

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 080366-GU

**SURREBUTTAL TESTIMONY
OF
ROBERT J. CAMFIELD**

**ON BEHALF OF
FLORIDA PUBLIC UTILITIES COMPANY**

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Robert J. Camfield, and my business address is 4610 University
3 Avenue, Madison, Wisconsin 53705.

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5 **Q. HAVE YOU PREPARED AND PRE-FILED DIRECT TESTIMONY IN
6 THIS DOCKET?**

7 A. Yes. On behalf of Florida Public Utilities Company (FPU or Company), I have
8 provided pre-filed direct testimony in Docket 080366-GU on two topics
9 including 1) cost of capital for setting the return on equity and the overall rate of
10 return, and 2) expected inflation for determining cost escalation.

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12 **Q. WHAT IS THE SCOPE OF YOUR REBUTTAL TESTIMONY?**

13 A. This rebuttal testimony is offered to the Commission in response to the pre-filed
14 direct testimony of Ms. Patricia Merchant on behalf of the Office of Public
15 Counsel (OPC). My rebuttal testimony focuses on recommendations advanced
16 by Ms. Merchant regarding expected inflation. Expected inflation, often
17 referred to as the inflation factor is used to determine projections of natural gas

1 operating expenses of FPU, a key component of the total costs incurred by the
2 Company to provide retail gas service.

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4 **Q. HOW DOES MS. MERCHANT CHARACTERIZE EXPECTED**
5 **INFLATION AND HOW IT SHOULD BE ACCOUNTED FOR WITHIN**
6 **A REGULATORY FRAMEWORK?**

7 A. OPC witness Merchant states that my recommendations to the Commission
8 regarding inflation during 2008 and 2009 overstate the true underlying rate of
9 inflation for these two years. On page 16 of the testimony, Ms. Merchant states:

10 “Utility witness Camfield (page 85) states that the
11 (C)ompany’s inflation factor was developed using three
12 methods to develop five estimates of inflation covering the
13 general economy for 2008 and 2009. Those factors and
14 estimates are shown below:”

15 The table shown by Ms. Merchant correctly reproduces the table shown in my
16 original pre-filed testimony.

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18 On page 18, the testimony by Ms. Merchant goes on to state:

19 “For 2008, FPUC’s inflation factor (4.12%) is much higher
20 than the actual and the factor estimated by PGS (2.9%). The
21 2008 actual inflation factor issued by the U.S. Department of
22 Labor was 3.8%. I believe that it is appropriate to use the

1 actual factor for 2008 since that number is known and
2 measurable.”

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4 The rebuttal testimony of Ms. Merchant then continues with a discussion of
5 price inflation during 2009 and beyond, as follows:

6 “For 2009, FPUC’s inflation factor (2.74%) is also higher than
7 the actual and the factor estimated by PGS (2.1%). However,
8 both of these factors are much higher than the 2009 fourth
9 quarter average to average factor of 0.8% from the CBO report
10 (report of the “Congressional Budget Office”). If you compare
11 the year to date annual average from August 2008 to August
12 2009, the historical inflation rate is 0.19%....I believe that it is
13 appropriate to use the current projection of the CPI_U
14 (“Consumer Price Index – Urban”) of 0.8% as issued by the
15 CBO....I would note the average of the projections for 2009-
16 2011 is 1.16%. This reflects that the current 2009 projection of
17 the CPI-U is in line with the near term future out to 3 years.
18 Using the actual CPI-U rate for 2008 and the revised average
19 projection for 2009-2011 of 0.8%, the combined impact of
20 inflation for 2007 to 2009 should be 4.63% instead of the
21 company requested 6.97%.”

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1 **Q. WHAT RESPONSE DO YOU HAVE TO THE REBUTTAL**
2 **TESTIMONY ADVANCED BY MS. MERCHANT, OFFICE OF PUBLIC**
3 **COUNSEL?**

4 A. I appreciate the concerns raised by Ms. Merchant and Office of Public Counsel.
5 Expected inflation for 2009 and beyond has no doubt declined from the
6 comparatively high level for 2008, which was to a substantial extent driven by
7 the unusually high prices for primary fuels, which ramified throughout the
8 macro-economy. In view of the declines in price escalation since '08, it is
9 arguably appropriate to again address the issue of future inflation. My response
10 to Ms. Merchant's approach and recommendations will assume three general
11 themes, as follows:

- 12 1. Singularity: The appropriateness of relying exclusively on a single
13 projection of inflation in lieu of drawing on a consensus view of
14 expected inflation.
- 15 2. Approach to estimating expected inflation: Whether or not it is
16 appropriate to utilize multiple approaches such as the projections of
17 structural models and forecast services, surveys, and yield spreads, or
18 alternatively to rely exclusively on a single methodology as the basis to
19 infer expected inflation.
- 20 3. Time-frame: The issue of time-frame includes 1) the time-frame used to
21 measure inflation for application of inflation factors within the
22 immediate proceeding, and 2) the implicit rates of inflation assumed by
23 economic agents in buy-sell resource commitments.

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Q. BEFORE PROCEEDING TO REVIEW THE ABOVE POINTS AT ISSUE, WOULD YOU LIKE TO COMMENT ON YOUR FORECAST OF INFLATION FOR 2008?

A. Yes. As cited above, Ms. Merchant describes the Company’s forecast of inflation for 2008 as “much higher” than actual inflation. I disagree with this characterization; rather, I suggest that the Company’s forecast of 4.12% for 2008 compares quite favorably with actual inflation of 3.80%, as measured by the CPI-U. However, Ms. Merchant is correct to describe my forecast as being substantially above the projected 2008 inflation factor of 2.90% as advanced by PGS. PGS substantially understated inflation 2008, as did the Congressional Budget Office and forecast services.

Q. PLEASE PROCEED BY DISCUSSING THE ISSUE OF SINGULARITY. WHAT COMMENTS DO YOU HAVE?

A. Aside from drawing on one method, forecasts developed with structural models, my general concern is that Ms. Merchant draws exclusively on the projections of inflation advanced by the Congressional Budget Office, rather than relying on the consensus view of forecasters about expected future. While the CBO is certainly credible, the Florida Public Service Commission (Commission) should draw upon and utilize a consensus view, as far as general inflation is concerned. The consensus view of forecasters can be obtained through two general forecast services, including *Blue Chip Economic Indicators* and the *Survey of*

1 *Professional Forecasters* (SPF, or Survey). The so-called *Blue Chip* outlook is
2 a subscription service, whereas the SPF is compiled by the Philadelphia Federal
3 Reserve Bank. Over the years, I have drawn upon both Blue Chip and the
4 Survey, and it's not surprising that the differences are typically modest, though
5 Blue Chip and the Survey can present divergent views from time to time.
6 Generally speaking, the Blue Chip outlook is more highly disaggregated, and
7 covers a number of descriptive metrics for economic performance. In any case,
8 the Commission can reliably draw upon either of these perspectives to obtain
9 the consensus view of the current economic outlook. In essence, the consensus
10 view reflects a broad sample of professional opinion, tosses out the high and
11 low extremes and takes the median of the res. Inflation forecast error is to some
12 extent a random process, implying that a point estimate based on a sample
13 rather than just one source is presumably less error-prone on average. The
14 larger sample includes forecasts made using a variety of different conceptual
15 and model approaches which inherently tends to reduce forecast errors to the
16 extent that no single approach is always the preferred one. To the degree that
17 the Commission takes account of and utilizes macro economic forecast services
18 in its deliberations, I highly recommend that the Commission not exclusively
19 utilize any one forecast service. Rather, the Commission should, as a general
20 rule, draw upon the consensus view.

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22 **Q. WHAT IS THE CONSENSUS VIEW OF FORECASTERS REGARDING**
23 **INFLATION DURING 2009 AND THE NEAR-TERM HEARS?**

1 A. The third quarter 2009 survey of forecasters—*i.e.*, third quarter SPF—indicates
2 that the expected rate of average inflation of 1.57% for the CPI-U for 2009 –
3 2011, including projections of 0.70% for 2009, 1.80% for 2010, and 2.20% for
4 2011. In other words, we can expect to experience a steady acceleration in the
5 rise of prices over the ensuing three years, where the end result is that price
6 escalation will approach the long-term trend level of approximately 2.25 –
7 2.75%. Such projections of inflation are in keeping with the consensus view
8 that, beginning during the third quarter of 2009, real economic activity is
9 expected to advance and to more closely approximate the potential level of
10 output as the U.S. economy moves forward through 2010 – 2011. Two things
11 are revealed by this. First, inflation during 2009 represents a significant
12 departure from normal levels of long-term inflation, which, as I mention above,
13 will likely average within the 2.00 – 3.00% range. Second, that inflation during
14 2010-2011 is expected to return to normal levels, and be quite unlike (and
15 higher than) the experience for 2009. This consensus outlook is in sharp
16 contrast to the perspective presented in the forecast report of the CBO and the
17 view advanced by Ms. Merchant. Inflation during 2009 is unquestionably an
18 anomaly, and resides well outside anchored inflationary expectations reaching
19 back for over a decade.

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21 **Q. WHAT IS THE ACCURACY OF CBO FORECASTS OF INFLATION**
22 **OVER NEAR TERM YEARS?**

1 A. The Congressional Budget Office has consistently understated expected
 2 inflation for each of two forward years, beginning in 2001. Aside from the
 3 problem of singularity, the Commission and the Company cannot rely on
 4 projections of inflation by CBO, precisely for this reason.

Year	Actual	1-year-ahead CBO Forecasts			2-year-ahead CBO Forecasts		
		Prediction (% change from prev. year)	Date of Forecast	Error (Predicted minus Actual)	Prediction (% change from prev. year)	Date of Forecast	Error (Predicted minus Actual)
2003	2.3%	2.3%	Jan. 2003	0.0%	2.5%	Jan. 2002	0.2%
2004	2.7%	1.6%	Jan. 2004	-1.1%	2.2%	Jan. 2003	-0.5%
2005	3.4%	2.4%	Jan. 2005	-1.0%	1.7%	Jan. 2004	-1.7%
2006	3.2%	2.8%	Jan. 2006	-0.4%	1.9%	Jan. 2005	-1.3%
2007	2.9%	1.9%	Jan. 2007	-1.0%	2.2%	Jan. 2006	-0.7%
2008	3.8%	2.9%	Jan. 2008	-0.9%	2.3%	Jan. 2007	-1.5%
Average:	2.8%	2.3%			2.1%		
Mean Error:				-0.5%			-0.3%
Std. Dev:				0.7%			1.6%

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 6 As shown above, the CBO has understated inflation for the first and second
 7 forward years by -0.5% and -0.3%, respectively, beginning in 2003, which
 8 would be the first year that demonstrated substantial economic growth
 9 following the recession of 2001. This experience is in contrast to that of the
 10 latter 1990s, where the CBO appears to have overstated inflation for successive
 11 years. In any case, the CBO forecasts cannot be exclusively utilized as a basis
 12 for accurate forecasts of inflation over near-term years because of serial bias, at
 13 least for recent years. Insofar as CBO is significantly below the current
 14 consensus view of inflation for 2010 – 2011, the Commission has reason to be

1 cautious about the inflation outlook and perspective advanced by CBO and Ms.
2 Merchant.

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4 **Q. PLEASE CONTINUE WITH THE DISCUSSION OF SINGULARITY OF**
5 **METHODOLOGY.**

6 A. The relevant question is whether or not macro economic structural models,
7 which focus on the CPI-U and GDP implicit price deflator as the measure of
8 inflation, adequately capture the expected rate of price inflation harbored by
9 economic agents. For this reason, I have drawn upon other approaches,
10 including consumer surveys and the inflation expectation implied by the yield
11 spread between nominal and inflation-protected U.S. Treasury debt.

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13 I recommend that the Commission, in its deliberation on the issue of inflation,
14 utilize this broader perspective which would include a consensus view of macro
15 economic forecasts (which can be construed as a survey), consumer surveys of
16 expected inflation, and yield spreads. Over extended history, the SPF survey of
17 forecasters as well as surveys of consumer, such as the University of
18 Michigan's periodic surveys of consumers, generally provide the better
19 methodology. For a general assessment, please reference the technical
20 discussion by Andrew Ang, Geert Bekaert, and Min Wei, "Do Maco Variables,
21 Asset Markets, or Surveys Forecast Inflation Better", as published by the
22 Federal Reserve Board, February 13, 2006. The authors reach the conclusion
23 that structural models and time series methods will generally underperform

1 surveys of forecasters and consumers, as a basis for determining future levels of
2 inflation.

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4 **Q. YOU HAVE MENTIONED TIME-FRAME. CAN YOU PLEASE**
5 **ELABORATE?**

6 A. Yes. “Time-frame” refers to the forward period over which economic agents
7 commit resources. The commitment of resources by agents, including
8 individuals and firms, is the result of market processes—the buy-sell decisions
9 of counterparties that purchase and sell products and services. The prices
10 underlying resource commitments reflect agents’ expectations of inflation.

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12 Time-frame is important because, in any single period such as 2009, the
13 Company is engaging in commitments with sellers, including vendor services,
14 materials suppliers and, importantly, the explicit and implied contracts with its
15 labor force including both skilled and professional employees. The resulting
16 prices for the resources purchased reflect expected inflation over the relevant
17 forward period. The forward period, however, is unlikely to reflect the
18 immediate time-frame only. Rather, the prices/charges for resources paid by
19 FPU during 2009 account for a longer forward period. As a result, it is
20 appropriate to recognize expected inflation over a somewhat longer time-frame
21 perhaps reaching into 2010 – 2011.

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1 Along this line, there is evidence that inflation expectations are fairly well
2 anchored, so that sharp but brief departures from long-term inflation such as the
3 experience so far for 2009, carries very little weight in the determination of
4 future inflation and the commitment of resources. For a useful discussion,
5 please reference the technical discussion by Chairman Ben Bernanke, “Inflation
6 and Inflation Forecasts”, delivered before the *Monetary Economics Workshop of*
7 *the National Bureau of Economic Research Summer Institute*, July 10, 2007.

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9 In brief, the Commission should not use in isolation some notion of inflation for
10 a specific but narrowly defined period such as 2009, as suggested by Ms.
11 Merchant, when the inflation for the period varies substantially from trends over
12 longer periods that form the basis for expectations.

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14 **Q. WHAT CONCLUSIONS DO YOU DRAW? WHAT SHOULD THE**
15 **COMMISSION USE AS THE INFLATION FACTOR FOR SETTING**
16 **RETAIL PRICES IN THE CURRENT DOCKET?**

17 A. First, I recommend that the Commission utilize long-term expectations of
18 inflation, where such expectations are inferred from survey information—
19 including surveys of macroeconomic forecasters and consumers, coupled with
20 yield spreads. As I mentioned earlier, there is evidence that the expected rate of
21 inflation has receded somewhat—though not greatly—with respect to past
22 years. To this end, I offer the following projections of inflation for the
23 Commission’s consideration, for 2009 and the ensuing two years:

PROJECTED RATES OF INFLATION, U.S. ECONOMY (%)					
Year	3rd Q '09 Survey of Professional Forecasters for 2009-2011	U.S. Treasury Yield Spread, Nominal - TIPS, 2009	U.S. Treasury Yield Spread, Adjusted for Liquidity, Nominal -TIPS, 2009	University of Michigan, Survey of Consumer Expectations, 2009	Average of Methods
2009-2011	1.57	0.93	2.58	2.52	2.09%

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The above result reflects expectations of inflation for the 2009 – 2011 time-

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frame, which is the time-frame over which agents are likely to commit

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resources during 2009 and the near-term. If the Commission were to utilize

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3.80% actual inflation for 2008 and 2.09% expected inflation for 2009 and the

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near term, the result would be a compounded inflation factor of 5.97%.