BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 080318-GU

In the Matter of:

PETITION FOR RATE INCREASE BY
PEOPLES GAS SYSTEM.
______________________________/

VOLUME 2

Pages 114 through 241

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PROCEEDINGS: HEARING

BEFORE: CHAIRMAN MATTHEW M. CARTER, II
COMMISSIONER LISA POLAK EDGAR
COMMISSIONER KATRINA J. McMURRIAN
COMMISSIONER NANCY ARGENZIANO
COMMISSIONER NATHAN A. SKOP

DATE: Wednesday, March 4, 2009

TIME: Commenced at 9:30 a.m.

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

REPORTED BY: JANE FAUROT, RPR
Official FPSC Reporter
(850) 413-6732

APPEARANCES: (As heretofore noted.)

I N D E X

WITNESSES

EXHIBITS

NUMBER:		ID.	ADMTD.
92	Gas Rider Comparison	190	192
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38	Exhibit DWH-1	193	207
93	Response to OPC Interrogatory No. 26, Pages 3-11 of 26	201	210
83	Revised Exhibit BN-1	224	

PROCEEDINGS

(Transcript continues in sequence from Volume 1.)

DONALD A. MURRY, Ph.D.

was called as a witness on behalf of Peoples Gas System, and having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. BEASLEY:

Q Sir, would you please state your name and your address, business address?

A My name is Donald A. Murry. My business address is 5555 North Grand Boulevard in Oklahoma City, C.H. Guernsey & Company.

Q And you were sworn in this proceeding earlier, correct?

A I was.

Q By whom are you employed and in what capacity?

A I'm a Vice President with C.H. Guernsey & Company, an Oklahoma City company.

Q Sir, did you prepare and submit in this proceeding a document entitled Prepared Direct Testimony of Donald A. Murry consisting of 51 pages?

A I did.

Q Do you have any corrections or changes to make to that testimony?

A No, I do not.

Q If I were to ask you the questions contained in that testimony, would your answers be the same?

A Yes, they would.

MR. BEASLEY: I would ask that Doctor Murry's direct testimony be inserted into the record as though read.

COMMISSIONER EDGAR: The prefiled direct testimony will be inserted into the record as though read.

I. POSITION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Donald A. Murry. My business address is 5555 North Grand Boulevard, Oklahoma City, Oklahoma 73112.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT POSITION?

A. I am a Vice President and economist with C. H. Guernsey & Company. I work out of the Oklahoma City, Oklahoma and the Tallahassee, Florida offices. I am also a Professor Emeritus of Economics on the faculty of the University of Oklahoma.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I have a B. S. in Business Administration, and a M.A. and a Ph.D. in Economics from the University of Missouri - Columbia.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. From 1964 to 1974, I was an Assistant and Associate Professor and Director of Research on the faculty of the University of Missouri - St. Louis. For the period 1974 to 1998, I was a Professor of Economics at the University of Oklahoma, and since 1998, I have been Professor Emeritus at the University of Oklahoma. Until 1978, I also served as Director of the University of Oklahoma's Center for Economic and Management Research. In each of these positions, I directed and performed academic and applied research projects related to energy and regulatory policy. During this time, I also served on several state and national committees associated with energy policy and regulatory matters, and published and presented a number of papers in the field of regulatory economics in the energy industries.

Q. WHAT IS YOUR EXPERIENCE IN REGULATORY MATTERS?

A. Since 1964, I have consulted for private and public utilities, state and federal agencies, and other industrial clients regarding energy economics and finance and other regulatory matters in the United States, Canada and other countries. In 1971-72, I served as Chief of the Economic Studies Division, Office of Economics of the Federal Power Commission. From 1978 to early 1981, I was Vice President and Corporate Economist for Stone & Webster Management Consultants, Inc. I am now a Vice President with C. H. Guernsey & Company. In all of these positions, I have directed and performed a wide variety of applied research projects and conducted other projects related to regulatory matters. I have assisted both private and public companies and government officials in areas related to the regulatory, financial and competitive issues associated with the restructuring of the utility industry in the United States and other countries.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE OR BEEN AN EXPERT WITNESS IN PROCEEDINGS BEFORE REGULATORY BODIES?

A. Yes, I have appeared before the U.S. District Court-Western District of Louisiana, U.S. District Court-Western District of Oklahoma, District Court-Fourth Judicial District of Texas, U.S. Senate Select Committee on Small Business, Federal Power Commission, Federal Energy Regulatory Commission, Interstate Commerce Commission, Alabama Public Service Commission, Regulatory Commission of Alaska, Arkansas Public Service

Commission, Colorado Public Utilities Commission, Florida Public Service Commission, Georgia Public Service Commission, Illinois Commerce Commission, Iowa Commerce Commission, Kansas Corporation Commission, Kentucky Public Service Commission, Louisiana Public Service Commission, Maryland Public Service Commission, Mississippi Public Service Commission, Missouri Public Service Commission, Nebraska Public Service Commission, New Mexico Public Service Commission, New York Public Service Commission, Power Authority of the State of New York, Nevada Public Service Commission, North Carolina Utilities Commission, Oklahoma Corporation Commission, South Carolina Public Service Commission, Tennessee Public Service Commission, Tennessee Regulatory Authority, The Public Utility Commission of Texas, the Railroad Commission of Texas, the State Corporation Commission of Virginia, and the Public Service Commission of Wyoming.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. Peoples Gas System ("Peoples" or the "Company") has retained me to analyze its current cost of capital and to recommend a rate of return that is appropriate in this proceeding. Peoples, a local distribution company ("LDC") serving retail gas customers in Florida, is a division of Tampa Electric Company which is, in turn, a wholly-owned subsidiary of TECO Energy, Inc. ("TECO Energy").

Q. HOW DID PEOPLES' AFFILIATE RELATIONSHIP WITH TECO

ENERGY AFFECT YOUR ANALYSIS OF THE COST OF CAPITAL IN THIS PROCEEDING?

A. I selected a group of LDCs to serve as proxy companies for Peoples in my analysis because Peoples is not publicly traded and it is only a small component of TECO Energy. Although for comparative purposes, I did review some of the market-based costs of TECO Energy; however, because of the differences, the TECO Energy financial information was not useful for determining the cost of capital of the LDC. Instead, I focused my analysis on the market-based financial information of a group of comparable LDCs.

Q. METHODOLOGICALLY, HOW DID YOU USE THESE LDCS?

A. The comparable companies are the primary focus of my analysis of the cost of capital of Peoples, and I used them as proxies for Peoples. Methodologically, I selected these companies for my analysis because they were comparable to Peoples in key financial statistics. I also analyzed the relative financial and business risks of Peoples and the LDCs.

Q. ARE YOU SPONSORING ANY EXHIBITS WITH YOUR TESTIMONY?

A. Yes. I am sponsoring Exhibits ___(DAM-1) through ___(DAM-25), which are attached to my testimony.

Q. WERE THESE EXHIBITS PREPARED BY YOU OR UNDER YOUR DIRECT SUPERVISION?

A. Yes.

III. UTILITY REGULATION

Q. PLEASE EXPLAIN HOW REGULATORY POLICIES MAY HAVE

AFFECTED YOUR ANALYSIS AND RECOMMENDATION OF THE COST OF CAPITAL IN THIS PROCEEDING.

A. I structured my analysis based on prevailing regulatory policies regarding the natural gas distribution industry. Economies of scale at the distribution level of utility service indicate that duplicative facilities can be economically inefficient. For this reason, analysts have long recognized the potential for market power to exist in franchised utility markets, and this is the principal economic rationale for utility regulation.

Q. HOW DID THIS RATIONALE FOR UTILITY REGULATION INFLUENCE YOUR ANALYSIS AND RECOMMENDATIONS CONCERNING THE APPROPRIATE ALLOWED RETURN FOR PEOPLES IN THIS PROCEEDING?

A. I recognized that a utility market structure and the associated economic rationale implied that an allowed return for Peoples should be sufficient to recover its costs of providing service, but at the same time, not be higher than necessary to attract and maintain capital. This was the objective of my analysis. I also believe this analytical objective is consistent with my understanding of the legal standard of a fair rate of return in regulation.

Q. WHAT DO YOU MEAN BY THE TERMS A "FAIR RATE OF RETURN" AND A "LEGAL STANDARD?"

A. When I used the term "fair rate of return," I was referring to a return that meets the standards set by the United States Supreme Court decisions in *Bluefield Water Works and Improvement Company vs. Public Service Commission*, 262 U.S. 679 (1923), and *Federal Power Commission vs. Hope Natural Gas Company*, 320 U.S. 591 (1944). As an economist, my understanding of these decisions is that they characterize a "fair rate of return" as one that provides earnings to investors similar to returns on alternative investments in companies of equivalent risk. Such a return will be sufficient to enable the company to compensate investors for assumed risk, attract capital, operate successfully, and maintain its financial integrity. As an economist, I believe one should recognize that this standard implies that utilities typically do not face the same market influences as more competitive markets, and a single supplier is likely to exist in a market because of economies of scale and scope in providing retail service. This market structure is the common economic rationale for regulation.

IV. ECONOMIC ENVIRONMENT

Q. WHAT ECONOMIC FACTORS ARE IMPORTANT TO YOUR ANALYSIS OF PEOPLES' COST OF CAPITAL IN THIS PROCEEDING?

A. Expectations regarding inflation and interest rates are major economic factors that influence investors' decisions. Generally, inflation expectations cause investors to require returns sufficient to compensate for any loss of purchasing power over the life of a security. In many cases, increasing inflation leads to higher long-term interest rates. Higher interest rates, in turn, lead to higher overall costs of capital. In the case of a regulated utility such as Peoples, the regulatory environment is also a critical component of the business environment. Anticipated regulatory actions, as well as forecasts of inflation and interest rates, affect investors' expectations of utility returns and their evaluations of the risks and returns of alternative investments.

Q. HOW WOULD YOU DESCRIBE THE CURRENT ECONOMIC ENVIRONMENT?

A. Entering the third quarter of 2008, the U.S. economy is facing record oil prices, increasing inflation, a continuation of the housing market contraction, further credit-market write-downs, increasing unemployment, and falling consumer confidence. On July 11th, the price of a barrel of crude oil on the New York Mercantile Exchange traded for over $148 -- the highest price ever recorded and more than double the price from a year earlier. Strong worldwide demand for crude and the low value of the U.S. dollar have some market analysts estimating the price of a barrel of oil could reach $170. On July 2, 2008, the Dow Industrial average closed down 20 percent from October 2007. In May, 2008, consumer prices rose at an annual rate of 4.2 percent while the labor department reported that wholesale prices rose 7.2 percent. According to the Reuters/Jeffries CRB Index of raw materials prices, commodity prices rose to a record on June 26, 2008 and are up 29 percent in 2008.

Financial institution asset write-downs and credit losses have totaled approximately $400 billion since 2007 and an estimated additional $170 billion may have to be written off by the end of 2009. In June 2008, Moody's downgraded bond insurers MBIA and Ambac to A2 and Aa3 respectively, from AAA, which could lead to further downgrades by financial institutions for structured product hedges. These bond insurers play important roles in financial markets and their downgrading could have serious ramifications. Consequently, it is possible the ongoing crises in the credit and capital markets could re-intensify.

The housing market continues in a severe slump that threatens the prospects for an economic recovery in the second-half of 2008. Rising mortgage rates, stricter borrowing rules, and a glut of unsold homes indicates the housing market still faces a period of adjustment. New home sales fell to an annual rate of 512,000 in May 2008 and they are at their lowest rate since 1991. Housing starts and building permits suggest the slump in housing may intensify. Housing starts in March 2008 of 947,000 stand in stark contrast to 2.3 million housing starts at the peak of the housing cycle in January 2006. Sales of previously owned homes increased 2 percent in May 2008 to a 4.99 percent annual rate from a record low in April 2008, indicating depressed prices are attracting buyers. The May 2008 sales were down 16 percent from May 2007.

First quarter Gross Domestic Product ("GDP") rose at a revised 1.0 percent annual rate as a result of strong U.S. export activity, an increase in government spending, and an increase in inventories. Continued strength in exports, the government's stimulus program, and the lagged effect of the Federal Reserve Board's ("Fed's") seven rate cuts since September 2007 are expected to counter the overall general economic malaise and result in a low increase in economic activity in the second half of 2008, continuing into 2009. *Blue Chip Financial Forecasts*' ("*Blue Chip's*") consensus forecast for GDP is shown in Exhibit ___(DAM-1).

Q. **WHY DID YOU USE *BLUE CHIP* INFORMATION AND FORECASTS IN YOUR ANALYSIS?**

A. *Blue Chip* is a respected publication that reports the consensus forecasts of forty-six leading financial forecasters. These consensus forecasts, which embody the expectations of the leading forecasters of major financial institutions, will influence the market. For this reason alone, these forecasts are more likely to move the market than individual forecasts. After all, in this analysis, it is the overall opinion of investors that we are trying to determine, and this is a very likely source of information on which investors will rely.

Q. HAVE THE FEDERAL RESERVE INTEREST RATE CUTS LOWERED RELEVANT LONG-TERM INTEREST RATES?

A. Unfortunately, they have not. The Federal Open Market Committee ("FOMC") has reduced the target federal funds rate seven times since September 2007, a reduction from 5.25 percent to 2.00 percent. However, the aggressive cutting of the federal funds and discount rates by the Fed has not resulted in lower long-term rates to consumers or businesses similar to the reduction in short-term rates. Although the Fed's actions directly affect short-term borrowing rates between banks, long-term rates are set competitively in the marketplace and only are indirectly affected, if at all. As shown on Exhibit ___(DAM-2), rates for long-term Baa/BBB utility bonds are virtually unchanged from a year ago -- 6.53 percent then to 6.48 percent today. Rates for A-rated industrial bonds also are virtually unchanged at 6.21 percent one year ago and 6.19 percent today.

Q. HAS THE FEDERAL RESERVE BOARD UNDERTAKEN ANY EXCEPTIONAL POLICIES IN RESPONDING TO THESE MARKET CONDITIONS?

A. Yes. In December 2007, the Fed announced it would inject emergency short-term funds into the market through a never-before-used Term Auction Facility ("TAF") to address "heightened liquidity pressures in term funding markets." On May 2, 2008, the Fed announced it would boost the TAF to $150 billion per month from $100 billion per month, the third increase since the program began in December 2007. The TAFs began as a coordinated effort with the central banks of the United Kingdom, Canada, Switzerland, and the European Union to increase short-term funds after losses on subprime mortgages unhinged normal bank lending practices. On March 11, 2008, the Fed announced another new vehicle, the Term Securities Lending Facility ("TSLF"), to address the deepening crisis in the credit markets. Under this new program, the Federal Reserve Board will lend up to $200 billion of Treasury securities to primary dealers to promote liquidity and to foster the functioning of the financial markets generally. The TSLF program subsequently expanded the list of acceptable collateral for loans. In March, the Fed also established the Primary Credit Dealer Facility that made the Fed the lender of last resort to brokers as well as banks. This marked the first time since the 1930's the Fed lent money directly to non-depository institutions.

On March 16, 2008, the Fed arranged a $30 billion bail out of investment bank Bear Stearns Cos. using J.P. Morgan, another investment bank, as a conduit. The extraordinary measures needed to be taken by the Fed highlight how the crises in the credit and capital markets have increased risks to investors.

Q. WHAT ARE SOME OF THE CONSEQUENCES OF THE CURRENT ECONOMIC SITUATION?

A. Forecasts for economic growth have decreased over the last several months while forecasts of inflation have gone up. *Blue Chip* predicts 0.8 percent real GDP growth for the second quarter of 2008, 1.2 percent real GDP growth for the third quarter, and 0.9 percent growth for the fourth quarter. *Blue Chip* forecasts a 4.2 percent increase in the Consumer Price Index ("CPI") in the third quarter of 2008 and increasing interest rates through the fourth quarter of 2009.

Q. YOU MENTIONED THE INFLATION RATE AS AN IMPORTANT FACTOR TO EXAMINE. WHAT ARE THE CURRENT INFLATION CONSIDERATIONS?

A. The forecast for core inflation, which excludes food and energy prices, is 2.4 percent for 2008, which is above the Fed "comfort zone" of 1 percent to 2 percent. In its June 25, 2008 press release, the FOMC stated, "Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased."

Increasing energy prices and the developing economies continue to exert pressure on world commodity prices and hence, U.S. inflation. Prices paid to factories, farmers and other producers were up 6.5 percent in April. Steel mill products increased 5.5 percent in April and agricultural chemicals were up 5.6 percent. Scrap steel and iron increased 32 percent, the most since July 2004, and scrap copper was up 5.3 percent. The Reuters/University of Michigan Survey of households showed inflation expectations of 5.1 percent for the coming 12 months -- the largest increase since 1982.

Q. WHAT IS THE FORECASTED LEVEL OF BOND INTEREST RATES?

A. Generally, analysts expect long-term bond rates to increase despite the Federal Reserve's efforts to lower short-term rates. For example, in the near-term, *Blue Chip* forecasts show increases from 4.75 percent today to 5.1 percent for the 30-year Treasury through the fourth quarter of 2009. I have shown forecasts for the 10-year and 30-year Treasuries in Exhibit ___(DAM-3). As an example of longer term forecasts, *Value Line* recently predicted the AAA corporate bond yield would increase from 5.6 percent today to 6.5 percent over the 2011-2013 period. As a benchmark for the rates of return set in this proceeding, long-term corporate interest rates are the most relevant for utility returns. I have shown the longer-term forecasts for long-term corporate yields and some Treasury securities in Exhibit ___(DAM-4).

Q. CAN YOU SUMMARIZE HOW THE ECONOMIC ENVIRONMENT WAS IMPORTANT TO YOUR ANALYSIS AND RECOMMENDATIONS IN THIS PROCEEDING?

A. The risks facing the credit and capital markets are significant. Energy prices are at all-time highs and inflation is accelerating. At the same time, utilities are facing record high energy prices, increasing infrastructure and environmental requirements, and increasing operating costs. The challenges facing the credit and capital markets compound the risks to capital-intensive utility companies. Rising inflation and rising interest rates erode earnings and adversely affect the cost of a utility's debt and equity, eroding utility margins. That is, despite the lowering of short-term rates, the expected increase in long-term interest rates increases the cost of utility securities.

V. METHODOLOGY

Q. HOW DID YOU CONDUCT YOUR ANALYSIS AND DETERMINE YOUR RECOMMENDATION?

A. I studied the current economic environment to provide a perspective for my analysis. The current and forecasted long-term interest rates and investors' fears of inflation are the backdrop for gas distribution utility rates of return at this time. I also noted the current return on common stock equity earned by the comparable companies and Peoples. I reviewed published financial information for Peoples, TECO Energy, the parent company of Peoples, and the comparable natural gas distribution utilities. Because of the recent and prospective volatility of the equities markets, I took special note of the financial and business risks faced by Peoples.

Because Peoples does not have publicly traded common stock, I applied the generally accepted Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") methods to the comparable companies to develop a market-based measure of the cost of common equity of Peoples. The comparable companies are publicly traded LDCs that are similar in many respects to Peoples so, as representative, proxy LDCs, their costs of common equity are also relevant to Peoples.

As an important measure of adequacy in determining a sufficient but not higher than necessary return, I tested my recommended return by evaluating the After-Tax Interest Coverage ratio at my recommended return. Then I compared this coverage to similar coverages for the comparable LDCs.

Q. IN EXPLAINING YOUR METHODOLOGY IN THIS CASE, YOU SAID YOU USED A GROUP OF COMPARABLE LDCS AS PROXY COMPANIES FOR PEOPLES IN YOUR ANALYSIS. WHAT CRITERIA WERE USED TO SELECT THOSE PROXY LDCS?

A. First, I selected comparable companies -- all publicly traded LDCs -- from a group of primarily gas distribution companies reported on by *Value Line*. Second, because of the importance of size in determining the cost of capital of a utility, I limited the group of distribution companies to firms with a market capitalization of less than $1.7 billion. Third, as a measure of financial health and similar investor expectations, I excluded companies that do not pay a dividend. By selecting a group of publicly-traded LDCs comparable to Peoples with these various characteristics, I could use them as suitable proxies for this analysis.

Q. YOU SAID THAT YOU USED TECO ENERGY MARKET DATA. HOW DID YOUR USE OF THESE DATA TO DEVELOP THE COST OF CAPITAL OF PEOPLES AFFECT YOUR ANALYSIS?

A. Although I recognized TECO Energy as the source of the common equity funds for Peoples and the cost of capital of the two are obviously somewhat related, I did not use the TECO Energy market data in my determination of the appropriate cost of capital for Peoples. The financial information and the cost of capital of the comparable companies are more relevant and the determinant information for establishing an allowed rate of return for Peoples in this proceeding. These companies provide a representative sample of the financial and cost of capital information for a financially healthy gas distribution utility such as Peoples.

Q. WHY DID YOU NOT USE THE TECO ENERGY INFORMATION IN YOUR ANALYSIS?

A. The risks associated with the recent financial difficulties of TECO Energy are not relevant to measuring the cost of capital of Peoples. Consequently, I did not use the market-based calculations of the cost of capital of TECO Energy and the financial information of TECO Energy had little bearing on my analysis.

Q. CAN YOU EXPLAIN IN MORE DETAIL WHY YOU USED *VALUE LINE* AS THE SOURCE FOR CHOOSING COMPARABLE LDCs FOR YOUR ANALYSIS?

A. *Value Line* is a respected financial information source. It is readily available to investors and often found in most libraries, so it is a source that is likely to influence investors' decisions. A second important consideration for selecting *Value Line* is that it is independent from the investment community. *Value Line* does not underwrite securities. In the past, critics have justifiably condemned organizations that publish financial data while benefiting directly from a relationship with the company under review. In contrast, *Value Line* just sells financial information and does not have this conflict of interest.

Q. WHAT LDCS DID YOU SELECT FOR THE PROXY COMPANIES IN YOUR ANALYSIS OF PEOPLES?

A. The six LDCs that are similar to Peoples are Laclede Group, New Jersey Resources, NICOR, Northwest Natural Gas, South Jersey Industries, and Southwest Gas.

VI. CAPITAL STRUCTURE

Q. WHAT CAPITAL STRUCTURE DID YOU USE IN ESTIMATING PEOPLES' COST OF CAPITAL IN THIS PROCEEDING?

A. For ratemaking purposes in this proceeding, Peoples' capital structure in the projected test year consists of long-term debt of $227,773,987 (39.53 percent), short-term debt of $3,456,397 (0.61 percent), residential customer deposits of $9,338,641 (1.66 percent), commercial customer deposits of $26,309,935 (4.67 percent), tax credits of $7,862 (0.00 percent), inactive customer deposits of $480,368 (0.09 percent), deferred income taxes of $27,670,682 (4.91 percent), and common equity of $273,561,565 (48.54 percent). This capital structure is illustrated in Exhibit ___(DAM-5).

Q. HOW DOES THE CAPITAL STRUCTURE PROJECTED BY PEOPLES FOR RATEMAKING PURPOSES COMPARE WITH THE CAPITAL STRUCTURES OF THE LDCS YOU HAVE USED AS PROXY COMPANIES IN YOUR ANALYSIS?

A. I compared the common equity ratio proposed by Peoples to the common equity ratios of the group of comparable companies. Equity ratio is a most critical component of the capital structure when estimating the cost of common stock. Peoples' common equity ratio of 48.54 percent is low relative to the 56.5 and 58.3 percent average common equity ratio of the comparable gas utilities (for 2007 and estimated 2008, respectively). I have illustrated the common equity ratios of these companies in Exhibit ___(DAM-6). I also show in this schedule the 2007 common equity ratio of TECO Energy of 39.0 percent. This common stock equity ratio is very low, reflects the recent financial stress and write offs of TECO Energy and is not appropriate for ratemaking for Peoples.

Q. TECO ENERGY AND PEOPLES HAVE DIFFERING COMMON EQUITY RATIOS. HOW DID THESE CAPITAL STRUCTURES INFLUENCE YOUR ANALYSIS?

A. Peoples' common equity ratio for ratemaking is similar to the financial risk profile of the group of comparable companies. TECO Energy has a lower common stock equity ratio of 38.5 percent in 2008 which reflects the extensive write-offs of its merchant investments and the associated financial distress. This further distinguishes it from Peoples and the comparable LDCs.

Q. YOU MENTIONED THAT THIS CAPITAL STRUCTURE IS THE CAPITAL STRUCTURE USED FOR RATEMAKING PURPOSES. IS THERE ANOTHER CAPITAL STRUCTURE THAT SHOULD BE COMPARED TO THE PROXY GROUP?

A. Yes. Since the ratemaking capital structure includes components that analysts typically do not consider as capital structure items, such as customer deposits, deferred taxes and investment tax credits, I have compared a financial capital structure, using only investor sources of capital components, to the capital structures of the proxy group. Removing the "non-typical" components I mentioned previously and focusing on a capital structure comprised of the investor sources only – long term debt, short term debt and common equity – results in a higher equity ratio for Peoples of 54.7 percent. This common equity ratio of Peoples is still comparatively lower than the 58.3 percent equity ratio of the proxy group. It is also important to note that some regulatory jurisdictions do not include short term debt and customer deposits in the ratemaking capital structure. Since Florida uses these components in setting rates, this should be taken into consideration when comparing the common equity percentage for Peoples to the proxy group.

Q. WHAT HAS PEOPLES PROJECTED AS ITS COST OF SHORT-TERM DEBT?

A. Peoples has projected a cost of short-term debt in the projected test year of 4.50 percent.

Q. WHAT IS PEOPLES' COST OF LONG-TERM DEBT?

A. The embedded weighted average cost of Peoples' long-term debt in the projected test year is 7.20 percent.

Q. WHAT ARE THE COSTS OF THE OTHER CAPITAL STRUCTURE COMPONENTS IN THE PROJECTED TEST YEAR?

A. The costs for the remaining capital structure components, except common equity, are 6.00 percent for residential customer deposits, 7.00 percent for commercial customer deposits, and 0.00 percent for the others.

VII. <u>FINANCIAL RISK</u>

Q. YOU SAID YOU CONSIDERED "FINANCIAL RISKS." WHAT DO YOU MEAN BY THE TERM FINANCIAL RISK?

A. Financial risk is the risk to a company's common stockholders resulting from the company's use of financial leverage. This risk results from using fixed income securities, or debt, to finance the company. Any return to common stockholders is a residual return because it is available only after a company pays its debt-holders. This means the return on common stock is less certain than the contracted return to debt-holders. Consequently, the common stock equity ratio is a measure of financial risk. The lower the common equity ratio, the greater the relative prior obligation owed to debt-holders, and the greater the risk faced by common stockholders.

Q. YOU SAID PEOPLES' COMMON EQUITY RATIO IS LESS THAN THE AVERAGE EQUITY RATIO OF THE COMPARABLE LDCS. DOES THIS INDICATE THAT PEOPLES' FINANCIAL RISK IS GREATER THAN THE FINANCIAL RISK OF THE PROXY GAS DISTRIBUTORS?

A. Yes. The relative common equity ratios indicate that the proxy companies have less financial exposure than Peoples.

Q. HAVE YOU IDENTIFIED ANY OTHER MEASURES OF FINANCIAL RISK THAT MIGHT BE IMPORTANT IN ANALYZING PEOPLES' COST OF CAPITAL?

A. Yes. I reviewed some published measures that assess the level of financial risk. I examined *Value Line*'s "Financial Strength" and Standard & Poor's ("S&P's") "Bond Ratings." These metrics are shown in Exhibit ___(DAM-7). As illustrated, *Value Line*'s "Financial Strength" is A for three of the six comparable companies. S&P's bond rating for four of the comparable LDCs is A, or higher. From these independent measures of risk, I concluded that the proxy group was, in general, recognized as relatively financially healthy. This indicates that this group is an appropriate proxy group for ratemaking.

VIII. <u>BUSINESS RISK</u>

Q. YOU SAID YOU INVESTIGATED THE "BUSINESS RISK" OF PEOPLES DURING YOUR ANALYSIS. WHAT DO YOU MEAN BY THE TERM BUSINESS RISK?

A. Business risk is the exposure of the returns to common stockholders that results from business operations. At this time, unprecedented high natural gas prices are a particularly significant source of threats to LDCs' margins, and this is a risk to common equity investors.

Q. CAN YOU EXPLAIN IN MORE DETAIL THE POTENTIAL SOURCES OF BUSINESS RISKS TO LDCS?

A. A pervasive business risk to LDCs is the threat to operating margins resulting from generally declining sales because of such factors as price elasticity, customer by-pass, more energy-efficient buildings and increased appliance efficiencies. In today's gas markets, operating costs are increasing as a result of high gas costs, inflation, and high borrowing costs. High gas costs increase costs to customers and also lead to increases in the LDCs' working capital requirements, short-term debt costs, accounts receivable, and bad debt expenses. To the common equity investors, these added costs threaten the margins they expect and are therefore a threat to capital acquisition.

Q. ARE BUSINESS RISKS IMPORTANT TO LDCS CURRENTLY?

A. Yes. Natural gas prices are at unprecedented, extremely high levels. Additionally, higher prices in other countries have been attracting liquefied natural gas ("LNG") supplies at a time when LNG imports have been emerging as the marginal source of U.S. natural gas supply. All customer groups respond to high gas prices and some demand destruction is inevitable, especially from anticipated levels based on forecasts that assumed lower gas prices. This substitution and reduction of customer consumption is likely to continue. Often, conservation measures require installing equipment and altering industrial and consumptive practices, and it takes time for their effects to work through the economic system. How investors will respond to these conditions, in an otherwise volatile equities market, is not entirely clear, but investors will perceive them as added risks.

Q. DID YOU REVIEW ANY COMPARABLE MEASURES OF BUSINESS RISK FOR PEOPLES AND THE COMPARABLE COMPANIES?

A. Yes. I reviewed *Value Line*'s measures of "Safety" and "Timeliness." Each of these measures is influenced by business risks, and, for that matter, regulatory risk, which one can think of as a sub-category of business risk. The Safety measure for the comparable companies ranges from "1" to "3," with a "1" being the highest and a "5" the lowest. The Safety ranking for the comparable LDCs is relatively strong. However, *Value Line* considers none of the comparable LDCs as better than an average "3" in Timeliness. I illustrate these rankings in Exhibit ___(DAM-8).

Q. IS PEOPLES SUBJECT TO BUSINESS RISKS SIMILAR TO THOSE OF OTHER LDCS?

A. In some respects the business risk exposure of Peoples is greater than for other LDCs because of the relatively warm climate in the Company's service territory. Peoples' customers can shift consumption in response to high prices, which is less likely to be the case in markets where heating loads predominate. The customer usage decline in Peoples' service territory is large relative to other LDCs, and this relatively greater risk exposure is likely to continue with high gas prices. As stated in a Baird Utilities Research report dated April 30, 2008, "Peoples Gas 1Q08 net income declined 9% YOY to $10 million from $11.0 million in 1Q07 primarily reflecting lower average retail customer usage due to milder weather conditions and the slowing economy, partially offset by sluggish 0.3% customer growth. The 0.3% customer growth was well below the historical 3%-plus averages. Again reflecting the slowdown in the housing market, with average customer usage patterns continuing to decline."

IX. FINANCIAL STATISTICS

Q. YOU SAID YOU REVIEWED KEY FINANCIAL STATISTICS. WHAT FINANCIAL STATISTICS DID YOU REVIEW?

A. I reviewed common stock earnings, dividend histories and forecasts, dividends declared and the payout ratios and market-price earnings ratios for the comparable LDCs.

Q. WHAT DID THE RECENT COMMON STOCK EARNINGS SHOW?

A. *Value Line* forecasts the proxy LDCs to earn 11.5 percent on common equity in 2008. Notably, *Value Line* predicts that both New Jersey Resources and South Jersey Industries will earn 13.0 percent on common equity this year. I have shown these earnings on common equity in Exhibit ___(DAM-9). As this schedule also shows, the average common equity earnings for the comparable companies have been in the range of 11.4 to 12.7 percent over the past five years.

Q. WHAT DID YOUR ANALYSIS OF THE DIVIDENDS PAID OUT BY THE COMPARABLE LDCS SHOW?

A. The comparable LDCs have generally experienced a very modest growth in declared dividends over the past five years. I have compared these results in Exhibit ___(DAM-10). The current dividend payout ratios of the comparable LDCs average 56.3 percent. Exhibit ___(DAM-11) contrasts the dividend payout ratios for each of the comparable LDCs.

Q. WHAT DID YOUR REVIEW OF THE PRICE-EARNINGS RATIOS OF THE COMPARABLE COMPANIES SHOW?

A. My Exhibit ___(DAM-12) shows the current average price-earnings ("P/E") ratio for the comparable group of 16.5. From other market information I have reviewed previously, I believe this is representative of the current P/E ratios in the utility industry.

X. COST OF COMMON STOCK

Q. YOU STATED PREVIOUSLY THAT YOU CALCULATED THE COST OF COMMON STOCK FOR PEOPLES. WHAT METHODS DID YOU USE?

A. I used the two generally accepted market-based methods, the DCF and the CAPM, to estimate the cost of common stock in my analysis. I applied each of these methods to estimate the costs of common stock equity for Peoples by estimating the cost of common equity of each of the comparable gas distribution utilities, and I compared the results among these various companies. For each of these two methods, I assessed their underlying assumptions and their analytical strengths and weaknesses. Subsequently, I evaluated the results from these analyses in the context of current market conditions and the relative risks.

Q. CAN YOU DEFINE THE DISCOUNTED CASH FLOW, OR "DCF" METHODOLOGY FOR MEASURING THE COST OF COMMON EQUITY?

A. The following formula expresses the DCF calculation of an investor's required rate of return:

$$K = D/P + g$$

Where:
- K = cost of common equity
- D = dividend per share
- P = price per share and
- g = rate of growth of dividends, or alternatively, common stock earnings.

In this expression, "K" is the capitalization rate required to convert the stream of future returns into a current value. "D" is the current level of dividends paid to the common stock holders. "P" is the valuation of the common stock by the investors reflected by recent market prices. Consequently, the ratio "D/P" is the current dividend yield on an investment in the company's common stock. The "g" is the growth rate anticipated by the investor.

Q. WHAT ASSUMPTIONS UNDERLYING THE DCF METHOD ARE IMPORTANT WHEN ESTIMATING THE COST OF COMMON EQUITY IN PRACTICE?

A. I believe one can identify the following important underlying assumptions associated with the basic annually compounded DCF model:

1. Investors are risk averse. That is, for a given return, investors will seek the alternative with the lowest amount of risk. In other words, the greater the risk that investors attribute to a given investment, the greater the return they require from that investment.
2. The discount rate must exceed the growth rate, *i.e.*, "K", in the stated expression, must exceed "*g*". The mathematics associated with the derivation of the basic annually compounded DCF model requires this assumption.
3. The payout and the price earnings ratios remain constant.
4. Expected cash flows consist of dividends and the future sale price of the stock. The sales price in any period will equal the present value of the dividends and the sales price expected after that period including any liquidating dividend. Consequently, the sales price in any period is equal to the present value of all expected future dividends.
5. Dividends are paid annually.
6. There is no external financing.

As noted in these assumptions, expected cash flows consist of dividends and the future sale price of common stock. Common stock earnings are the critical common denominator because earnings make paying dividends possible and retained earnings, invested in the company, provide for the future growth in stock value.

XI. STRENGTHS OF THE DCF

Q. WHAT ARE THE KEY STRENGTHS OF THE DCF METHOD THAT YOU THINK ARE IMPORTANT TO YOUR ANALYSIS?

A. The DCF method is theoretically sound, and this is its greatest strength. It relates an investor's expected return in the form of dividends and capital gains to the value that an investor is willing to pay for those returns. The DCF implies that an investor is willing to pay a market price that is equal to the present value of an anticipated stream of earnings. This relationship theoretically reveals the opportunity cost of investors' funds. In this way, the DCF relates known market price information and the company's dividend and earnings performance to determine the value that investors place on anticipated returns. A practical advantage of the DCF, as a cost of capital tool in a ratemaking proceeding, is that regulatory analysts commonly use it, and participants in proceedings generally understand it.

Q. IS THIS ESTIMATE OF THE COST OF COMMON EQUITY CONSISTENT WITH THE REGULATORY OBJECTIVE OF SETTING AN ALLOWED RETURN EQUAL TO THE RETURNS OF EQUIVALENT RISK?

A. Yes. The DCF develops an estimate of the marginal cost of investing in a given utility, but this may not be sufficient to attract capital in subsequent markets. It is consistent with the principle of setting a return equal to returns of equivalent risk at the margin, but this cost of capital is not necessarily sufficient to assure that a return at this level will attract and maintain capital even in the near term.

XII. WEAKNESSES OF THE DCF

Q. WHAT WEAKNESSES OF THE DCF MAY BE IMPORTANT

WHEN USED IN A RATEMAKING PROCEEDING?

A. A DCF analysis may have either conceptual or data problems or both. As to the conceptual problems, analysts may misinterpret and consequently misapply the DCF because they do not understand the limits of the analysis. For example, a common conceptual problem is the use of historical growth rates in DCF calculations, when these rates are not accurate estimates of investors' expectations of the future returns. Likewise, using dividend growth rates mechanically in a DCF formulation will be misleading if investors are purchasing and selling a stock because of anticipated changes in earnings and potential capital gains. That is, if an assumption (such as dividends being the sole source of value expectations of an investor) is not accurate, then analysts will err if they do not recognize this.

Also, as I stated previously, the DCF method calculates the marginal, or incremental, cost of common stock equity of a company. If analysts do not recognize the theoretical significance of this calculation, they may misapply the results of their calculations. As a marginal cost estimate, the DCF produces an estimate of the minimal return necessary to attract or maintain investments in a company's common stock.

Q. FROM A PRACTICAL STANDPOINT, WHY IS THE MARGINAL COST NATURE OF THE DCF SIGNIFICANT IN A REGULATORY SETTING?

A. If a DCF-based cost of common equity, even if realistically developed, becomes the allowed return for a regulated utility, this will not provide enough cushion so the realized return will be sufficient to attract and maintain capital. Analysts, interpreting the results of the DCF calculations, may not recognize this. Consequently, the DCF-based calculations may be misleading. In fact, this misunderstanding of the DCF results can virtually assure that a regulated company will not have the opportunity to earn its allowed return.

Q. DO YOU KNOW WHETHER REGULATORY COMMISSIONS HAVE RECOGNIZED THESE LIMITATIONS OF THE DCF?

A. Yes. Regulatory commissions have recognized the difficulties of relying on the raw, unadjusted DCF calculations. In one such example, a regulatory commission recognized that the assumptions underlying the DCF model rarely, if ever, hold true.[1] This commission stated that an "...unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible and therefore requires an upward adjustment based largely on the expert witness' judgment."[2]

Q. IN ADDITION TO AN ADJUSTMENT BASED ON "EXPERT" JUDGMENT, IN YOUR EXPERIENCE, ARE YOU AWARE OF ANY ATTEMPTS BY REGULATORS AND ANALYSTS TO COMPENSATE FOR THE MARGINAL COST NATURE OF THE DCF?

A. Yes. Both regulators and analysts have often applied compensating adjustments for the marginal cost nature of the DCF method, and they do so in a variety of ways. Although these various adjustments may differ greatly in their approaches, each addresses the inadequacy of the DCF's

[1] Phillips, Charles F., Jr. and Robert G. Brown, *Chapter 9: The Rate of Return,* The Regulation of Public Utilities: Theory and Practice, (1993: Public Utility Reports, Arlington, VA) p. 423.
[2] Ibid, *In re Indiana Michigan Power Company,* 116 PUR4th 1, 17 (Ind. 1990).

marginal cost estimates of the cost of capital in some manner. For example, I have observed such practices as applying a "flotation" adjustment, a "market pressure" adjustment or an adjustment to common equity to reflect the market values of debt and equity.

Q. WHAT IS A FLOTATION ADJUSTMENT?

A. It is a calculation adjustment applied to the DCF to compensate for costs associated with the issuance of new securities.

Q. WHY DO ANALYSTS USE A FLOTATION ADJUSTMENT AS ONE WAY OF ADDRESSING THE MARGINAL COST NATURE OF THE DCF?

A. Analysts apply a flotation adjustment because the market-based DCF estimate of the cost of capital does not account for the costs of issuing common stock. That is, the market-based DCF does not incorporate the unavoidable costs incurred when issuing securities, such as legal fees, investment banker fees and the publication costs of a prospectus. The flotation adjustment attempts to raise the market-measured cost of capital, which is the return required to attract the marginal investor, to the same level as the true cost of capital of the utility.

Q. DID YOU APPLY A FLOTATION ADJUSTMENT IN YOUR DCF ANALYSIS?

A. No, I did not. I believe that recognizing the high end results of the DCF method is usually sufficient compensation for the price impact of flotation costs on a common stock.

Q. IF A UTILITY INCURS FLOTATION COSTS THAT REDUCE THE LEVEL OF FUNDS RECEIVED FROM A STOCK

ISSUANCE, WHY DID YOU NOT APPLY SUCH AN ADJUSTMENT?

A. Although the costs of flotation are inescapable and real, I believe it is an adequate recognition of the marginal cost nature of the DCF, which also recognizes the potential impact of flotation costs, to focus on the higher end of the various DCF results. In my opinion, this normally provides appropriate compensation to attract and maintain investment in a utility's common stock, and it also avoids trying to exact a level of implied precision from the DCF methodology that is not realistic.

Q. WHAT IS A "MARKET PRESSURE" ADJUSTMENT?

A. A market pressure adjustment is compensation for the impact of a common stock issuance on the prices of that common stock. Analysts apply this adjustment because the DCF measured cost of common stock cannot account for the prospective price impact of additional, newly issued shares. This is another instance when the marginal cost of common stock measured prior to this issuance will fail to capture the true cost of capital necessary to attract investors.

Q. ARE YOU RECOMMENDING THAT AN ANALYST SHOULD ADD A MARKET PRESSURE ADJUSTMENT TO A DCF RESULT WHEN DETERMINING A RECOMMENDED ALLOWED RETURN?

A. No. Normally, the higher end of the DCF market-based results will provide an adequate return on common stock for a regulated utility. This is sufficient under most market circumstances. Such a return should be adequate to compensate for the impact of newly issued securities and to attract investors to newly issued common stock.

Q. WHY WOULD AN ADJUSTMENT TO THE COST OF EQUITY TO REFLECT MARKET VALUES FOR DEBT AND EQUITY BE APPROPRIATE?

A. Regulatory convention dictates that an analyst should use the book values of securities when establishing the capital structure of a utility for ratemaking. However, some analysts adjust the cost of equity for ratemaking to compensate for the difference between market value and book value. Of course, investors must measure the marginal cost returns against the market values of their investment. Some analysts recognize the difference between market valuation and book valuation of common stock to recognize the marginal cost nature of the DCF method.

Q. DID YOU ADJUST PEOPLE'S CAPITAL STRUCTURE FOR THE DIFFERENTIAL IN MARKET VALUE AND BOOK VALUE?

A. No, I did not. As in the cases of the other adjustments that analysts and regulators develop largely to compensate in ratemaking for the marginal cost nature of the DCF technique, I believe that recognizing the high end of the DCF results is adequate.

XIII. DATA USED IN DCF ANALYSIS

Q. YOU DEFINED THE VARIABLES USED IN THE DCF ANALYSIS. WHAT GROWTH RATE DATA DID YOU USE IN YOUR DCF ANALYSIS?

A. I used forecasted earnings growth estimates as the primary measure in my DCF analysis. Forecasts of common stock earnings capture investors' expectations about future returns, and these are the expectations that affect their decisions to invest. The financial academic literature is replete with findings that analysts' forecasts are superior to historical performance for determining expected growth.

Q. YOU MENTIONED FINDINGS IN THE ACADEMIC LITERATURE. HAVE ANALYSTS PERFORMED STUDIES REGARDING WHICH DATA USED IN A DCF ANALYSIS ARE MOST LIKELY TO CAPTURE INVESTORS' EXPECTATIONS ABOUT FUTURE RETURNS?

A. Yes. As early as 1982, academic studies showed that analysts' forecasts were superior to historical, trended growth rates for DCF analyses.

Q. PLEASE EXPLAIN SOME OF THOSE STUDIES.

A. A number of authors have addressed the merits of analysts' forecasts in a DCF analysis of the cost of capital. For example, a well-known financial textbook by Brigham and Gapenski explains why analysts' growth rate forecasts are the best source for growth measures in a DCF analysis. They state:

> Analysts' growth rate forecasts are usually for five years into the future, and the rates provided represent the average growth rate over the five-year horizon. Studies have shown that analysts' forecasts represent the best source for growth for DCF cost of capital estimates.[3]

Research reported in the academic literature supports this position. For

[3] Brigham, Eugene F., Louis C. Gapenski, and Michael C. Ehrhardt, "Chapter 10: The Cost of Capital," Financial Management Theory and Practice, Ninth Edition (1999: Harcourt Asia, Singapore), p. 381.

example, Gordon, Gordon and Gould found:

> … the superior performance by KFRG (forecasts of growth by security analysts) should come as no surprise. All four estimates of growth rely upon past data, but in the case of KFRG a larger body of past data is used, filtered through a group of security analysts who adjust for abnormalities that are not considered relevant for future growth.[4]

Q. ARE YOU FAMILIAR WITH ACADEMIC ARTICLES THAT APPLY SPECIFICALLY TO THE DCF GROWTH RATES USED IN REGULATORY PROCEEDINGS?

A. Yes. Timme and Eisemann examined the effectiveness of using analysts' forecasts rather than historical growth rates for determining investors' expectations in rate proceedings. They concluded:

> The results show that all financial analysts' forecasts contain a significant amount of information used by investors in the determination of share prices not found in the historical growth rate… The results provide additional evidence that the historical growth rates are poor proxies for investor expectations; hence they should not be used to estimate utilities' cost of capital.[5]

Q. DO YOU FIND THESE STATEMENTS BY THESE AUTHORS CREDIBLE?

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[4] Gordon, David A., Myron J. Gordon, and Lawrence I. Gould, "Choice among methods of estimating share yield," *Journal of Portfolio Management;* Spring 1989, Volume 15, Number 3, pages 50-55.

[5] Timme, Stephen G. and Peter C. Eisemann, "On the Use of Consensus Forecasts of Growth in the Constant Growth Model: The Case of Electric Utilities," *Financial Management*, Winter 1989, pp. 23-35.

A. Yes. These results are not surprising because investors, when contemplating an investment in a common stock, very frequently review reputable analysts' forecasts. Such information, available to them at the time they contemplate investing, will influence their decision to invest.

Q. IN DEVELOPING YOUR DCF ANALYSIS, DID YOU ALSO REVIEW HISTORICAL COMMON STOCK EARNINGS AND DIVIDEND INFORMATION?

A. Yes. For a historical perspective, I reviewed the common equity earnings and dividend histories of the proxy companies studied. As I stated previously, for analytical purposes and to enhance the reliability of my DCF analysis, I relied principally on forecasted common stock earnings in my DCF analysis.

Q. WHAT DID YOUR REVIEW OF THE GROWTH RATES OF COMMON STOCK EARNINGS AND DIVIDEND HISTORIES SHOW?

A. The most significant observation was that TECO Energy's dividends and earnings both declined significantly by 11.0 percent over the previous five years. Also, the financial decline of TECO Energy reinforced my methodological decision to use the comparable companies as proxies for Peoples in this analysis. Both the historical and forecasted dividend growth rates of the proxy LDCs are lower than the earnings per share growth rates. This is indicative of conservative dividend policies of these companies, which one could expect in the recent volatile markets. I have shown these dividend and earnings per share growth rates in Exhibit ___(DAM-13).

Q. PLEASE ELABORATE ON THE IMPORTANCE OF THE RELATIONSHIP BETWEEN EARNINGS PER SHARE AND DIVIDEND GROWTH RATES.

A. Earnings must be sufficient to support the dividend policies of the companies over time, and many factors influence boards of directors in determining common dividend policies. In the industry generally, the relatively stable dividend growth rates, as compared to common stock earnings, have been observable for many utilities for a number of years. One can determine that this differential reflects a consistent, relatively conservative dividend policy. Previously, I noted that dividend payout ratios have been declining, and this differential in earnings and dividend growth rates is another way of looking at the same phenomenon. This differential is particularly revealing because Congress reduced the tax rates on dividends in 2003. This should make dividends relatively more attractive to investors and might induce boards of directors to increase dividend payouts rather than reduce them. For TECO Energy, the declines in earnings and dividends are especially important, because this means that its market-measured cost of capital may not be a reliable estimate of the cost of capital of Peoples. This confirms my methodological decision to use the comparable LDCs as proxies for Peoples in my analysis.

Q. WHAT WAS THE SOURCE OF THE COMMON STOCK PRICE DATA THAT YOU USED IN YOUR DCF ANALYSIS?

A. I used *YAHOO! Finance* as the source of market price information. I obtained current prices for a recent two-week period and the high and low share prices for a 52-week period. *YAHOO! Finance* is a widely-used internet portal that provides electronic financial information including daily prices. The current market prices reflect current market valuations. The longer time period recognizes the changing market conditions over time and helps determine a reasonable allowed return to develop rates expected to be in place for the period.

XIV. DCF CALCULATIONS

Q. PLEASE EXPLAIN THE RESULTS OF YOUR DCF CALCULATIONS.

A. In one DCF analysis, I took a relatively long-term outlook by reviewing the combined historical and forecasted dividend growth rates and the common stock prices for the past year. Looking at more current DCF results, I used the longer-term dividend growth rates and market prices from a recent two-week period. As an illustration of the volatility and unreliability of the TECO Energy DCF for measuring the cost of common equity for Peoples for ratemaking, the results are 2.44 percent and 4.00 percent. Because these are less than the current costs of even low-risk U.S. Treasuries, they are not useful in this proceeding. The most important benchmark results were the average for the comparable LDCs, which were 6.94 percent and 7.72 percent. These also are unrealistic because they are similar to the returns on Baa-rated corporate bonds. I illustrate the results of these DCF calculations using the two different price series in Exhibits ___(DAM-14) and ___(DAM-15).

Q. YOU MENTIONED THAT EARNINGS PER SHARE GROWTH IS LIKELY TO BE A MORE RELIABLE ESTIMATE OF THE COST

OF COMMON EQUITY FOR PEOPLES. WHAT WERE THE RESULTS OF YOUR ANALYSIS USING EARNINGS PER SHARE GROWTH RATES?

A. To take a longer-term view of the earnings per share growth, I combined the historical earnings per share growth and the forecasted earnings per share growth. These DCF results are somewhat more credible, but they are still relatively close to the current returns on corporate bonds. This also calls these results into question, so I adopted them along with, and in the context of, other findings. The high end estimates for the proxy LDCs were 10.24 percent and 11.02 percent for the more recent and longer price series respectively. I have illustrated these results in Exhibits ___(DAM-16) and ___(DAM-17).

Q. WHEN YOU DISCUSSED THE PROBLEMS WITH THE DCF ANALYSIS AND FINDINGS REPORTED IN THE ACADEMIC LITERATURE YOU POINTED OUT THE RELIANCE OF INVESTORS ON ANALYSTS' FORECASTS. WHAT WERE THE RESULTS OF YOUR DCF ANALYSIS USING FORECASTED EARNINGS PER SHARE GROWTH RATES?

A. The similar DCF result for the comparable companies using the recent prices was 9.26 percent. The higher end result of the comparable companies' DCFs using the longer price series was 10.04 percent. Exhibits ___(DAM-18) and ___(DAM-19) show these comparative results.

XV. CAPITAL ASSET PRICING MODEL

Q. YOU SAID YOU USED THE CAPITAL ASSET PRICING MODEL IN YOUR ANALYSIS. WHAT IS THE CAPITAL ASSET PRICING

MODEL?

A. The Capital Asset Pricing Model, or "CAPM," is a risk premium method that measures the cost of capital based on an investor's ability to diversify by combining securities of various risks into an investment portfolio. It measures the risk differential, or premium, between a given portfolio and the market as a whole. The diversification of investments reduces the investor's total risk. However, some risk is non-diversifiable, *e.g.*, market risk, and investors remain exposed to that risk. The theoretical expression of the CAPM is:

$$K = R_F + \beta\,(R_M - R_F)$$

Where: K = the required return

R_F = the risk-free rate

R_M = the required overall market return

β = beta, a measure of a given security's risk relative to that of the overall market.

In this expression, the value of market risk is the differential between the market rate and the "risk-free" rate. Beta is the measure of the volatility, as a measure of risk, of a given security relative to the risk of the market as a whole. By estimating the risk differential between an individual security and the market as a whole, an analyst can measure the relative cost of that security compared to the market as a whole.

XVI. STRENGTHS OF THE CAPM

Q. WHAT ARE THE NOTABLE STRENGTHS OF THE CAPM METHOD?

A. The CAPM is a risk premium method that typically provides a longer-term perspective of capital costs than more market sensitive methods such as the DCF. The CAPM relates current debt costs to the cost of common stock by linking the incremental cost of capital of an individual company with the risk differential between that company and the market as a whole. Although it is a less refined calculation than the DCF, it is a valuable tool for assessing the general level of the cost of a security. Since the DCF estimates are more sensitive to changes in market prices and earnings, and hence, are more volatile than the CAPM estimates, I have used the CAPM as a stable benchmark of the reasonable cost of common stock of the studied companies. The CAPM will also typically produce relatively similar results for companies in the same industry, whereas the DCF method may produce wide-ranging calculations even among companies in the same industry.

XVII. <u>WEAKNESSES OF THE CAPM</u>

Q. DOES THE CAPM HAVE PROBLEMS THAT MAY BE IMPORTANT WHEN APPLYING IT IN A RATEMAKING PROCEEDING?

A. Yes. The CAPM results are very sensitive to a company's beta. The beta is a single-dimension, market-volatility-over-time, measure of risk. For this reason, the CAPM cannot account for any risks not included as measures of market volatility, and may not identify significant market risks to investors. It may also understate or overstate the cost of capital. Most utilities have betas less than one, and a number of analysts have shown that the CAPM underestimates the cost of capital of companies with betas less than one. This is obviously important when one uses the

CAPM to estimate the cost of capital in a rate proceeding because utilities generally have betas less than one. Also, the academic literature has shown that the standard CAPM underestimates the cost of capital of smaller companies, and this underestimation of capital costs may require an adjustment.

Q. CAN YOU CITE SOURCES IN THE ACADEMIC LITERATURE THAT RECOGNIZE THAT THE CAPM METHOD UNDERESTIMATES THE COST OF CAPITAL OF SMALLER COMPANIES?

A. Yes. For at least two decades, various authors have reached this conclusion, and together they reveal the empirical consistency of this finding. For example, R. W. Banz[6] and M. R. Reinganum[7] in the 1980's are good references which point out the size bias in the CAPM. Reinganum examined the relationship between the size of the firm and its price-earnings ratio. He found that small firms experienced average returns greater than those of large firms which had equivalent risk as measured by the beta. Of course, the beta is the distinguishing measure of risk in the CAPM. Banz confirmed that beta does not explain all of the returns associated with smaller companies; hence, the CAPM would understate their cost of common equity. In the same time frame, Fama and French confirmed that the Banz analysis consistently rejected the central CAPM hypothesis that beta sufficed to explain the expected return

[6] Banz, R.W., "The Relationship Between Return and Market Value of Common Stock," *Journal of Financial Economics*, March 1981, pp. 3-18.

[7] Reinganum, M. R., "Misspecification of Capital Asset Pricing: Empirical Anomalies Based on Earnings, Yields, and Market Values," *Journal of Financial Economics*, March 1981, pp. 19-46.

of investors.[8]

Q. WHAT DID YOU MEAN WHEN YOU SAID THAT THE CAPM METHOD REQUIRES A SIZE ADJUSTMENT?

A. Although repeated studies showed that the CAPM method possesses a bias that understates the expected returns of small companies, for several years, this remained an empirical observation without a clear remedy. However, Ibbotson Associates developed an adjustment for this bias. Furthermore, Ibbotson is the common source of data for the risk premium used in CAPM analyses. Ibbotson discussed the size bias in the CAPM as follows:

> One of the most remarkable discoveries of modern finance is that of the 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. Many studies have looked at the effect of firm size on return.[9]

Q. IS THE SIZE BIAS IMPORTANT IN YOUR ANALYSIS OF THE COST OF CAPITAL OF PEOPLES?

A. Yes. In this instance, the LDCs are relatively small compared to all of the companies represented in the equities markets, and the size bias, or alternatively the adjustment necessary to adjust for this bias, is significant.

Q. ARE YOU CERTAIN THAT AN ANALYST SHOULD APPLY THE

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[8] Fama, Eugene F., and Kenneth R. French, "The CAPM is Wanted, Dead or Alive," *The Journal of Finance*, Vol. LI, No. 5, pp. 1947-1958.

[9] Chapter 7: Firm Size and Return, "Ibbotson Associates Stocks, Bonds, Bills, and Inflation: 2008 Yearbook Valuation Edition," edited by James Harrington, p. 129.

CAPM SIZE PREMIUM WHEN ESTIMATING THE COST OF COMMON EQUITY OF A REGULATED UTILTY?

A. Yes. In fact, Ibbotson Associates used an electric utility as an example to illustrate how to apply the size premium when developing a CAPM. I have included a page from that publication that shows this illustration as my Exhibit ___(DAM-20).

Q. IN YOUR ANALYSIS, DID YOU APPLY THE SIZE ADJUSTMENT RECOMMENDED BY IBBOTSON ASSOCIATES?

A. Yes. In my CAPM analysis, for the method requiring a size adjustment, I followed the approach that I discussed and presented previously.

Q. ARE YOU AWARE OF ANY REGULATORY COMMISSIONS THAT HAVE ACCEPTED THIS SIZE ADJUSTMENT TO THE CAPM IN UTILITY RATE PROCEEDINGS?

A. Yes. One example is the Minnesota Public Utilities Commission, which stated the following in the Interstate Power and Light Company case:

> ... the Commission concurs with the Administrative Law Judge in his conclusion that, whatever the merits and applicability of the Ibbotson study, for purposes of this case, it is reasonable to accept its principal conclusion – that size of a firm is a factor in determining risk and return.[10]

XVIII. CAPM METHODOLOGY

Q. PLEASE EXPLAIN THE CAPM METHODOLOGY YOU USED IN YOUR ANALYSIS.

[10] *In the Matter of the Petition of Interstate Power and Light Company for Authority to Increase its Electric Rates in Minnesota,* Docket No. E-001/GR-03-767, p. 12.

A. I applied two different, but complementary, approaches to estimate a CAPM cost of capital. One of these methods examines the historical risk premium of common stock over high grade corporate bonds. In this analysis, I used the long-term Aaa corporate bond rates as reported by the Federal Reserve and an arithmetic mean of the returns on Ibbotson small and large company stocks to estimate historical market returns. From this relationship, I calculated the differential as the historical market risk premium. The other method integrates the risk premium of common stocks to long-term government bonds in recent markets. The "risk free rate" is the current yield on 20-year Treasury bonds as reported by the Federal Reserve. This second method requires an adjustment for the bias because of company size. As I stated, this method for compensating for the size bias is a relatively recent analytical development, and I presented the explanation of how to apply this adjustment previously. The betas in both analyses are as reported by *Value Line*.

Q. ONE OF THE CAPM METHODS THAT YOU DEVELOPED USED HIGH GRADE GOVERNMENT BONDS AS REPRESENTATIVE OF THE MARKET RATES. WHY DID YOU USE THIS METHOD?

A. The Federal Reserve uses short-term Treasuries as a monetary policy vehicle, and the government market actions preclude an accurate, unbiased measurement of market valuations. The government securities are subject to the risk of changing Fed policies. The government securities also have been directly influenced by the "flight-to-quality" in the current volatile markets. Corporate bonds are a step removed from these direct federal policy influences and more representative of market-measured, benchmark measures for a risk premium analysis.

Q. DOES THE DECLINE IN EARNINGS PER SHARE AND DECLARED DIVIDENDS THAT YOU NOTED PREVIOUSLY AFFECT THE CAPM IN THE SAME WAY THAT IT AFFECTS THE DCF ANALYSIS?

A. No. The decline in earnings and dividends directly influences the mathematical DCF of the cost of capital. The decrease in common stock earnings and dividends will not affect the CAPM calculations in the same direct way. The CAPM has a longer-term, risk premium perspective.

Q. WHAT APPROACHES TO THE CAPM DID YOU USE?

A. As I stated previously, I used two different CAPM analyses based on slightly different assumptions. These two methods provide comparative long-term calculations. They provide complementary CAPM analyses and stable benchmarks for comparison with the more volatile DCF analysis. One of these methods recognized the risk associated with size of company in a rather traditional CAPM methodology, and I applied the compensation method recommended by Ibbotson Associates. The other method used historical market relationships to reveal a risk premium.

Q. HOW DID YOU CALCULATE THE ESTIMATED COST OF COMMON EQUITY USING THE MORE TRADITIONAL CAPM METHOD?

A. In this more traditional method, I used the risk premium of common stocks and the "risk free rate" of 20-year Treasury bonds in current markets as reported by the Federal Reserve. I used the company betas reported by *Value Line* to calculate the "Adjusted Equity Risk Premium".

As this method requires an adjustment for the size bias that I described earlier, I applied the appropriate adjustment recommended by Ibbotson and Associates. The sum of these results is the estimated cost of common equity for the comparable LDCs. Using this method produced an average CAPM result of 12.46 percent for the comparable LDC group. I have illustrated these results in Exhibit ___(DAM-21).

Q. YOU SAID THAT YOU ALSO DEVELOPED A CAPM ANALYSIS THAT WAS BASED ON HISTORICAL MARKET RELATIONSHIPS. WHAT DID THIS METHOD SHOW?

A. The second CAPM method is a method that does not require a separate recognition of the size bias because it embodies the historical relationship between common equity and debt. In this analysis, I used the long-term Aaa corporate bond rates as reported by the Federal Reserve and an arithmetic mean of the returns on Ibbotson Associates' small and large company stocks to estimate the historical market returns. From this relationship, I calculated the differential as the historical market risk premium. Again, I used the betas for the respective companies as reported by *Value Line* to estimate the "Adjusted Risk Premium". Applying this method, the average CAPM estimate for the comparable LDC utilities was 13.01 percent. I calculate and illustrate these results in Exhibit ___(DAM-22).

XIX. <u>CAPM RESULTS</u>

Q. PLEASE EXPLAIN THE RESULTS OF YOUR CAPM ANALYSIS.

A. The results of my two different CAPM analyses for the comparable LDCs are 12.46 percent and 13.01 percent. Because I used the comparable

LDCs as proxies for Peoples, these are the more relevant CAPM results for this proceeding. I have illustrated the CAPM calculations in Exhibits ___(DAM-21) and ___(DAM-22).

XX. TARIFF PROVISIONS

Q. IN YOUR ANALYSIS OF THE COST OF CAPITAL OF PEOPLES, DID YOU HAVE ANY CONCERNS ABOUT THE COMPANY'S RATE STRUCTURE?

A. Yes, I did. Peoples' is maintaining its previous rate structure at a time when many LDCs, including utilities in the comparable, proxy group, are altering, or have altered, their rate design in order to reduce their business risk. Although the LDCs call these individual provisions by various names, they fall under the general term of "decoupling."

Q. WHAT IS THE NATURE OF THIS BUSINESS RISK?

A. This business risk results from a problem in recovering fixed costs through rates because of declining per customer consumption. This risk, a product of high natural gas prices, is the business risk that I discussed earlier. It is a universal problem throughout the industry, and virtually all LDCs face this business risk. However, many have revised their tariffs to try to mitigate their exposure.

Q. CAN YOU IDENTIFY SOME OF THE RATE PROVISIONS THAT ADDRESS THIS BUSINESS RISK?

A. Although I have not made an exhaustive study of the rate provisions addressing this virtually universal business risk, I have noted a number of such provisions in LDC rates, including the comparable companies that I used in my analysis for this proceeding. Of course, weather normalization provisions are commonplace in regions where a large percentage of revenues are weather sensitive, but many rate provisions address directly the business risks of revenue exposure to customer consumption levels. For example, in Laclede Gas' 2007 rate case, the Missouri Public Service Commission approved rate design changes that would increase the likelihood of recovery of fixed costs and margins despite reductions in sales volumes. Weather and other factors that affect customer usage were the reasons for this provision.[11] New Jersey Natural Gas has both a Conservation Incentive Program (CIP) and a Weather Normalization Clause (WNC).[12] The Oregon Public Utility Commission renewed Northwest Natural Gas' Conservation Tariff as well as a Weather Normalization mechanism.[13] South Jersey Natural Gas has a tariff that provides for a Temperature Adjustment Clause (TAC) and a Conservation Incentive Program (CIP).[14] The California division of Southwest Gas has a Core Fixed Cost Adjustment Mechanism (CFCAM) which accounts for weather deviations from normal levels and customer conservation.[15]

Q. **HOW DID THIS BUSINESS RISK AFFECT YOUR ANALYSIS OF THE COST OF COMMON EQUITY OF PEOPLES?**

A. Although Peoples has not altered its rate design to mitigate the risk of declining per customer usage, many of the proxy LDCs have such provisions. Therefore, the measured costs of common equity of the proxy group are biased to the low side when used as estimates of the cost of

[11] Laclede Group 2007 10-K Report, page 24.
[12] New Jersey Resource 2007 10-K Report, page 3-4.
[13] Northwest Natural Gas 10-Q Report for the Quarter Ending September 30, 2007, page 19.
[14] South Jersey Industries 10-Q Report for the Quarter Ending September 30, 2007, page 22.
[15] Cal. PUC Sheets 6001-G and 6559-G.

common equity of Peoples. Therefore, I took this risk differential into account in my evaluation of the market-based costs of common equity of the proxy group. From a business risk capital standpoint, Peoples cost of common equity should be above the average cost of common equity of the proxy group.

XXI. RECOMMENDED RETURN

Q. HOW DID YOU DETERMINE A RECOMMENDED ALLOWED RETURN ON COMMON STOCK FOR PEOPLES GAS?

A. I relied on the measures of the costs of common equity of the comparable LDCs as proxies for Peoples, taking into consideration that the current actual market return is 11.5 percent. To interpret the current market measures of the cost of common equity of Peoples, I observed the critical factors of persistent inflationary pressures, capital flight to quality and, despite the Federal Reserve actions to lower short-term interest rates, high and forecasted rising long-term rates. In the current volatile market, not surprisingly, the market-based, estimated cost of capital for the proxy LDC group varied considerably, as shown in Exhibit ___(DAM-23). The results from relevant DCF calculations were 10.04 percent and 11.02 percent. The relevant CAPM results were 12.46 percent and 13.01 percent. Looking to the upper end of the DCF results and the lower end of the CAPM results, the relevant range is from 11.0 to 12.5 percent range. With the benchmark proxy LDCs currently earning 11.5 percent and Peoples' lower common equity, and therefore higher financial risk, I believe that a return slightly above the proxy companies is appropriate for Peoples in this proceeding.

Q. WHAT IS YOUR RECOMMENDED RETURN ON COMMON EQUITY FOR PEOPLES IN THIS PROCEEDING?

A. I am recommending an allowed return for Peoples in this proceeding of 11.50 percent. In addition to the market based estimates of the cost of common equity of the proxy LDCs, I especially noted the relatively low common equity ratio and high financial risk of Peoples as compared to the proxy LDCs, and the rising long-term corporate interest rates in a very volatile market.

Q. WHAT IS THE TOTAL COST OF CAPITAL THAT YOU ARE RECOMMENDING FOR PEOPLES IN THIS PROCEEDING?

A. When incorporated in Peoples' capital structure for the projected test year, an allowed return on common equity of 11.50 percent produces a total cost of capital of 8.88 percent. I have illustrated the calculation of this total cost of capital in Exhibit ___(DAM-24).

XXII. FINANCIAL INTEGRITY TEST

Q. YOU SAID YOU TESTED YOUR RECOMMENDED RETURN TO VERIFY ITS ADEQUACY AND APPROPRIATENESS FOR PEOPLES. WHAT WAS THE NATURE OF THIS TEST?

A. I compared the After-Tax Interest Coverage ratio at my recommended allowed return on common equity to the current After-Tax Interest Coverage ratios of the proxy LDCs. The After-Tax Interest Coverage is a straight-forward comparison of available funds to interest payments. It is a measure of a company's ability to meet fixed interest obligations and a quick test of the financial integrity of the Company at my recommended allowed return. That is, the higher the coverage ratio, the greater the likelihood that the returns from operations at my recommended allowed return will be sufficient to meet my fixed interest obligations.

Q. WHAT DID YOUR COMPARISON OF AFTER-TAX INTEREST COVERAGE RATIOS FOR PEOPLES AT YOUR RECOMMENDED ALLOWED RETURN SHOW?

A. The After-Tax Interest Coverage ratio for the comparable LDCs is 3.75 times and the After-Tax Interest Coverage ratio for Peoples at my recommended allowed return and the appropriate capital structure in this proceeding is 2.69 times. This confirms that my recommended allowed return for Peoples is very conservative relative to the coverages of other LDCs in current markets. I illustrate this comparison in Exhibit ___(DAM-25). If anything, these coverages call into question whether my recommended return will be adequate to attract capital if market volatility continues or worsens.

XXIII. SUMMARY

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. First, in order to analyze the current cost of capital and to recommend a rate of return and capital structure appropriate for Peoples in this proceeding, I studied the current background economic environment. I then determined the appropriate capital structure and the cost of debt for this proceeding. Methodologically, as Peoples is not publicly traded, I relied on the relevant financial and market information and current levels of returns of a proxy group of LDCs.

Based on Peoples' capital structure in the projected test year, I noted that the Company's common equity ratio is lower and of higher risk than the average of the proxy, comparable LDCs.

As market measures of the cost of common stock, I applied two methods, namely the Discounted Cash Flow and Capital Asset Pricing Models, to the group of proxy companies for my market analysis of the costs of common equity for Peoples. The relevant results ranged from 10.04 percent to 13.01 percent, with a relevant range of 11.0 to 12.5 percent. As an important measure of current market returns, the average return on common stock for the proxy, comparable LDCs is currently 11.5 percent.

Recognizing the recent market volatility, inflationary pressures, and rising long-term corporate interest rates, and significantly, that Peoples has a lower common equity ratio and higher financial risk than the proxy LDCs, I am recommending an allowed return on common equity of 11.50 percent for the Company. Based on the costs of the other capital components in Peoples' capital structure in the projected test year, I am recommending a return on total capital of 8.88 percent for Peoples.

Finally, I compared the After-Tax Interest Coverage for Peoples at my recommended allowed return to the current After-Tax Interest Coverage for the comparable, proxy LDCs. At my recommended allowed return of 11.50 percent the After-Tax Interest Coverage for Peoples will be 2.69 times. The comparable companies currently have a much higher After-Tax Interest Coverage of 3.75 times. This confirms that my recommended allowed return is very conservative.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

BY MR. BEASLEY:

Q Doctor Murry, did you also prepare and submit the exhibits that accompany your direct testimony, they being Exhibits DAM-1 through DAM-25, which have been identified as Hearing Exhibits 13 through 37?

A I did.

Q Thank you. And would you please summarize your direct testimony.

A Good morning, Commissioners.

In order to analyze the current cost of capital and to recommend a rate of return and capital structure appropriate for Peoples in this proceeding, I studied the current background economic environment. I then determined the appropriate capital structure and the cost of debt for this proceeding. Methodologically, as Peoples is not publicly traded, I relied on the relevant financial and market information and current levels of returns of proxy group of local gas distribution companies. Peoples' capital structure in the projected test year is lower than the average of the proxy comparable LDCs that I selected for my analysis. This means that Peoples has somewhat higher financial risk than the group. As market measures the cost of common stock, I applied two methods; namely, the discounted cash flow and capital asset pricing models to the group of proxy companies from our market analysis of the cost of common equity for Peoples.

The relevant results range from 10.04 percent to 13.01 percent with a relevant range of 11.0 to 12.5 percent. Significantly, the current market returns as measured by the average return on common stock for the proxy comparable LDCs is 11.5 percent.

At the time of my direct testimony, as well as the relatively higher financial risk, I recognized the market volatility, the then prospective inflationary pressures, and rising long-term corporate interest rates. In this environment I'm recommending an allowed return on common equity of 11.5 percent for Peoples. Based on the cost of the other capital components and Peoples' capital structure in the projected test year, I'm recommending a return on total capital of 8.88 percent for Peoples.

Finally, I compared the after-tax interest coverage for Peoples in my recommended allowed return to the current after-tax interest coverage for the comparable proxy companies. At my recommended allowed return of 11.5 percent, the after-tax interest coverage for Peoples will be 2.69 times. The comparable companies currently have a much higher after-tax coverage of 3.75 times on the average. This confirms that my recommended allowed return is very conservative. Thank you.

MR. BEASLEY: We tender Doctor Murry for questions.

MR. McWHIRTER: No questions.

COMMISSIONER EDGAR: Thank you.

Mr. Rehwinkel.

MR. REHWINKEL: Yes, thank you.

CROSS EXAMINATION

BY MR. REHWINKEL:

Q Doctor Murry, good morning. It's still morning.

A Good morning.

Q I'd like to ask you about your DCF results.

A Okay.

Q And I'd like to ask if you could turn to Exhibit DAM-14, please.

A Okay.

Q On this exhibit you show your DCF results with a dividend growth rate, is that correct?

A That's correct.

Q And therein you show a high and a low cost of capital of 6.87 to 6.94 percent for these comparable companies, is that correct?

A Yes, that's correct.

Q You also show a low and a high cost of capital for TECO Energy of 2.32 percent and 2.44 percent, is that correct?

A Applying the methodology, that's the result, yes, sir.

Q Okay. And this table, the growth rate is a projected dividend per share growth rate from Value Line, correct?

A That is a combination of a historical dividend growth rate from 2002 to 2004 and a forecast out to 2011 to '13.

Q Okay. But the projected or forecasted growth rate is from Value Line?

A That's correct.

Q Okay. And in your DCF model, the annual cash flows that investors receive are in the form of dividends, is that right?

A Excuse me?

Q In the DCF model that you use, the annual cash flows that investors receive are in the form of dividends, correct?

A In this particular narrow calculation, that would be the only return. Of course, investors also expect capital gains, and this particular formulation wouldn't provide any capital gains to the investors.

Q So the answer to my question is yes?

A Not really. But in this narrow way, you could say that it's affirmative.

Q I'm just asking you about this particular page right here.

A As to that page, the only return to an investor would be a dividend.

Q Okay. Now, your figures for TECO Energy are low compared to the rest of the group, correct?

A Oh, absolutely.

Q Okay. And you have ignored the DCF results for TECO

Energy in this DCF computation, correct?

A Yes. As I've pointed out in my testimony that I thought the financial difficulties in the past of TECO Energy probably should not have much bearing on the return in this proceeding, and so I relied on the returns for the comparable groups primarily.

Q And so another way to put it is you affirmatively made a decision to exclude TECO Energy from these DCF results.

A You are using the word exclude, which I think would imply 100 percent, and I would discount it perhaps close to that number. But I calculated it, I reported it because I thought it was at least information I would like to know.

Q But it's not incorporated into the results that you achieved, correct, the numbers?

A Well, I would consider a DCF result of 2.32 percent to 2.44 percent at a time when BAA corporate bonds are running around 8 percent an irrelevant number for this proceeding.

Q But to answer the yes or no part of my question, yes, you excluded it, TECO?

A As I have characterized what exclusion means, yes.

Q Okay. And, in fact, you have not used or included data for TECO Energy at all in this calculation, is that right?

A In my testimony or just this page?

Q This page.

A I would not consider that relevant; so I would ignore that, yes.

Q Okay. Let me ask you to turn to DAM-14, please.

A I was just looking at 14.

Q I'm sorry. Thank you for calling me on that. 15.

A Oh, certainly.

Q Sorry. There you show DCF results with a dividend growth rate, is that correct?

A Yes.

Q Okay. And you show an average low and a high cost of capital of 6.41 percent to 7.72 percent, correct?

A Yes, that's true.

Q And, once again, you did not incorporate in these figures a DCF equity cost -- I'm sorry, let me ask that again.

You did not use these figures in affirmatively arriving at a DCF equity cost rate of 11.5 percent for Peoples, correct?

A I think that is an accurate statement, yes, sir.

Q Now, in DAM-16, you show your DCF results using current share prices and earnings per share growth rate estimates from Value Line, correct?

A That is correct. That's an earning -- the difference between this table and DAM-14 is in the growth rate, and this is earnings per share as opposed to just dividend.

Q Okay. And the results are from -- the estimates are from Value Line?

A Yes.

Q Now, you show a low and a high cost of capital of 10.18 percent and 10.24 percent for the comparable companies, correct?

A Yes.

Q Now, how did you use these figures in arriving at a DCF equity cost rate of 11.5 percent for Peoples?

A I considered those numbers relevant with regard to the earnings growth for the comparable companies, if one looks at that as a DCF result.

Q But you did not use those in calculating the 11.5 percent rate?

A I wouldn't go so far as I did not use those. I would say that those numbers had bearing on my judgment.

Q On DAM-17 you show a DCF result -- you show DCF results using 52-week prices and with EPS growth rates estimated from Value Line, correct?

A That's correct.

Q Okay. For the comparable companies, you show a low of 9.72 percent and a high of 11.02 percent, correct?

A That's correct.

Q How did you use these figures in arriving at a DCF equity cost rate of 11.5 percent for --

A Again, those are results based on that methodology of calculating a DCF that I used, in my judgment, to recommend

11.5 percent.

Q Isn't it true -- I'm sorry.

A Let me add to that, because you are asking all of these -- this testimony was prepared in July. Since then there has been a huge decrease in market values. You know, the market has been in turmoil. The decline in prices of these comparable companies in the last three weeks has been 20 percent. The yield has gone up by a large amount, and these numbers now have increased by probably 100 basis points, if you recalculate them.

Q You only used the 11.02 percent figure here in determining your 11.5 percent recommendation for Peoples, isn't that correct?

A I'm not sure that's quite correct. I used the results on this page as part of the analysis, recognizing the origin of these numbers, and to affect my judgment that 11.5 was appropriate. If you note from my summary, I think I found the range that I considered relevant from 10.04 to 13.01.

Q DAM-18, if I could ask you to turn there.

A Certainly.

Q You show DCF results using current stock prices and with earnings per share growth rate estimates from Value Line and Yahoo, correct?

A That's correct.

Q Okay. And for the comparable companies you show a low of 7.5 percent and a high of 9.26 percent, correct?

A Those are correct readings, yes, sir.

Q Now, how did you use these figures in arriving at a DCF equity cost rate of 11.5 percent for Peoples?

A As I said previously, this is one formulation of the DCF, and I recognize this formulation. I used it in my evaluation. In my judgment, I have recommended 11.5 percent.

Q And one last question in this area on DAM-19?

A Okay.

Q Again, DCF results using 52-week prices and with earnings per share growth rate estimates from Value Line and Yahoo, correct?

A That's correct.

Q And for the comparable companies, you show a low of 7.04 percent and a high of 10.04 percent, correct?

A Yes, that's correct.

Q You did not incorporate these figures in arriving at a DCF equity cost rate of 11.5 percent, did you?

A I didn't ignore them. And let me point out in that same formulation calculation where we had a negative result for TECO earlier, now we have got a calculation of 11.4 percent. That indicates the volatility of the DCF, and how much it relies on the assumption of the data you are using and the methodology you are applying, and that's why some judgment -- it's not a formula that produces a magic number, some judgment, some analysis to support it is necessary.

Q Okay. And DAM-23, if I could ask you to turn there.

A Certainly.

Q You present what you call your summary of financial analysis, is that right?

A Those are the numbers I considered most relevant in my analysis, that is why I presented them as a summary.

Q Okay. Now, you show for TECO -- you show figures for TECO and the comparable electric companies, right?

A That's correct.

Q Okay. So is it true, again -- is it true that here you also ignore the results for TECO?

A I probably would say it's appropriate to say I weighted the results from the comparable companies more than I did for TECO, as I indicated in the methodology I followed that I thought it was inappropriate to rely too much on the TECO results. In some analyses I would say that it is more appropriate to look at the parent company because the stock is being traded. In this particular case, Peoples is a relatively smaller portion of TECO Energy, and that's one consideration. The second is there may be other factors affecting TECO Energy than just the gas business.

Q Okay. Now, in a somewhat tedious manner we have just gone through a summary of your DCF results for the comparable companies. For the DCF results here, you present the results for earnings growth DCF analysis and projected growth DCF analysis, correct?

A That is correct.

Q And you show here results of 9.72 percent and 11.22 percent for the earnings growth DCF analysis and 7.04 percent -- well, first of all, is that correct?

A That's correct.

Q And 7.04 percent and 10.04 percent for the projected growth DCF analysis, right?

A That's correct. This is as of last July.

Q On Page 51 of your testimony, you state -- I'll let you turn there, of your direct.

A Okay.

Q You state that your DCF results range from 10.04 percent to 13.01 percent, correct?

A You are on Page 51, is that correct?

Q I think of your direct. I'm looking on Line 6 of your direct, Page 51.

A Yes, sir.

Q Okay. When you say "yes, sir," you mean you're agreeing --

A Yes. I'm on that point, yes, sir. I'm sorry.

Q And by defining this as the relevant range, can I presume that you have ignored the 9.72 percent and the 7.04 percent results?

A When you say ignore, I don't -- I have a little trouble with that. No, I didn't ignore. I think my judgment said I would concentrate on numbers that were higher than the 9.72 percent, which is more to the center of all of these results.

Q Isn't it fair to say that in determining your DCF equity cost rate results you were only using the high end of the range of your results?

A It would be fair to say that in the case of the DCF, I focused on the high end of the range, which I explained in considerable detail in my testimony regarding the DCF methodology and the results it produces as a marginal cost calculation. And, yes, I think going -- I'm familiar with analysts who take a number and call it the answer and go to the low end of the DCF, and I can tell you based on the theoretical construct you are almost guaranteed that company will never earn that amount of money.

Q So it seems like in your -- the results that we have gone through here this morning, that the low end of the range is relatively meaningless in determining the equity cost rate for Peoples, is that correct?

A Well, I would not have used the word meaningless. I would use the characterization I just gave you, and I think it requires some analysis and judgment as to what is an appropriate return. When the BAA rate is -- I think two days ago it was 8.6 percent, numbers that are around 9 percent are not really relevant for this proceeding on a go-forward basis.

Q In determining your DCF result, did you ignore or exclude any results because the numbers were too high?

A Yes.

Q Can you give me an example?

A Well, obviously I ignored the 3.01 percent. And if you look at the Schedule 23 that you just cited, I ignored -- not ignored, because I don't like that word in these circumstances, I certainly didn't accept the 13.65 percent for TECO, which if you update that, I think that has gone up by a couple hundred basis points in recent markets because of the decline. So, no, I would -- as I point out, and I know we are not discussing the rebuttal here, but as I pointed out in my rebuttal, despite the market changes, I was not changing my recommendation. And all of these numbers have not just floated up, they have gone up rather sharply since July.

Q Okay. Just one final line of questioning on your CAPM analysis, if you could turn to DAM-21.

A Certainly.

Q That is where we find your CAPM analysis?

A Yes, sir.

Q You use a risk-free rate of 4.60 percent. Would you agree that the current rate on long-term treasury bonds is about 3.6 percent now?

A I'll accept that. I don't know what it is as of yesterday, but that is certainly --

Q It's in that range?

A It's in that range; yes, sir.

Q So if we substituted the current long-term treasury rate into your CAPM analysis, your results would decline by about 100 basis points, is that correct?

A In that particular formulation of the CAPM, the result would come down about 100 basis points, which is an interesting observation as we just discussed the DCF going up by 100 basis points by updating.

Q Now, the equity risk premium you used in DAM-20 is the difference between the arithmetic mean stock and bond return from 1926 to --

A Excuse me. I'm sorry.

Q I apologize. On DAM-20.

A DAM-20?

Q Yes.

A All right.

Q I will ask it again. The equity risk premium reflected there is the difference between the arithmetic mean stock and bond returns from 1926 to 2007 as published by Ibbotson Associates, is that correct?

A That would be correct.

Q The Ibbotson study is updated each year, correct?

A Yes, it is.

Q And I called it Ibbotson, but it is now Morningstar?

A That is correct.

Q Okay. The results which include the year 2008 should be out soon?

A Yes, it should.

Q Do you know what the return on the stock market in 2008 was?

A The stock market return in 2008?

Q Yes.

A I don't have that number in mind, no, sir.

Q Would a negative 35 percent be about right?

A I would accept that number given what the market has done.

Q Okay. So if we were to update --

A I was just going to say if we are talking about total return in this case, yes.

Q Yes. And if we were to update your CAPM results with the 1926 to 2008 Ibbotson results, when available, your results would be lower because the Ibbotson equity risk premium will be lower once we have included the historic results, the 2008 stock market return yielded, is that correct?

A It would have to be somewhat lower, although the calculation of market returns here is both small and large companies, and I would want to look at the update. But, yes, I understand the thrust.

MR. REHWINKEL: Thank you. That is all the questions I have. Thank you, Doctor Murry.

CHAIRMAN CARTER: Thank you.

Staff. One second.

Commissioner Skop.

COMMISSIONER SKOP: Thank you, Mr. Chairman.

Just a few questions of Mr. Murry. Going back to one of the exhibits, DAM-15, I would like to briefly discuss the limitations of both the DCF and CAPM models during periods of extensive market volatility.

On DSM-15, using the discounted cash flow method, the cost of equity for the low was 6.41 and the high was 7.72. In this particular case, did the DCF model, or the analysis using the data within this exhibit, were those results lower, or the predicted results lower than the current cost of long-term debt for an appropriate rated company?

THE WITNESS: Yes. Well, the current cost of BAA, as I mentioned earlier, I believe was 8.6 percent in the market just a day or two ago, and so even the high end of this calculation using just dividends as a growth rate is lower than the -- and it has to be somewhat higher just as a risk premium.

COMMISSIONER SKOP: So there are times where using both the discounted cash flow and the CAPM methods tend to fail by virtue of current economic conditions and actually produce inconsistent results with the reality of the bond market, is that correct?

THE WITNESS: Absolutely. They are both very data sensitive and the markets, of course, are generating the data and market volatility will generate sometimes peculiar numbers in that logic.

COMMISSIONER SKOP: Okay. And it is reasonable in historical practice based on cost of capital that the required return on equity would be in excess of the cost of debt for a company?

THE WITNESS: Absolutely, simple risk premium.

COMMISSIONER SKOP: Okay. So then basically, I guess, in using this statistical analogy where you have outlier points, and I know that you -- I'm trying to get your exact words so I don't put words in your mouth, but I think it was on Page 51 of your testimony, the relevant results that you spoke to, if I understand your discussion or your testimony correctly, what you have done is basically because of the inconsistent result predicted by the DCF model in relation to the current cost of debt, that that was not a reasonable result and, therefore, you excluded that from your professional recommendation as to what the appropriate return on equity would be, is that correct?

THE WITNESS: That is a very accurate characterization of my testimony, yes, sir.

COMMISSIONER SKOP: Okay. Just moving forward to -- and I am looking at this book because some pages are upside down, and so I am probably not doing a good job of flipping through pages on the fly. But, again, the relevant range would not include outlying results that seem to be inconsistent with reality, correct?

THE WITNESS: That is correct. That is one reason I used multiple methods because they imply different things and judgment are these -- it is not just a matter of there being an outlier, but the reason that they are outliers.

COMMISSIONER SKOP: Okay. If we could move on to DAM-21, and that discusses the risk free return that was used in the CAPM analysis that you performed. And the number mentioned was, I believe, 4.6 percent for the risk free return, and that is based on historical returns not including the 2008 market results, is that correct?

THE WITNESS: Well, the 4.6 percent is not historical, sir. The 4.6 percent was actually taken from the Federal Reserve statistic release in June, so that was a point in time. The risk premium was based on a historical relationship.

COMMISSIONER SKOP: Okay. But the risk free return that was used -- again, I am looking at data that is upside down, so I apologize. You mentioned that in your CAPM analysis the value that was used for the risk free rate was what?

THE WITNESS: Is 4.6 percent, which was the previous Federal Reserve release of that rate.

COMMISSIONER SKOP: Okay. Now, is that an historical number?

THE WITNESS: No, it is actually -- it is a monthly, I think it is a monthly weighted average, if I remember the calculation of the Federal Reserve exactly.

COMMISSIONER SKOP: Okay. And I guess, as Mr. Rehwinkel has indicated, that that number has subsequently fallen, is that correct?

THE WITNESS: Absolutely. The market crisis really happened in September, which created all of the actions to stimulate a variety of reserves in the market have, of course, driven down the long-term rates of the treasuries.

COMMISSIONER SKOP: Now, in using the input variables in the CAPM model, historical returns are used for the market returns, is that correct?

THE WITNESS: I used historical returns for that, yes.

COMMISSIONER SKOP: Now, are historical averages of the risk free rate ever used for the risk free rate?

THE WITNESS: They might be. I wouldn't say that they -- they shouldn't be, but I think that probably gets more of a historical flavor than I would tend to normally think is appropriate. Under current circumstances, clearly the current rates are abnormally low if one looks at it historically.

COMMISSIONER SKOP: Okay. And then with respect to -- I think that is my only question. Thank you.

CHAIRMAN CARTER: Commissioners, I am going to go to staff unless you are ready. I can come back to the bench.

Staff, you're recognized.

MS. FLEMING: Thank you.

CROSS EXAMINATION

BY MS. FLEMING:

Q Doctor Murry, we have kind of danced around a little bit about this. You talked with Charles Rehwinkel about your testimony on Page 51 where you discuss the relevant results and the ranges of those results, and I just have just a couple of quick questions for you.

A Okay.

Q Specifically on Lines 5 through 7, you state that the relevant ranges range from 10.04 percent to 13.01 percent with a relevant range of 11.0 to 12.5 percent. Can you explain to me how you determined that the relevant range of 11 to 12.5 percent -- how did you determine that to be the relevant range when you started with 10.5 to 13.01?

A Well, I guess the answer to that is it was my judgment, because those were are the middle points of looking at all of these various results. I consider the 10.04 -- I guess I consider the 10.04 and 13.01 as the boundaries that I consider even appropriate for consideration under the circumstances, and based on the results that I received from both the DCF and the CAPM and my interpretation at that time of the market conditions, and reminding you that my comparable companies earned 11.5 percent as actual returns, that I went to the center of that range certainly to consider what was relevant. Since 11.0 and 12.5 are clearly rounded numbers, I say those are based on my judgment.

MS. FLEMING: Thank you.

We have no further questions. However, at this time staff would like to hand out a stipulated exhibit that has been agreed to by all the parties. With this exhibit -- or I will wait to explain.

CHAIRMAN CARTER: Okay.

MS. FLEMING: We would ask that this be marked as the next hearing exhibit, which is 92, I believe.

CHAIRMAN CARTER: 92.

(Exhibit 92 marked for identification.)

MS. FLEMING: And just for the record, this exhibit represents a comparison of the existing and proposed cost-recovery clauses and riders that are available to Peoples Gas, and it also reflects the cost-recovery mechanisms available to the natural gas companies that are in Witness Murry's proxy group. And as I stated previously, we have provided this to all parties previously, and it has been stipulated to by all parties.

CHAIRMAN CARTER: Is this the agreement of the parties?

MR. REHWINKEL: Yes.

CHAIRMAN CARTER: Okay. So are you moving it into the record now?

MS. FLEMING: I will wait until the appropriate time.

CHAIRMAN CARTER: Will this be with Witness Murry?

MS. FLEMING: Yes, with Witness Murry.

CHAIRMAN CARTER: Okay. Let's see if there are any further questions and then we will deal with it afterwards.

Commissioners, any further questions for Witness Murry? Okay. Let's take a minute to look this over here.

Redirect.

MR. BEASLEY: No redirect, sir.

CHAIRMAN CARTER: Okay. Let's deal with the exhibits, then.

MR. BEASLEY: I would move admission of Exhibits 13 through 37.

CHAIRMAN CARTER: Any objection? Without objection, show it done.

(Exhibit Numbers 13 through 37 admitted into the record.)

CHAIRMAN CARTER: Now we are on Staff Exhibit Number 92. Parties have already had an opportunity to look it over and stipulated. Any objections?

MR. BEASLEY: No objection.

CHAIRMAN CARTER: Without objection, show it done.

(Exhibit Number 92 marked for identification and admitted into the record.)

CHAIRMAN CARTER: Anything further for this witness?

MR. BEASLEY: No, sir. We would ask that he be temporarily excused.

CHAIRMAN CARTER: Okay. You can go on recess. You can't leave the playground, though. Thank you, Doctor Murry.

Commissioners, let me just kind of help you with your planning purposes. I know a lot of you -- we have got things to do, and I probably should have said it this morning. For planning purposes, we won't go beyond 5:00 today, and it looks like this is probably a good breaking point for lunch. I want to kind of give staff an opportunity for lunch as well as take care of some details, so how about we come back at 1:40.

Does that work for everybody? Okay, we are on lunch.

(Lunch recess.)

CHAIRMAN CARTER: We are back on the record. And when we last left we had completed with Doctor Murry. Would you call your next witness, please.

MR. WATSON: Donna Hobkirk.

DONNA HOBKIRK

was called as a witness on behalf of Peoples Gas Company, and having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. WATSON:

Q Please state your name and business address.

A Donna Hobkirk, 702 North Franklin Street, Tampa Florida 33602.

Q By whom are you employed and in what capacity?

A I am the Manager of Plant Accounting at Peoples Gas.

Q Did you prepare and cause to be filed in this case direct testimony consisting of five pages?

A Yes, I did.

Q Do you have any corrections or other changes to that testimony?

A I do not.

Q And attached to your direct testimony, did you file an exhibit premarked as Exhibit DWH-1 and identified as Hearing Exhibit 38?

A Yes.

MR. WATSON: Mr. Chairman, we would ask that Ms. Hobkirk's Exhibit DWH-1 be formally identified as Hearing Exhibit 38.

CHAIRMAN CARTER: For the record, Exhibit 38 will be identified for the record.

(Exhibit 38 marked for identification.)

BY MR. WATSON:

Q Ms. Hobkirk, do you have any changes to Exhibit 38?
A No, I do not.
Q If I were to ask you the questions in your direct testimony today, would your answers be the same?
A Yes.

MR. WATSON: We would ask that Ms. Hobkirk's direct testimony be inserted into the record as though read.

CHAIRMAN CARTER: The prefiled direct testimony of the witness will be inserted into the record as though read.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Donna W. Hobkirk and my business address is 702 N. Franklin Street, Tampa, Florida 33602.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Peoples Gas System ("Peoples" or the "Company") as Manager, Plant Accounting, a position I have held with the Company since December 2000.

Q. PLEASE PROVIDE A BRIEF OUTLINE OF YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I graduated from the University of South Florida in 1993 with a Bachelor of Arts degree in Accounting. I began my career with Tampa Electric Company in 1981, and worked in a number of different positions and departments before being transferred to Peoples' plant accounting department in 1998.

Q. AS MANAGER, PLANT ACCOUNTING, WHAT IS THE NATURE OF YOUR DUTIES AND RESPONSIBILITIES?

A. I am responsible for Plant Accounting's financial reporting, rate setting and regulatory requirements. This includes, but is not limited to, maintaining the Project, Construction & Retirement Work In Progress (CWIP & RWIP) and Fixed Asset Management System (IntelliPlant), and coordinating and monitoring plant accounting's monthly close. I am also responsible for performing service life studies to ensure Company depreciation rates conform to the mortality characteristics of plant assets.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to present and support certain schedules of the Minimum Filing Requirements ("MFRs") identified as Exhibit ___(PGS-1) containing information on Peoples' utility plant for the 2007 historic base year, and other MFR schedules pertaining to projected utility plant for 2008 and 2009, the projected test year.

Q. HAVE YOU PREPARED OR CAUSED TO BE PREPARED ANY EXHIBITS TO BE INTRODUCED IN THIS PROCEEDING?

A. Yes. The MFR schedules listed in Exhibit___(DWH-1) were prepared by me or under my supervision. Each schedule contains a general explanation of what is called for and shown on the schedule.

Q. FROM WHAT SOURCES DID YOU OBTAIN THE INFORMATION SHOWN ON THE MFR SCHEDULES PERTAINING TO THE 2007 HISTORIC BASE YEAR?

A. The information shown on Schedules B-4, B-7, B-8, B-9, B-10 and B-12 was taken from the books and records of the Company, which are maintained in accordance with Generally Accepted Accounting Principles. Information shown on Schedules B-4, B-9 and B-10 required allocations of the values of certain common plant properties to be made between utility, or regulated, property and non-utility, or non-regulated property. The non-utility portion of these assets was then excluded from the Company's rate base for ratemaking purposes. The allocations are shown on Schedules B-5 and B-11.

Q. HOW WERE THE ALLOCATIONS BETWEEN UTILITY AND NON-UTILITY ASSETS MADE?

A. Accounts 374 (Land), 375 (Structures and Improvements-Distribution) and 390 (Structures and Improvements-General) were allocated based on the square footage percentage of non-utilized property. Accounts 303.01 (Customized Software) and 391.01 (Computer Equipment) are dependent upon, and were allocated based on, a combination of invoice count, number of transactions, number of bills and number of assets processed related to non-utility.

Q. DO THE ALLOCATIONS OF ASSETS PORTRAYED ON SCHEDULE B-5 REQUIRE CORRESPONDING ALLOCATIONS OF ANY EXPENSES BETWEEN UTILITY AND NON-UTILITY?

A. Yes, the allocations of various items of common plant between utility and non-utility require corresponding allocations of the depreciation expense associated with the plant items, and the associated depreciation reserve balances, between utility and non-utility expense. The non-utility expense is then excluded for ratemaking purposes. Those allocations are shown on MFR Schedule C-19.

Q. WHAT ADJUSTMENTS, IF ANY, ARE INCLUDED ON THE HISTORIC BASE YEAR SCHEDULES YOU HAVE IDENTIFIED?

A. Utility property for Account 303.01 (Customized Software) and Account 391.01 (Computer Equipment) have been adjusted by .5% and .1%, respectively due to usage of assets related to non-utility transactions. Account 374 (Land & Land Rights) and Accounts 375 & 390 (Structures & Improvements) have been adjusted 8%, 1.8% and 57.2%, respectively for non-use of utility property. The corresponding reserve and expense for these accounts have been adjusted as well.

Q. HOW IS THE DEPRECIATION EXPENSE FOR PEOPLES' DEPRECIABLE PROPERTY DETERMINED?

A. Depreciation expense is calculated based on average monthly plant in service and using depreciation rates ordered by the Commission as a result of Peoples' last depreciation study in Docket No. 060496-GU.

Q. WHAT IMPACT DID THE DEPRECIATION RATES ORDERED BY THE COMMISSION IN THAT DOCKET HAVE ON THE COMPANY'S DEPRECIATION EXPENSE?

A. As a result of the Commission's Order No. PSC-07-0125-PAA-GU, Peoples' depreciation expense was increased by approximately $2 million per year.

Q. WHAT IS SHOWN ON SCHEDULE G-1, PAGES 9 THROUGH 22, RELATING TO 2008, OR THE HISTORIC BASE YEAR PLUS 1, AND 2009, THE PROJECTED TEST YEAR?

A. These schedules represent a roll forward of the historic base year ending balances and incorporate projected capital expenditures and retirements for years 2008 and 2009. For both 2008 and the projected test year, projected retirements were based on actual historical trends, adjusted for known or reasonably foreseeable events.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. As Peoples' Manager, Plant Accounting, the MFR schedules which were prepared by me or under my supervision contain information on Peoples' utility plant for the historic base year of 2007, 2008 and the 2009 projected test year. Those schedules also exclude from rate base the non-utility portion of items of plant which are used for both utility and non-utility purposes, and make corresponding allocations of the depreciation expense and depreciation reserves associated with such common plant items between utility and non-utility. The non-utility portion has been excluded for ratemaking purposes.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BY MR. WATSON:

Q Ms. Hobkirk, could you please summarize your direct testimony?

A Good afternoon, Commissioners. The purpose of my testimony is to support utility plant-in-service, construction work in process, depreciation reserves, and the nonutility portion has been excluded for ratemaking purposes. That concludes my testimony.

CHAIRMAN CARTER: Outstanding.

MR. WATSON: I knew you would be pleased.

CHAIRMAN CARTER: Okay. Mr. McWhirter.

MR. McWHIRTER: I have no questions.

CHAIRMAN CARTER: Mr. Rehwinkel.

MR. REHWINKEL: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. REHWINKEL:

Q Good afternoon, Ms. Hobkirk.

A Good afternoon.

Q I have a series of questions for you, and I am only asking to the best of my ability just about numbers and facts. If you don't have that information, I have no problem with you referring to one of the witnesses that comes behind you. I understand that you are the person responsible for plant additions.

A That is correct.

MR. REHWINKEL: Mr. Chairman, I have passed out ahead of time some exhibits, I think three of them, and the first one that I would like to ask be identified is Peoples' response to Citizens First Set of Interrogatories Number 26, Pages 3 through 11.

CHAIRMAN CARTER: Okay. For the record, this will be identified as Exhibit Number 93, Exhibit Number 93.

MS. KLANCKE: For clarification, Mr. Chairman, it is my understanding that that document is already part of the record as part of staff's exhibit.

CHAIRMAN CARTER: Okay.

MR. REHWINKEL: Thank you.

(Exhibit Number 93 marked for identification.)

BY MR. REHWINKEL

Q Ms. Hobkirk, do you have that document in front of you?

A Yes.

Q Are you familiar with this, which it looks to be an excerpt for certain years of the annual status report analysis of plant-in-service accounts?

A Yes, I am.

Q Is this something that you assist in the preparation of?

A Yes.

Q On the first page, which is Page 3 of 23, this is just an excerpt from your 2003 year end plant-in-service account report, is that correct?

A Yes.

Q Under the additions column, about halfway across the top of the page, do you see that heading, additions?

A Yes.

Q At the bottom of that page under that column, what does that figure -- what is that figure and what does it represent?

A Are you referring to the 72?

Q Yes.

A It is the total 101 additions.

Q Okay. So 72,702,187 is the total plant-in-service additions for 2003?

A Yes, it is.

Q And, this is not the same as the capital budget or the expenditures for that year?

A No, it is not. That is correct, it is not.

Q These are dollars that are closed to your plant-in-service account?

A That is correct.

Q Okay. Can I ask you to turn to Page 5 of 23. And the corresponding number there is $41,006,843, is that correct?

A Yes.

Q Okay. And then on Page 7 of 23, the corresponding plant-in-service additions for 2005, can you give us that amount?

A 34,666,486.

Q Thank you. And for 2006 on Page 9, the corresponding amount?

A 54,662,733.

Q And then finally, for 2007 on Page 11 of 23, what is that amount?

A 37,373,186.

Q What was the amount for 2008?

A Without looking, 45 million something. Hold on.

Q We can take a minute for you to get the exact number.

A 45,148,182.

MR. REHWINKEL: Thank you.

Mr. Chairman, I would like to ask at this time that another exhibit amongst the ones I passed out be identified for cross-examination purposes, and that would be Late-filed Deposition Exhibit Number 1 from Mr. Binswanger's deposition.

CHAIRMAN CARTER: Okay. Commissioners, for the record that will be Number 94.

BY MR. REHWINKEL:

Q Ms. Hobkirk, do you have what has been identified now as Exhibit Number 94?

A Yes, I do.

Q Are you familiar with part of this exhibit?

A I have seen it, yes.

Q Are you familiar with the numbers on here that relate to the actual columns?

A Yes. I mean, I haven't tied those out to what I have in my records, but I'm sure the person that prepared it did.

Q Who was that person?

A Ms. Richards.

Q Okay. Are questions on this exhibit better posed to Mr. Narzissenfeld or Mr. Binswanger?

A Probably so, unless you are referring to the actual column.

Q Well, I do have some questions about the actual column. Why don't we just see where that takes us. I just have a few. If I could ask you on Page 1 of 2 of this exhibit, in the column that says 2008 per OPC POD 72, do you see that?

A Yes.

Q This was the initial projection of your capital expenditures at the time the case was filed, is that right?

A I believe that is correct, but I can't really talk to you about that column.

Q Okay. The actual column on the next -- to the right is --

A Yes.

Q -- what you know about, is that right?

A Yes.

Q Okay. Let me see if you know the answer to this. In the first column, the per OPC POD 72 column, under new projects near the top of the page there is miscellaneous on main and scattered. Do you see that line item?

A Yes.

Q And it has 3,550,000 there, do you see that?

A Yes.

Q Okay.

A In Column 2 I am seeing a dash, is that --

Q Yes, and I was going to ask you about that. Are the dollars that were projected in 2008, are they contained in the actual, the same dollars show up in the actual column?

A You might need to ask for a clarification later, but I am thinking that those are probably just not identified because they are smaller miscellaneous on main projects and these are projects on their own, not miscellaneous on main like saturation of main.

Q Okay. All right. I think I will hold off on those questions for the witnesses that follow you. Do you have with you -- I don't know if it is up there, do you have what was previously identified as Exhibit 90? This is the business plan.

A I do not.

Q I would like to ask you to turn to -- in Exhibit 90 if you could turn to Bates-stamped Page 2985.

A Okay.

Q Would you be familiar with the actual expenditures that are shown here on this page for the year 2003?

A Yes.

Q To the best of your knowledge, do the numbers in the actual column represent what you actually spent on capital expenditures in 2003?

A You would have to give me a few minutes to see if I could get that information to confirm it. Without having --

Q Do you have that with you?

A I don't know. Let me see if I can it. With what you gave me I might be able to figure it out. I would really need the Form 2 in its entirety to have it broken down this way versus how the Form 2 pages that you provided are broken down.

Q Okay. And that would be the same for any other year in this report that I asked you about?

A Yes.

Q Okay.

A Some of the items like, I mean, office equipment, I could probably tie to, but not all the other numbers on the page.

Q I am just asking about the bottom line numbers and the split between maintenance and revenue producing. Actually, all I want to know is if those three numbers, actual revenue producing capital, total maintenance capital, and then total capital expenditures in 2003 are accurate.

A As far as capital expenditures, all the stuff I have is what is closed to plant, not capital expenditures.

MR. REHWINKEL: Okay. Well, then I have no further questions.

CHAIRMAN CARTER: Thank you. Staff.

MS. KLANCKE: Staff has no questions for this witness.

CHAIRMAN CARTER: Commissioners, any questions at this time for this witness?

Redirect.

MR. WATSON: No redirect, but we would move Exhibit 38 into the record.

CHAIRMAN CARTER: Okay. Wait a second here. Any objections?

MR. McWHIRTER: No objections.

CHAIRMAN CARTER: Without objection, show it done, Exhibit 38.

(Exhibit Number 38 admitted into the record.)

CHAIRMAN CARTER: Mr. Rehwinkel, you were using yours for cross examination purposes?

MR. REHWINKEL: Mr. Chairman, I would move at this time 93.

CHAIRMAN CARTER: Are there any objections?

MR. WATSON: No objections.

CHAIRMAN CARTER: Without objection, show it done.

MR. REHWINKEL: Oh, I apologize. Staff counsel had reminded me that is already in the record, so I would withdraw that if that would be appropriate.

CHAIRMAN CARTER: Okay. Then is 94 also in the record?

MR. REHWINKEL: I have not moved that one yet. I will wait on that.

MS. KLANCKE: Yes, sir.

CHAIRMAN CARTER: Okay. Well, why don't we just go back to our placeholders and we will pick up at 92, since what we marked for 93 and 94 are in the record already.

MR. REHWINKEL: That is correct.

MS. KLANCKE: Perhaps we could just move on with 95 and just keep going with the enumeration. We just won't move 93 and 94 into the record.

CHAIRMAN CARTER: We just won't enter them because they are already in the record, is that right?

MS. KLANCKE: Yes, sir.

CHAIRMAN CARTER: Okay, good. Thank you.

MR. WATSON: Mr. Chairman, may Ms. Hobkirk be excused?

CHAIRMAN CARTER: Okay. Is she coming back for rebuttal or anything like that?

MR. WATSON: No, sir.

CHAIRMAN CARTER: You get to leave the playground. Thank you so kindly. You are excused.

You may call your next witness.

MR. WATSON: Mr. Bruce Narzissenfeld.

CHAIRMAN CARTER: Say that again slowly.

MR. WATSON: Narzissenfeld.

CHAIRMAN CARTER: Okay, good. Thank you.

MR. McWHIRTER: While they are doing that --

CHAIRMAN CARTER: Yes, sir, Mr. McWhirter.

MR. McWHIRTER: -- if Exhibit 93 is already in the record, could staff tell us where it is? I see response to staff's --

CHAIRMAN CARTER: Staff, for ease of purpose for Mr. McWhirter, if it is easier for you we could just go ahead on and enter it and you can refer to it like that. Would that be better for you?

MR. McWHIRTER: Would you mind repeating that, sir?

CHAIRMAN CARTER: I said for ease of purpose we could just enter it in for 93 and 94. Would that be easier for you rather than going through the --

MR. McWHIRTER: Yes, sir.

CHAIRMAN CARTER: Why don't we do that. Any objections?

MR. WATSON: Peoples has no objection.

CHAIRMAN CARTER: Okay. So, 93 and 94 are entered.

Mr. Rehwinkel, you are going to come back to 94 later. Do you want to do it at that point in time or do you want to move it now?

MR. REHWINKEL: Actually, it was -- I am going to ask questions of Mr. Narzissenfeld. I can move it at that time.

CHAIRMAN CARTER: Okay. Let's do that on 94. Thank you, Mr. McWhirter. And what we will do is we will just keep 93 and 94 and we will move 94 in at the appropriate time, but 93 is in now.

MR. McWHIRTER: That sure makes it easier for me, Mr. Chairman.

CHAIRMAN CARTER: I want to accommodate you, Mr. McWhirter.

MR. McWHIRTER: Thank you, sir.

CHAIRMAN CARTER: Thank you. Let's kind of take five in place, running in place. Nobody leave. Just hold on for a second.

(Exhibit Number 93 admitted into the record.)

CHAIRMAN CARTER: You may proceed.

BRUCE NARZISSENFELD

was called as a witness on behalf of Peoples Gas Company, and having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. WATSON:

Q Please state your name and address for the record.

A Bruce Narzissenfeld, 702 North Franklin Street, Tampa Florida 33602.

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

A By Peoples Gas as Vice-President of Operations.

Q Mr. Narzissenfeld, did you prepare and cause to be prefiled in this proceeding direct testimony consisting of four pages?

A Yes.

Q Do you have any corrections or changes to that testimony?

A I do not.

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

A Yes, they would.

MR. WATSON: Mr. Chairman, we would ask that Mr. Narzissenfeld's direct testimony be inserted into the record as though read.

CHAIRMAN CARTER: The prefiled direct testimony of the witness will be inserted into the record as though read.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Bruce Narzissenfeld and my business address is 702 North Franklin Street, Tampa, Florida 33602.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Peoples Gas System ("Peoples" or the "Company") as Vice President - Operations, having held that position since July 2006.

Q. PLEASE PROVIDE A BRIEF OUTLINE OF YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I graduated from the University of Florida in 1979 with a Bachelor of Science degree in accounting. Upon graduation, I was employed by Arthur Andersen, where I worked for four years in the auditing group. On leaving Arthur Andersen, I joined Florida Power & Light Company where I worked in Finance from 1984 to 1985. I have been with the TECO Energy family of companies since 1985, and have been employed by Peoples since 1998. I served as Peoples' Assistant Controller until becoming Vice President - Operations. I have been a Certified Public Accountant since 1980, and earned a Masters in Business Administration from the University of Tampa in 1988.

Q. WHAT ARE YOUR CURRENT RESPONSIBILITIES?

A. As Vice President - Operations, I am responsible for all operations, maintenance and construction activities throughout the state and work closely with our sales organization to ensure seamless coordination of customer additions and expansion projects. Additionally, I am responsible for development, communication and implementation of business strategies.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses Peoples' capital expenditures for 2008 and the 2009 projected test year, and how those projections were developed.

Q. HAVE YOU PREPARED OR CAUSED TO BE PREPARED ANY EXHIBITS TO BE INTRODUCED IN THIS PROCEEDING?

A. Yes. I am sponsoring, and prepared or caused to be prepared, the following schedules of the minimum filing requirements ("MFRs") Composite Exhibit __(PGS-1) required by Rule 25-7.039, *Florida Administrative Code*:

-- Schedule G-1, page 23, which consists of the Company's 2008 construction budget;

-- Schedule G-1, page 24, listing monthly plant additions for 2008;

-- Schedule G-1, page 26, consisting of the Company's 2009 construction budget; and

-- Schedule G-1, page 27, showing monthly plant additions for 2009.

Q. PLEASE EXPLAIN HOW PEOPLES DETERMINES ITS ANNUAL CAPITAL EXPENDITURE BUDGET.

A. To determine its annual capital budget Peoples quantifies two categories, normal expenditures and major projects. Normal expenditures are those recurring costs required to provide service to new customers as well as routine costs associated with the replacement and/or relocation of existing facilities and equipment. Major projects generally represent expansions with costs in excess of $500,000. In quantifying its annual capital budget for normal expenditures, Peoples details all existing revenue-producing projects having activity in the current year. This information is used in the establishment of capital expenditures by budget category to be incurred the next fiscal year. Information obtained from this analysis aids in the forecast of new customers and is used to calculate blanket expenditures such as meter sets and service lines. In addition, main expansion within a development, city, or into new areas will be projected. Maintenance capital is forecasted by budget category and consists of known projects and an average amount based on historical experience.

Q. WHAT ARE THE COMPANY'S PROJECTED CAPITAL EXPENDITURES FOR 2008?

A. Capital expenditures for 2008 are projected to be $62 million. Of this amount, $39 million is projected to be spent to construct revenue producing facilities to serve new customers or to accommodate increased use by existing customers. This includes construction of mains and services, together with installation of metering and pressure regulation stations, control equipment, corrosion prevention systems and other appurtenances. Another $15 million of the total capital expenditures forecasted for 2008 is for investment in the replacement or removal of mains and services, improvements to the distribution systems and relocations and replacements to accommodate municipal, state and federal road construction. Capital expenditures of this nature are required annually to assure adequate and efficient service for Peoples' customers and to assure compliance with this Commission's rules. The remaining $8 million is forecasted to be required for improvements to structures, replacement of vehicles, office equipment and communication systems, and other tools and equipment.

Q. PLEASE QUANTIFY THE COMPANY'S PROJECTED CAPITAL EXPENDITURES FOR 2009.

A. Our planned expenditures for 2009 total $60 million of which $42 million is for facilities to serve new customers or accommodate increased use by existing customers. In addition, we plan to spend $13 million for replacement or removal of mains and services, improvement of the distribution systems, and relocations and replacements to accommodate municipal, state and federal road construction. The remaining $5 million is forecasted to be required for improvements to structures, replacement of vehicles, office equipment and communication systems, and other tools and equipment.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BY MR. WATSON:

Q Did you also prepare and cause to be prefiled rebuttal testimony consisting of seven pages?

A Yes, I did.

Q And if I were to ask you the questions in your rebuttal testimony today, would your answers be the same?

A Yes, they would.

MR. WATSON: Mr. Chairman, we would ask that Mr. Narzissenfeld's rebuttal testimony be inserted into the record as though read.

CHAIRMAN CARTER: Consistent with our preliminary matters, the prefiled rebuttal testimony of the witness will be inserted into the record as though read.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Bruce Narzissenfeld and my business address is 702 North Franklin Street, Tampa, Florida 33602.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Peoples Gas System ("Peoples" or the "Company") as Vice President - Operations.

Q. ARE YOU THE SAME BRUCE NARZISSENFELD WHO FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my rebuttal testimony is to address the distribution plant rate base adjustments proposed in the prepared direct testimony of witness Helmuth Schultz, III, hired by the Office of Public Counsel ("OPC"), and testifying on behalf of the Citizens of the State of Florida.

Q. HAVE YOU PREPARED ANY EXHIBITS SUPPORTING YOUR REBUTTAL TESTIMONY?

A. Yes I have. Exhibit No.____(BN-1) was prepared by me or under my direction and supervision.

Q. PLEASE SUMMARIZE YOUR CONCERNS AND DISAGREEMENTS REGARDING THE SUBSTANCE OF WITNESS SCHULTZ'S TESTIMONY.

A. Mr. Schultz recommends a reduction to distribution plant rate base by $15,277,686 for projected 2008 and 2009 capital expenditures. He accuses the Company of significantly overstating capital expenditures. This is not correct. Results for 2008 are now known and disprove Mr.

Schultz's claims since actual capital expenditures *exceeded* projections for 2008. Peoples has a very good history of estimating capital expenditures compared to its budget. The Company's five-year average of actual capital expenditures compared to budget is within 3 percent. This demonstrates the Company's ability to reliably project capital expenditures and challenges the credibility of Mr. Schultz's proposed reductions which are 19 percent and 15 percent of 2008 and 2009 projected capital expenditures, respectively. Finally, Mr. Schultz's proposed adjustments are computed using incorrect data.

Mr. Schultz reduced depreciation expense and accumulated depreciation to reflect his proposed distribution plant revisions. Because the distribution plant adjustments are not appropriate, the adjustments to depreciation expense and accumulated depreciation are not necessary.

Q. PLEASE SUMMARIZE MR. SCHULTZ'S PROPOSED ADJUSTMENTS FOR CAPITAL EXPENDITURES.

A. As shown on Exhibit No.____(BN-1), Mr. Shultz proposes to reduce capital expenditures for steel main, plastic main and plastic services by $11,612,550 for 2008 and by $8,912,444 for 2009. Together these items reduce the 2009 13-month average distribution plant rate base by $15,277,686.

Q. PLEASE EXPLAIN IN MORE DETAIL YOUR CONCERNS WITH MR. SCHULTZ'S PROPOSED 2008 ADJUSTMENT.

A. Mr. Schultz recommends an $11,612,550 adjustment for 2008 or 19 percent of the Company's total 2008 capital expenditure projection, implying that Peoples grossly over-estimated capital expenditures. Mr.

Schultz makes three fundamental errors in his analysis. First, he selected only three categories of capital spending when considering the adjustment. He ignores other categories of spending and the Company's history of managing its overall capital budget. Because the Company's budgets are prepared during the summer before the calendar fiscal year begins, it is not uncommon for capital projects and priorities to change. The Company constantly re-prioritizes and adjusts among spending categories of the total capital budget. Therefore, variances in specific categories are typically offsetting. In addition, there may be variances between years simply due to timing issues. Exhibit No.____(BN-1) compares total budget to actual capital expenditures for each of the past five years, and shows that over this time frame the Company was within 3 percent of budget. This is a far cry from the magnitude of the adjustment proposed by Mr. Schultz.

Additionally, in recommending his adjustment, Mr. Schultz re-estimates 2008 capital expenditures based on certain erroneous data provided by the Company. However, as it relates to 2008, this is a moot issue since 2008 actual costs are now known, and exceed the Company's projections for the year.

Q. PLEASE DESCRIBE HOW ERRONEOUS DATA WAS PROVIDED.

A. The Company, in an effort to be fully responsive to OPC's Interrogatory No. 70, *estimated* projected footages for several sizes of pipe by dividing projected spending by what it believed to be its 2007 actual costs per foot. Peoples estimated footages because its budget system does not capture this type of data. Projected budgets are prepared by operating personnel at a project level and only the financial projections are captured in the budget system. Therefore, the information necessary to apply Mr. Schultz's adjustment methodology is not available and, unfortunately, he used the inaccurate estimated footage amounts to recommend his adjustments to capital expenditures.

Q. HAS PEOPLES PROVIDED A CORRECTED ANSWER TO OPC'S INTERROGATORY NO. 70?

A. Yes. Peoples has provided a corrected answer to Interrogatory No. 70. In addition, the Company has provided corrected answers to OPC's Interrogatories Nos. 72 and 73.

Q. DESPITE PROVIDING ERRONEOUS INFORMATION IN RESPONSE TO OPC'S INTERROGATORIES NOS. 70, 72 AND 73, DID THE COMPANY PROVIDE OTHER DATA TO OPC AND MR. SCHULTZ WITH RESPECT TO 2008 CAPITAL SPENDING?

A. Yes. There were other data points from which Mr. Schultz could have validated his calculated adjustment for 2008, but failed to do so. For example, Peoples' answer to OPC's Interrogatory No. 1 (served almost three months before Mr. Schultz's testimony was filed) reflected that Peoples had spent almost $41.6 million of its budgeted $62 million as of July 31, 2008. Peoples' answer to Staff Interrogatory No. 53, served November 12, 2008 – slightly more than a month before Mr. Schultz's testimony was filed – indicated that as of the date of the answer, Peoples' 2008 capital expenditures were expected to be $68 million, about $6 million more than projected in the MFRs filed with the Company's petition. That interrogatory answer also stated that there had been no changes to the projected 2009 capital expenditures shown on MFR Schedule G-1, page 26.

Q. PLEASE EXPLAIN YOUR CONCERNS WITH MR. SCHULTZ'S PROPOSED ADJUSTMENT FOR 2009.

A. In addition to making the same erroneous adjustment for 2009 based on inaccurate estimated footage data, Mr. Schultz, as he did for 2008, considers only three categories of spending in his analysis. He recommends an $8,912,444 reduction to capital expenditures for 2009, or 15 percent of the Company's total 2009 projection. Nothing has occurred which would cause the Company to believe that its 2009 projections should be changed, and history strongly suggests that actual capital expenditures for the projected test year will be very close to what was projected in the Company's filing in this case.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING MR. SCHULTZ'S TESTIMONY?

A. Yes. Mr. Schultz claims that the Company's capital expenditure growth assumptions are inconsistent with the Company's assumptions about customer growth and use per customer. There is no direct relationship between use per customer and capital expenditures. For example, the cost to establish service to a new customer is not impacted by whether customers, both in total or individually, are conserving and using less gas. In addition, use per customer can be decreasing while overall system usage is increasing due to an increase in the total number of customers or changes in customer mix.

While it is true that economic conditions have reduced the near-term customer growth estimate, the Company's planning cycle employs a longer time horizon. Consistent with Commission requirements, the Company evaluates expansion capital based on a four-year payback period, and this criterion is reflected in the Company's 2009 budget. Short-term economic conditions should not automatically reduce the Company's expansion plans and delay bringing gas to areas not currently served. The Company's expansion plans support Florida's initiative to improve fuel diversity and reduce the state's carbon footprint consistent with Governor Crist's Executive Order No. 07-126.

Q. DO YOU AGREE WITH MR. SCHULTZ'S ADJUSTMENTS TO DEPRECIATION EXPENSE AND ACCUMULATED DEPRECIATION?

A. No. Because his adjustments to capital expenditures for 2008 and 2009 are improper, so are his recommended adjustments to depreciation expense and accumulated depreciation for those years.

Summary of Rebuttal Testimony

Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

A. Mr. Schultz has proposed reductions in capital expenditures of $11,612,550 and $8,912,444 for 2008 and 2009, respectively, based on his estimated costs in three selected spending categories. Final 2008 total capital expenditures are now known and not only validate, but exceed, the level of capital spending included in the Company's filing. Mr. Schultz's adjustments are computed using incorrect data, despite the fact that other data provided by Peoples strongly suggested his adjustments were incorrect and ignored the Company's proven track record of reliably estimating total capital expenditures. Since the adjustments to capital expenditures are not appropriate, the adjustments proposed by Mr. Schultz to depreciation expense and accumulated depreciation are unnecessary and inappropriate.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

BY MR. WATSON:

Q With your direct testimony, did you also file an exhibit premarked as Exhibit BN-1 Revised, which has been identified as Hearing Exhibit 83?

A Yes, I did.

MR. WATSON: We would ask that Mr. Narzissenfeld's Revised Exhibit BN-1 be formally identified for the record as Hearing Exhibit 83.

CHAIRMAN CARTER: For the record, Exhibit 83 is identified for the record.

(Exhibit 83 marked for identification.)

BY MR. WATSON:

Q Do you have any changes to that exhibit, Mr. Narzissenfeld?

A No, I do not.

Q Please summarize your direct and rebuttal testimonies.

A Good afternoon, Commissioners. The purpose of my direct testimony is to support the company's actual capital expenditures for 2008 and projected capital expenditures for 2009. Peoples Gas' 2008 capital expenditures of 62 million were originally projected to consist of 39 million for investments to reach new customers and to accommodate increased load, and 15 million for improvements to the system, mandatory relocations, and replacements to accommodate municipal, state, and federal road construction, and the replacement and removal of mains and services. For 2009, Peoples Gas capital is expected to be 60 million, consisting of 42 million for new revenue producing projects, and 13 million for replacement and removal of mains and services, improvements to the system, and mandatory relocations and replacements to accommodate municipal, state, and federal road construction. The projections for both 2008 and 2009 also included amounts for improvements to structures and replacement of vehicles, equipment, and tools.

In my rebuttal testimony, I address concerns and inaccurate conclusions reached by the Office of Public Counsel's Witness Schultz who recommends a reduction to rate base due to lower capital spending. Based on actual 2008 capital expenditures, any adjustment to rate base should be an increase, not a reduction to reflect almost 7 million more spent on capital projects in 2008. Accordingly, any adjustments to depreciation expense and accumulated depreciation should also be reflective of more, not less rate base. That concludes my summary.

MR. WATSON: Mr. Narzissenfeld is tendered for cross examination.

CHAIRMAN CARTER: Thank you. Mr. McWhirter.

CROSS EXAMINATION

BY MR. McWHIRTER:

Q Mr. N --

A That works just fine.

Q -- you indicated that capital expenditures for 2008 and 2009 would be in the range of $122 million?

A Yes, sir.

Q Of that amount, as of the date of this hearing, what amount of that is presently in used and useful service?

A Could you rephrase the question? I want to make sure I get it just right.

Q Do you want me to rephrase it?

A Just repeat it, I'm sorry.

Q I have that same trouble. It's a pain, isn't it? On Page 3, Line 10, you say there will be $162 million in capital expenditures in 2008, and then on Page 4, Line 3, you indicate that there will be another 60 million in 2009. And that, if my math is correct, is $122 million. And my question was how much of that is presently in the ground and in use and useful service to the utility?

A Okay, thank you. I understand. The entirety of 2008 is considered used and useful, and while we have not closed the books and records for 2009, I would approximate $10 million of 2009.

Q And if I understand your testimony correctly, the remaining $51 million for 2009 would go into the rate base if you understand this concept, and you would be entitled to earnings on that $51 million as soon as these rates go into effect?

A Yes, sir.

Q I see. And that is even before it goes in the ground?

A I could go line-by-line, but on most of this one we are expending the dollars -- it is in an effort to put the pipe in the ground, so I guess it would be concurrent with putting it into the ground.

Q Well, you said 9 million is in the ground now.

A Correct.

Q And I presume it is connected to customers. There is another 51 million, when does that go in the ground, so much each month until the end of the year?

A Yes, sir, over the course of the remaining ten months.

Q And of this amount of money, what percentage of the $122 million in expenditures are expenditures of the type that would be included in your new proposed riders? Do you know what I am talking about in the proposed riders?

A Yes, I am familiar with the riders, but as far as what percent, I would defer to Witness Binswanger.

Q Are some of the things that are mentioned in your testimony the same kinds of things that would be included in those riders? You mentioned relocating pipes to respond to municipalities. Those would be henceforth --

A Yes. The same type of items, correct, yes.

Q So there would never be any need to come back for a rate proceeding with respect to anything that a municipal government required you to replace, is that correct?

A Yes. I would defer to Witness Binswanger as far as all the subtleties of that, but they would be common type of expenditures, correct.

Q Now, the riders also provide that you can -- and I guess this is what you all call maintenance -- as pipes wear out, you can replace those pipes. Is that your understanding of one of the riders?

A That is my understanding, but I would tell you Witness Binswanger is the expert on the riders. But that is my understanding, yes.

Q Okay. So, you also collect a depreciation expense, as I understand it, on your rate base that is in the ground. Are you familiar with that?

A Yes, on rate base we do collect the depreciation, yes.

Q And that depreciation is an expense that is included in the charge that goes to customers in your base rate proceeding, is that correct to your knowledge?

A Correct.

Q So, what steps to your knowledge, and this may be somebody else's question, what steps have you taken for those pipes that wear out to ensure customers that they don't pay for those pipes through the depreciation charge they are being charged in addition to paying for the same pipes in the new cost-recovery clause?

MR. WATSON: Mr. Chairman, I have held back here for awhile. Mr. McWhirter has not taken a position, his clients take no position on the areas in this proceeding in which Mr. Narzissenfeld has been offered as a witness. Further, Mr. Narzissenfeld has deferred each question on the riders to Mr. Binswanger, who was offered as a witness to cover the riders, and I am going to object to his asking questions about the rider of Mr. Narzissenfeld.

CHAIRMAN CARTER: Mr. McWhirter.

MR. McWHIRTER: Well, this gentleman is responsible for capital expenditures, and I acknowledge I don't take any position on what he says that capital expenditures have been and will be. I don't take any position on that. I was just asking if he knew the kinds of pipes that are included in the type of testimony he is giving, and I think that is fair inquiry for this witness who sponsors that purpose irrespective of the fact that I haven't opposed what he said that they are going to spend. That is anybody's budget. They can talk about their budget, and I'm not opposing the budget.

CHAIRMAN CARTER: Ms. Helton.

MS. HELTON: Mr. Chairman, it is my understanding that this witness is testifying only to Issue 5, which is -- if you will hold on one minute --

CHAIRMAN CARTER: Okay.

MS. HELTON: -- an accounting issue, not an engineering or plant issue. So it seems to me that Mr. McWhirter's cross examination may be outside the scope of the witness' testimony.

MR. McWHIRTER: I would yield to that expert opinion, Mr. Chairman, and ask no further questions of this witness.

CHAIRMAN CARTER: Thank you, Mr. McWhirter.

Mr. Rehwinkel.

MR. REHWINKEL: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. REHWINKEL:

Q Mr. Narzissenfeld, can I ask you just quickly -- in your summary, you said that $42 million is expected to be expended in 2009 for revenue producing assets, is that correct?

A That is what I said in my summary, correct, yes.

Q Is that still the case?

A For 2009, yes, that is still the case.

Q Okay. Do you have what has been identified as Hearing Exhibit Number 94 with you, which is Mr. Binswanger's Late-filed Deposition Exhibit Number 1 in front of you?

A Yes.

Q You are familiar with this document, are you not?
A Yes.
Q Just on that last point, on Page 1 of this exhibit, in the projected 2009 column all the way on the far right, at the very bottom there it shows in the total revenue producing line, $39,191,632. Do you see that?
A Yes.
Q What does that represent relative to the $42 million number you just mentioned?
A The 42 million I mentioned is -- and I may have not correctly responded to your question. It was in my summary that I stated that number, and that number of 42 million referred to 2009 revenue producing as filed in the MFRs. The 39 million refers to the updated projections for 2009 subsequent to the filing.
Q Okay. And those projections are something you are familiar with?
A Yes.
Q Okay. In your job -- actually, tell me what your job position entails at a high level with Peoples Gas?
A Vice-President of Operations. I have been in the role two and a half years, responsible for oversight of the company's operation, maintenance, expansion plans, development of strategies, implementation, personnel, safety.
Q And the budget process is a major aspect of that?

A You know, interestingly it is a proprietary of mine, but the budget group does not report to me, nor are the personnel and budget in my area, but it is something that is important to me.

Q You have input certainly to the budget?

A Yes.

Q Can you tell me the timing of the capital budget development process usually culminates in the late fall of the year, is that correct?

A That is correct.

Q Okay. And the budget that is submitted in this case that underlies the MFRs was conducted in the March to May 2008 time frame? For 2009, I mean.

A I'm sorry, say it one more time.

Q Yes, let me ask that again. The budget that underlies the projected test year MFRs for the capital accounts for the rate base was prepared in March to May 2008 time frame, correct?

A Correct.

Q Okay. In your summary and in your testimony -- well, actually in your testimony on Page 3, on your direct testimony, for 2008 you identify a revenue producing to total capital budget dollars split of 39 million to 62 million, is that correct?

A Yes.

Q And that is about, subject to check, 63 percent of the budget is in the revenue producing area?

A Yes.

Q For 2009, as we just discussed, it was 42 million out of 60 million, or 70 percent, correct?

A Yes.

Q Subsequently, the company has revised its filing to reflect that you overspent your 2008 budget by about $6.5 million, right?

A Correct.

Q At the same time, you have not made any change to the total amount of your 2009 capital budget, right?

A That is correct.

Q Okay. You did adjust the split between revenue producing and maintenance for both years, is that correct?

A That is correct.

Q So for 2008, you spent 44 million out of 68.5 million on revenue producing capital assets, correct?

A Correct.

Q And for 2009 you are now projecting to spend 39 million out of 60 million on revenue producing assets, correct?

A That is correct.

Q You filed your direct on or about August 11th of 2008?

A Correct.

Q And on January 30th, 2009, you filed your rebuttal?

A That is correct.

Q Now, is it your testimony that nothing has happened between the two filings to materially impact your 2009 total budget, is that right?

A I would say more precisely many things have happened, but I am committed to staying within the $60 million.

Q Would it be fair to say that you are committed to spending at least $60 million?

A Yes. I think that is fair to say, yes.

Q Is it fair to say that the changes in economic conditions that caused you to -- let me step back and ask you this. Can you identify for me any conditions that caused you to increase your revenue producing capital spending by $5 million, or over 13 percent over what you projected in the spring?

A I'm sorry for what year, please?

Q For 2008.

A I believe I can, but please restate the question so I can get it just right.

Q Okay. What economic conditions, if any, caused you to increase your revenue producing capital spending by over $5 million, or 13 percent over what you had originally projected in the spring of 2008 to spend for the year 2008?

A There is a lot of activity that goes into the actuals, but to be responsive to your question, I would point to two items of significance that contributed significantly if not entirely to that overage you referred to. The first one would be $4 million more than was contained in the original MFRs were expended on Bayside, and 2 million more than were contained in the original MFRs have shown up on the JEA project, and that 6 million would be essentially the flux. Admittedly, there is a lot of puts and takes for other things, but those are two significant variances.

Q So, Bayside is the -- JEA are reflected in the ongoing section up at the very top of Hearing Exhibit 94?

A More specifically, Bayside and JEA are included in the ongoing for their mains and also in the others for some of the other work that was done, work other than mains. So in both areas. So, yes, it is included in ongoing, but additionally in the other section, as well.

Q When you say the other section, you mean at the bottom of Page 1 of 94?

A Yes, sir.

Q For 2009, you reduced your projected revenue producing spending by $3 million, or 8 percent, but you did not change the overall capital budget by a single dollar, did you?

A That is correct.

Q So, the only thing that really happened was that the only change to your revenue -- let me step back and start that question again. From a capital budgeting standpoint, the net effect change to your revenue producing category of your capital budget over the last six months during the worst economic times that we have had in many years was a net increase of about $2 million for the two periods together, is that right?

A I mean, subject to check on the math, I would agree that that statement -- the arithmetic is correct, yes.

Q You were not with Peoples in 2003?

A I was with Peoples in 2003, yes, I was.

Q Okay. Are you familiar in 2003 with the rate case that Peoples conducted?

A Yes.

Q And that had a projected test year of 2003?

A Yes.

Q In that case, would you agree, subject to check, that plant-in-service was reduced by $15.3 million due to delayed, canceled, or underbudgeted projects?

A Sure, subject to check, yes, I would agree with that.

Q Was the reason for delayed, canceled, or under budget projects in 2003 because those projects became questionable with respect to the timing of their occurrence?

A I don't know.

Q You don't know?

A I don't know.

Q In your rebuttal testimony, on Pages 5 through 6, could you turn?

A Sure. I am on Page 5.

Q Okay. Is it fair to say that beginning on Line 16 of Page 5 through Line 9 of Page 6, that you are saying that current economic conditions are not impacting your overall capital expenditure budget?

A I would think it is fair to say that overall economic conditions are not impacting the overall capital budget that we have for 2009, yes.

Q On Page 6, Line 5, you state there short-term economic conditions should not automatically reduce the company's expansion plans and delay bringing gas to areas not currently served. Do you see that?

A Yes, I do.

Q Okay. Are you contending that the economic conditions that we find ourselves in now are short-term?

A I hope so. I am not an economist, I don't know. I certainly hope so.

Q If they are not short-term, should they affect your capital budget for 2009?

A If they are not short-term, they would have an impact in the specifics of the capital budget.

Q Okay. Even if they are short-term, you are saying here that they should not automatically reduce the expansion plans, is that right?

A That is what I said, yes.

Q But that implies that even in short-term economic conditions, adverse I would assume, that you could have reason to reduce your expansion plans, is that fair?

A It is fair to say, yes.

Q Okay. But, again, nothing in the current economic conditions, whether short-term or longer lasting, have caused you to adjust downward your 2009 budget, is that right?

A That is correct.

Q As Vice-President of Operations, are you charged with being aware of the real estate development impact on your needs to deploy capital?

A No, I'm not charged with that, but I think it is fair to say I have an awareness.

Q Let's take a look at Exhibit 94, if you could.

A Help me out. I still have the old numbers. I apologize, 94 is --

Q I'm sorry, it is the one -- it is Mr. Binswanger's Number 1.

A Thank you. I apologize.

Q No problem. You have discussed a little bit the Bayside and JEA projects impact on 2008. And you say that that impact is found in the ongoing section at the top and in the other section at the bottom, and I assume that refers to the Gulfstream gate station is one of the --

A If I may, could I help out more specifically?

Q Yes, sure.

A It is included in the ongoing on the line items JEA and Bayside. Under the subheading others, it would be included in the line item meter installations, and, yes, a little further down on the page, the Gulfstream gate station.

Q Under the new projects area, I need to take you through some of these items here.

A Sure.

Q In some cases, some of the projects that you show in 2008, the first column, the per OPC POD 72, some of the projects that these were to serve were deferred or delayed, is that correct?

A In some cases they were delayed, that is correct.

Q In some cases -- well, let me stick with 2008. In some cases, they were projects that were canceled?

A None of the named projects on this list have been canceled. There may have been a project less than 250,000 that was canceled, but these named projects, no, none have been canceled.

Q Well, if I look down just for example, near the bottom of that section, U.S. 41 and I-275, $289,630.

A Yes.

Q Those dollars don't show in 2008 or 2009, do they?

A They do not know show. That project specifically is where we were going to potentially bring service to eight commercial customers, and that project is on hold until the market turns around, but it has not been canceled.

Q Okay. How many other projects that are listed in 2008 are on hold because of the market? Actually, if you could identify them for me, I would appreciate it.

A It may take a moment, but --

Q Okay.

A Under new projects, and I believe they are substantially -- I believe they are all alphabetical. Half way down, Island Way, which is in Jupiter; the project entitled North Manatee County, I-75 between 275 and county line; the project Saw Mill Creek; the project Stuart east; the project East Manatee; and lastly, the project Waterset.

(Transcript continues in sequence with Volume 3.)

STATE OF FLORIDA)

: CERTIFICATE OF REPORTER

COUNTY OF LEON)

I, JANE FAUROT, RPR, Chief, Hearing Reporter Services Section, FPSC Division of Commission Clerk, do hereby certify that the foregoing proceeding was heard at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorney or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 5th day of March, 2009.

Jane Faurot

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Official FPSC Hearings Reporter
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