will reduce the revenue requirement by about 4.5% relative to FPL's equity ratio recommendation, even if the FPL requested ROE is retained and adjusted for the recommended equity ratio. Even more importantly, the 45% equity ratio will provide incentives for FPL to lock-in long term fixed rate financing for a much larger portion of capital,substantially reducing ratepayers' dependence on volatile equity financing for the longer run.*

**ISSUE 54**: Should FPL's request for a 25 basis point performance adder to the authorized return on equity and proposed annual review mechanism be approved?

**POSITION**: *No. FPL proposes this incentive for keeping the lowest typical bill in the state, but as long as natural gas prices remain low for the next few years this is not likely to require any extraordinary effort beyond current expectations.*

**ISSUE 58**: What is the appropriate authorized return on equity (ROE) to use in establishing FPL's revenue requirement?

**POSITION**: *10.75%. If the Commission adopts my recommended equity ratio as specified in the response to Issue 51 and explained in context in the response to Issue 60, the appropriate ROE is approximately 10.75%. My assumption of constant investor-capital WACC, with adjustments for the increasing percentage of long-term fixed rate debt, results in ROE estimates that increase with debt percentage as one would expect. My ROE recommendation is based on the mid-point between relying on the ROE request of FPL (which yields 12.25%) and the ROE recommendation of OPC (which yields 9.25%) as most appropriate estimate.*

**ISSUE 59**: What is the appropriate capital structure that should be used by FPL for ratemaking purposes in this case?

**POSITION**: *The appropriate investor capital structure is 45% common equity and 55% long-term debt. I have not investigated the non-investor sources of capital and take no position on them, except to assert that the common equity and long term debt components should be as recommended.*

**ISSUE 60:** Is the combination of regulatory ROE, debt costs, capital structure and performance adder (if any) appropriate?

**POSITION:** *No, FPL's proposed capital financing is not appropriate. It is far too equity heavy for a time when long term debt is available at historically low rates and the gap between average utility ROE and debt costs is so high. When viewed from the ratepayer perspective, the PreTax Weighted Cost of investor Capital, which drives the revenue requirement, is more meaningful than the WACC. I found the analysis for both FPL and other interveners ROE to have merit. My analysis suggests that a lower equity ratio is strongly advantageous at this time but the appropriate ROE is not so clear.

**Comparison of Alternative Capital Structure and ROE Combinations**

| Case # | | Equity % | ROE | Log Term Debt % | LT Debt Interest Rate | Wgtd Avg Cost Invest Capital | Income Tax in Rev Req | PreTax Wgtd Avg Cost Invest Capital | % Reduction in Rev Req from FPL Req |
|---|---|---|---|---|---|---|---|---|---|
| 1 | FPL Requested | 59.6% | 11.50% | 40.4% | 5.26% | 8.98% | 3.84% | 12.82% | 0.00% |
| | | | | | | | | | |
| 3 | FPL CS, OPC ROE | 59.6% | 8.50% | 40.4% | 5.26% | 7.19% | 2.84% | 10.03% | -27.81% |
| 4 | OPC Midpoint CS Option | 55% | 8.75% | 45.0% | 5.41% | 7.25% | 2.70% | 9.94% | -28.92% |
| 2 | OPC Recommended | 50% | 9.00% | 50.0% | 5.63% | 7.32% | 2.52% | 9.84% | -30.31% |
| | | | | | | | | | |
| 5 | JWH Rec CS w/FPL ROE | 45% | 12.25% | 55.0% | 6.68% | 9.19% | 3.09% | 12.27% | -4.44% |
| **6** | **JWH Rec CS w/ midpoint ROE** | **45%** | **10.75%** | **55.0%** | **6.28%** | **8.29%** | **2.71%** | **11.00%** | **-16.52%** |
| 7 | JWH Rec CS w/OPC ROE | 45% | 9.25% | 55.0% | 5.88% | 7.40% | 2.33% | 9.73% | -31.75% |

*

**ISSUE 61:** What is the appropriate weighted average cost of capital?

**POSITION:** *The appropriate weighted average cost of capital from investor sources (common equity and long-term debt) is approximately 8.29%, which is the midpoint between my estimates based on FPL's request and OPC's recommendation. I have not investigated the non-investor sources of capital and take no position on the WACC that includes them, except to assert that the common equity and long term debt components should be as recommended.*

**ISSUE 62:** Has FPL maximized the sources of net jurisdictional revenue that are projected to be reasonably available and technically viable for the 2013 test year? If not, what action, if any, should the Commission take in setting FPL's rates in this case? (For purposes of this issue, "net jurisdictional revenue" **may** include net revenue related to the supply of CO2 captured from an FPL facility.)

**POSITION:** *This issue refers to "revenue related to supply of CO2 captured from an FPL facility," but utility scale capture of CO2 is not economically feasible. FPL ratepayers should not bear any costs of investigating CO2 sales as a revenue source until carbon capture becomes economically feasible at a utility scale.*

**ISSUE 85:** Should FPL salaries, costs and overheads for activities associated with (a) public relations or external affairs, (b) shareholder services, (c) attempted acquisitions of

electric facilities, and (d) efforts opposing municipalizations pursuant to a franchise agreement be removed from operating expenses?

**POSITION:** *No, assuming they are for appropriate and reasonable activities.*

**ISSUE 86:** Should FPL costs to pay contractors for legal, public relations or other consulting services be borne by customers or FPL shareholders?

**POSITION:** *Yes, as long as these contractors and consultants are providing appropriate services under reasonable terms.*

**ISSUE 131:** What is the appropriate weighted average cost of investor capital, including the proper components, amounts and cost rates associated with the capital structure, to calculate the base rate step adjustment for the Canaveral Modernization Project?

**POSITION:** *The appropriate weighted average cost of capital for the CC project is 8.29% with a 45% investor equity ratio as recommended for the base rate. Whatever the Commission decides for the base rate, 45% equity should be adopted for the CC step increase and other major projects. The very low interest rates provide a rare opportunity to lock-in more low cost fixed rate financing that will reduce the risks of future rate increases. The current wide gap between bond and equity costs presents an opportunity to reduce risks that should not be ignored. The tax savings of shifting from equity to debt more than compensate for the slightly higher WACC required.*

**ISSUE 134:** Is FPL's requested base rate step increase of $173,851,000 for the Canaveral Modernization Project appropriate?

**POSITION:** *No. If the recommended equity ratio and ROE are adopted the required increase should be reduced by about 17% while also reducing the risk of future rate increases to support this facility.*

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

| In re: Petition for increase in rates by Florida Power & Light Company. | DOCKET NO. 120015-EI<br><br>DATED: September 7, 2012 |
|---|---|

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of JOHN W HENDRICKS' POST-HEARING STATEMENT OF ISSUES AND POSITIONS AND POST-HEARING BRIEF has been furnished to the following by electronic mail this 21th day of September, 2012:

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