BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In The Matter of the Application of Rocky Mountain Power for Authority to Increase Its Retail Electric Service Rates in Utah and for Approval of Its Proposed Electric Service Schedules and Electric Service Regulations, Consisting of a General Rate Increase of Approximately $161.2 Million Per Year, and for Approval of a New Large Load Surcharge	**§**	**Docket No. 07-035-93** **Direct Rate of Return Testimony of Daniel J. Lawton For the Committee of Consumer Services**

March 31, 2008

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DIRECT TESTIMONY OF
DANIEL J. LAWTON

SECTION I: INTRODUCTION/BACKGROUND

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 816 Congress Avenue, Suite 1120, Austin, Texas 78701.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

A. I have been working in the utility consulting business as an economist since 1983. Consulting engagements have included electric utility load and revenue forecasting, cost of capital analyses, revenue requirements/cost of service reviews, and rate design analyses in litigated rate proceedings before federal, state and local regulatory authorities. I have worked with municipal utilities developing electric rate cost of service studies. In addition, I have a law practice based in Austin, Texas. My main areas of legal practice include administrative law representing municipalities in electric and gas rate proceedings and other litigation and contract matters. I have included a brief description of my relevant educational background and professional work experience in Exhibit CCS 3.1.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN RATE PROCEEDINGS?

A. Yes. A list of cases where I have previously filed testimony is included in my Exhibit CCS 3.1.

Q. ON WHOSE BEHALF ARE YOU FILING TESTIMONY IN THIS PROCEEDING?

A. I have been retained to review Rocky Mountain Power's ("Company") cost of capital request on behalf of the Committee of Consumer Services ("Committee").

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

A. The purpose of my testimony in this proceeding is to address the Company's requested overall cost of capital. I will address the Company's requested return on equity, capital

structure, and cost rates for equity, debt and preferred stock, which is presented in the direct testimony of its cost of capital witnesses, Dr. Samuel Hadaway and the direct and supplemental testimony of Mr. Bruce Williams.

Q. WHAT MATERIALS DID YOU REVIEW AND RELY ON FOR THIS TESTIMONY?

A. I have reviewed the Company's testimony in this case, Company responses to interrogatories, Value Line Investment Survey ("Value Line"), financial reports of the Company, and various other financial information available in the public domain. When relying on other sources, I have referenced such sources in my testimony and included copies or summaries in my attached exhibits or workpapers.

Q. PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS IN THIS CASE.

A. My analysis of the Company's requested 10.75% return on equity indicates such request is overstated in current capital markets. Updating the Company's discounted cash flow ("DCF") equity return analysis for current data, correcting the flawed long-term growth rate assumption and relying on current interest rates rather than outdated forecasts, results in a DCF range of 9.4% to 9.9% with a midpoint of about 9.70%. These same market data updates applied to the capital asset pricing model ("CAPM") and relevant risk premium analyses indicate a cost of equity range of 9.0% to 10.3% with a 9.85% midpoint. My alternative DCF analysis results in a range of 9.82% to 10.08% with a midpoint of about 9.95%. A 9.65% cost of equity is supported by the DCF analyses as well as a check of reasonableness from the CAPM and risk premium results.

Based on my analysis, I make the following conclusions and recommendations:

(i) The Company's proposed 8.54% overall return on investment is overstated and should not be adopted as representative of the Company's cost of capital requirements;[1]

(ii) The Company's requested 10.75% return on equity is an overstatement of the required return on equity for the Company;

(iii) The Company's required return on equity is 9.85% and is reasonable for the Company;

[1] The Company's 8.54% requested overall return on investment as set forth in the Supplemental Direct Testimony of Bruce Williams at 3:43-50.

(iv) The Company's long-term debt cost is 6.27%; and

(v) The Company's overall cost of capital for this case should be set at 8.07%.

SECTION II: REGULATORY ISSUES AND COST OF CAPITAL

Q. PLEASE EXPLAIN THE COST OF CAPITAL CONCEPT AS IT RELATES TO THE REGULATORY PROCESS.

A. The rate of return is an essential element in the process of rate regulation. The overall return to be earned on rate base investment is typically a major part of overall revenue requirement. For example, in this case the Company's originally requested cost of capital of 8.59% produced a revenue requirement (before federal income taxes) of $378.7 million or 24% of revenue requirements.[2] Thus, return on invested capital is a substantial component of overall revenue requirements.

Q. PLEASE EXPLAIN HOW THE VARIOUS COMPONENTS OF COST OF CAPITAL ARE DETERMINED.

A. The overall rate of return in the regulatory process is best explained in two parts. First, there is the return to senior securities, such as debt and preferred stock, which is contractually set at issuance. The reasonableness of the cost of this contractual obligation between the utility and its investors is examined by regulatory agencies as part of the utility's overall cost of service.

The second part of a Company's overall return requirement is the appropriate cost rate to assign the equity portion of capital costs. The return to equity should be established at a level that would permit the firm an opportunity to earn a fair rate of return. By fair rate of return, I mean a return to equity holders, which is sufficient to hold and attract capital, sufficient to maintain financial integrity, and a return to equity comparable to other investments of similar risks.

The cost of capital is defined as the annual percentage that a utility must receive to maintain its financial integrity, to pay a return to security owners and to insure the continued attraction of capital at a reasonable cost and in an amount adequate to meet future needs. Mathematically, the cost of capital is the composite of the cost of several

[2] See Direct Testimony of A. Richard Walje at 6:121.

classes of capital used by the utility – debt, preferred stock, and common stock, weighted on the basis of an appropriate capital structure.

The ratemaking process requires the regulatory authority to determine the utility's cost of capital (debt, preferred stock and equity costs). These calculations, when combined with the proportions of each type of capital in the capital structure, result in a percentage figure that is then multiplied by the value of assets (investment) used and useful in the production of the utility service to ultimately arrive at a rate charged to customers. Rates should not be excessive (exceed actual costs) or burdensome to the customer and at the same time should be just and reasonable to the utility.

In summary, the objective of overall rate of return determination in the regulatory process is to compute the return such that the embedded (contractually required) cost of senior securities is recovered. In addition, a regulated utility should be provided an opportunity to generate additional earnings that are sufficient to compensate equity investors at a level that will hold existing investors, attract new investors, and maintain the financial integrity of the utility.

Q. PLEASE EXPLAIN THE COST OF EQUITY CONCEPT.

A. The cost of equity, or return on equity capital, is the return expected by investors over some prospective time period. The cost of equity one seeks to estimate in this proceeding is the return investors expect prospectively when the rates from this case will be in effect.

The cost of common equity is not set by contract, and there are no hard and fast mathematical formulae with which to measure investor expectations with regard to equity requirements and perceptions of risk. As a result, any valid cost of equity recommendation must reflect investors' expectations of the risks facing a utility.

Q. WHAT PRINCIPAL METHODOLOGY DO YOU EMPLOY IN YOUR COST OF EQUITY CAPITAL ANALYSES?

A. I employ the Discounted Cash Flow methodology for estimating the cost of equity, keeping in mind the general premise that any utility's cost of equity capital is the risk free return plus the premium required by investors for accepting the risk of investing in an equity instrument. It is my opinion that the best analytical technique for measuring a

utility's cost of common equity is the DCF methodology. Other return on equity modeling techniques such as the CAPM or risk premium are often used to check the reasonableness of the DCF results.

Q. PLEASE DESCRIBE THE RISKS YOU REFER TO ABOVE.

A. As I stated earlier in this testimony, equity investors require compensation above and beyond the risk free return because of the increased risk factors investors face in the equity markets. Thus, investors require the risk free return plus some risk premium above the risk free return. The basic risks faced by investors that make up the equity risk premium include business risks, financial risks, regulatory risks, and liquidity risks.

Q. PLEASE DESCRIBE ROCKY MOUNTAIN POWER.

A. The Company is one of three business units owned by PacifiCorp. The Rocky Mountain Power business unit provides electrical service to customers in Utah, Wyoming and Idaho. PacifiCorp was acquired and is now a division owned by MidAmerican Energy Holdings Company ("MEHC") in 2006. The equity investment of Rocky Mountain Power is not publically traded.

Q. PLEASE DISCUSS YOUR UNDERSTANDING OF THE COMPANY'S UPDATED REVENUE REQUIREMENT FILING AND THE TEST YEAR ORDERED BY THE PUBLIC SERVICE COMMISSION OF UTAH ("COMMISSION") IN THIS CASE.

A. The Company has filed for an annual revenue increase of $99.8 million including a request for a 10.75% return on shareholder equity. The Company's rate request and cost of service analyses are based on a forecasted test year for the twelve months ending December 31, 2008 as ordered by the Commission on February 14, 2008.

SECTION III: CURRENT ECONOMIC CONDITIONS

Q. WHAT CURRENT ECONOMIC CONDITIONS IMPACT THE COST OF CAPITAL?

A. Current economic conditions have resulted in the Federal Reserve lowering projections for economic growth due to the housing slump and recent banking problems and credit conditions. Generally, the U.S. economy has weakened, which has prompted recessionary concerns from financial analysts. Such concern continues despite the

Federal Reserve's recent cut of 50 basis points to the federal funds rate down to 3 percent. This 50 basis point reduction in the federal funds rate followed a 75 basis point reduction just eight days earlier. The two rate cuts together total 125 basis points and represent the most substantial single month reduction in over twenty years.

The liquidity crisis has resulted in the Federal Reserve further reducing the discount rate on Sunday March 16, 2008 from 3.5% to 3.25%. This rate cut along with creating additional lending facilities are two recent initiatives to bolster credit market liquidity. On March 18, 2008, the Federal Reserve again announced a 75 basis point reduction to the federal funds rate.

This latest action by the Federal Reserve reduces the federal funds rate to 2.25 percent. The federal funds rate has been cut six times since September 2007 with the most recent reductions being quite aggressive cuts. These Federal Reserve actions indicate interest rates are not increasing.

In particular, housing market problems around the country and rising energy prices have had an impact on economic growth and the projections of growth are being revised downward. Moreover, recent cuts in short-term interest rates have impacted the longer-term interest rate outlook. As can be seen from the Table 1 below, the 10 year and 30 year Treasury rates have declined from the June 2007 time period.

TABLE 1[3]

10 Year and 30 Year Treasury Rates

Month	10 Year Treasury	30 Year Treasury
June 2007	5.10%	5.20%
July 2007	5.00%	5.11%
August 2007	4.67%	4.93%
September 2007	4.52%	4.79%
October 2007	4.53%	4.77%
November 2007	4.15%	4.52%
December 2007	4.10%	4.52%
January 2008	3.74%	4.33%
February 2008	3.74%	4.52%

While the Federal Reserve continues to deal with the competing pressures of inflation, declining gross domestic product ("GDP") growth and the prospects of a recession, the prevailing view appears to be a continuation of lower interest rates.

SECTION IV: ROCKY MOUNTAIN POWER'S COST OF EQUITY REQUEST OVERVIEW

Q. HOW DID COMPANY WITNESS SAMUEL HADAWAY ESTIMATE THE REQUESTED 10.75% COST OF EQUITY?

A. Mr. Hadaway based his 10.75% equity return recommendation on the results of a Constant Growth DCF model and Multistage Growth DCF model (relying primarily on a 6.6% long-term growth rate) combined with two capital asset pricing models (CAPM) and two risk premium results.[4] It appears that Dr. Hadaway ignored his constant growth DCF (Analysts Growth) and Harris-Marston Risk Premium results.[5]

[3] www.federalreserve.gov/releases/h15/data, March 4, 2009.
[4] Direct Testimony of Samuel Hadaway at 2:38-43 and at 36: 758-778.
[5] *Id.*

Dr. Hadaway's results can be summarized in Table 2 below:

TABLE 2[6]

Summary of Equity Cost Results of Dr. Hadaway

Methodology	Results
1). Constant Growth DCF (GDP Growth)	11.0% - 11.1%
2). Multistage Growth DCF	10.6% - 10.9%
3). CAPM Long-Term Risk Free Rate	9.83%
4). CAPM Short-Term Risk Free Rate	10.61%
5). Utility Debt and Risk Premium	10.8%
6). Morningstar Risk Premium Analysis	10.9%

Based on the results set forth in the table above and review of economic data, Dr. Hadaway concluded an equity return point estimate of 10.75% is appropriate for this case.[7]

Q. DO YOU HAVE ANY COMMENTS REGARDING DR. HADAWAY'S ANALYSIS?

A. Yes, I have a number of comments. First, the analytical tools employed by Dr. Hadaway, Constant Growth DCF, Multistage Growth DCF, CAPM, and Risk Premium Measures, are the same tools employed by most analysts and regulatory authorities when seeking to estimate cost of equity. These are the same analytical tools I relied on in making my estimate of cost of equity in this case.

Second, because the Company's stock is not publicly traded, Dr. Hadaway relied on the market data of a proxy risk group of companies for his DCF analyses.[8] It is common practice for cost of capital experts to rely on a proxy group when estimating cost of equity when the target company is not publicly traded. However, analysts must exercise

[6] *Id*. at 36: 758-776.
[7] *Id*. at 2:41-43.
[8] *Id*. at 2:44-46 to 3:47-60.

judgment in selecting the companies that comprise a proxy group and, therefore, the composition of proposed proxy groups may sometimes differ among analysts. In this case, I have used the same proxy group as Dr. Hadaway in making my cost of equity recommendation.

Third, Dr. Hadaway's assumptions with regard to expected growth rates in his DCF analyses, use of forecasted interest rates, and use of stale data renders his results unreliable. My difference with Dr. Hadaway's analysis is largely in these three areas.

Q. IF THE SAME MODELS AND COMPARABLE GROUP ARE USED, BUT DR. HADAWAY'S DATA AND ASSUMPTIONS ARE EITHER UPDATED OR CORRECTED, WHAT COST OF EQUITY RESULTS?

A. When Dr. Hadaway's equity return models are correctly applied the ROE is about 9.65 percent, rather than his estimate of 10.75%. Correcting and updating Dr. Hadaway's analyses results in a lower equity return, lower overall return earned on investment and a substantial drop in the revenue requirement necessary to hold and attract investors.

Q. PLEASE ADDRESS THE SPECIFIC PROBLEMS AND ERRORS IN DR. HADAWAY'S TESTIMONY.

A. I will address each of the errors and problems in Dr. Hadaway's December 2007 testimony in the same order as presented in his testimony.

First, Dr. Hadaway uses a traditional constant growth DCF model for the comparable group of companies employing traditional dividend yield calculations and the average of earnings per share forecasts made by three different analysts.[9] Dr. Hadaway concludes that the model results of 9.6% to 9.9% should be excluded from consideration because such results are "well below risk premium checks of reasonableness".[10] Given the recent decline in interest rates, I believe the traditional DCF model results of 9.6%-9.9% are consistent with risk premium and CAPM results and should not be excluded from consideration in this case. I discuss CAPM and risk premium calculations later in my testimony.

[9] Dr. Hadaway Direct Testimony at 32:679-684, also see (SCH-5) pp. 1 and 2 of 5.
[10] *Id.* at 32:683-684.

Q. DO YOU HAVE ANY COMMENTS REGARDING DR. HADAWAY'S SECOND CONSTANT GROWTH DCF CALCULATION, WHICH USES FORECASTED GROWTH IN GROSS DOMESTIC PRODUCT RATHER THAN ANALYSTS' EARNINGS FORECASTS?

A. Yes. Dr. Hadaway substitutes a 6.6% GDP growth rate for the three different analysts' earnings per share ("EPS") forecasts to arrive at a DCF equity return result of 11.0% to 11.1%.[11]

Q. DO YOU HAVE ANY COMMENTS REGARDING DR. HADAWAY'S GDP GROWTH RATE CALCULATION?

A. Yes. As a long-term growth measure of the future, relying on the GDP historical growth measure as one of the measures to predict future earnings growth is not unreasonable. So long as future growth in GDP approaches the historical GDP measure, then the GDP growth rate proxy could be a reasonable estimate. However, caution should be taken in relying on historical GDP growth as the sole measure of expected growth in earnings.

I also differ with Dr. Hadaway in his change in methodology in calculating the GDP measure. In previous testimony such as the PacifiCorp rate case, Docket No. 03-2035-02, filed in May 2003, Dr. Hadaway employed a simple 20-year historical average of GDP growth for his long-term earnings growth proxy, which would produce a 5.6% GDP growth estimate. Since the 2003 case, Dr. Hadaway changed his methodology for calculating the historical GDP long-term growth rate. Rather than using the 20-year GDP average of 5.6%, Dr. Hadaway now takes an average of six different GDP growth period averages as illustrated in Table 3 below:

TABLE 3[12]
Summary GDP Growth Averages

10-year GDP average	5.4%
20-year GDP average	5.6%
30-year GDP average	6.9%
40-year GDP average	7.3%
50-year GDP average	7.1%
59-year GDP average	7.0%
Average of periods	**6.6%**

[11] Direct testimony at 32:684-687 also see (SCH-5) pp. 1 and 3 of 5; and (SCH-4) p.1 of 1.
[12] Dr. Hadaway Direct Testimony Exhibit RMP_ (SCH-4).

In other words, Dr. Hadaway's new methodology averages the historical averages. Dr. Hadaway provides no explanation or basis for his changed methodology, the net impact of which is to increase the long-term growth estimate from the 20-year average of 5.6% to 6.6%.

Q. DO YOU RECOMMEND THE COMMISSION ACCEPT DR. HADAWAY'S NEW METHODOLOGY FOR COMPUTING LONG TERM GROWTH?

A. No. A 20-year period is certainly a sufficiently long time period to smooth aberrations and/or outliers to project into the future. I find no theoretical (economic or mathematical) reason to employ an average of the 10, 20, 30, 40, 50 and 59 year averages. It could be argued that more recent GDP growth data is more important, and the 10-year GDP average of 5.4% would be the best GDP proxy of growth. This may be especially true given recent Federal Reserve projections of a much lower GDP growth. In my opinion, if the GDP average is to be used as one of the growth rate estimates, then the 10-year or 20-year average of 5.4% to 5.6% is a reasonable compromise for consideration in this case. I have employed the mid-point of 5.5% as a GDP growth rate proxy. Such a growth estimate is consistent with analyst estimates for earnings and reflects current expectations of declining GDP growth.

Q. IF YOU CORRECT DR. HADAWAY'S GDP GROWTH RATE CALCULATION WHAT DCF RESULTS DOES HIS DATA AND MODEL PRODUCE?

A. Reducing the GDP growth estimate from 6.6% to 5.5% is a 110 basis point reduction to Dr. Hadaway's claimed 11.0% to 11.1% results. Thus, correcting Dr. Hadaway's results using a 5.5% GDP growth rate indicates a 9.9% to 10.0% constant growth DCF result.

It is important to note that the corrected ROE results above are consistent with the constant growth results of 9.6% to 9.9% employing analyst's estimates of earnings per share – which Dr. Hadaway mistakenly discarded.

Q. DID DR. HADAWAY ESTIMATE A DCF RESULT EMPLOYING A MULTI-STAGE DCF GROWTH MODEL?

A. Yes. Dr. Hadaway's two-stage growth rate DCF model produces DCF estimates for ROE of 10.6% - 10.9%.[13] The problem with this analysis is his primary reliance on the faulty

[13] Exhibit RMP_ (SCH-5) p.1.

6.6% GDP growth measure. When Dr. Hadaway's results are corrected for a 5.5% GDP growth rate, the results are in the 9.6% to 9.8% range. I discuss this analysis in more detail later in this testimony. Thus, the corrected multi-stage DCF model produces results consistent with the previous two DCF analyses discussed above.

Q. DID DR. HADAWAY PRESENT RESULTS FROM A CAPITAL ASSET PRICING MODEL ("CAPM") CALCULATION?

A. Yes. Dr. Hadaway presents two CAPM calculations: one based on the August through October 2007 average 30-year Treasury Bond rate; and the second based on the 90-day Treasury Bill rate.[14] The results of his two CAPM analyses are 9.83% for the 30-year Treasury Bond rate and 10.61% for the 90-day Treasury Bill rate.[15] However, interest rates have declined since Dr. Hadaway made these CAPM calculations and his results are substantially overstated.

Q. HAVE YOU REVIEWED 30-YEAR TREASURY BOND AND 90-DAY TREASURY BILL RATES FOR A MORE RECENT THREE-MONTH PERIOD?

A. Yes. Table 4 below presents a comparison of the interest rates employed by Dr. Hadaway compared to more current interest rate data.

[14] Direct Testimony Samuel Hadaway at 33:696-706 and (SCH-7).
[15] *Id.*

TABLE 4[16]

COMPARISON OF 30 YEAR TREASURY BOND AND 90 DAY TREASURY BILL MONTHLY INTEREST RATES

MONTH	30-YEAR TREASURY BOND	90-DAY TREASURY BILL
August 2007	4.93%	4.20%
September 2007	4.79%	3.89%
October 2007	4.77%	3.90%
3-month average	4.83%	4.00%
November 2007	4.52%	3.27%
December 2007	4.52%	3.00%
January 2008	4.33%	2.75%
February 2008	4.52%	2.12%
3-month average Dec.-Feb.	4.46%	2.62%

As shown in Table 4, the 30-year Treasury Bond rate has declined from the 4.83% average employed by Dr. Hadaway to 4.46% currently. The 90-day Treasury Bill rate has also declined from the 4.00% average used by Dr. Hadaway to 2.62% currently.

If current rates are used in Dr. Hadaway's CAPM analysis his results would range from about 9.0% to 9.3%. Thus, the CAPM results are consistent with the DCF results discussed earlier.

Q. DID DR. HADAWAY ALSO ESTIMATE EQUITY RETURN BASED ON RISK PREMIUM ANALYSES?

A. Yes. Dr. Hadaway estimated three risk premium results in his testimony. These risk premium analyses are as follows:

[16] www.federalreserve.gov/releases/h15/data, March 2008.

TABLE 5

DR. HADAWAY RISK PREMIUM SUMMARY[17]

(i) Utility Debt Plus Risk Premium	10.8%
(ii) Morningstar Risk Premium Analysis	10.9%
(iii) Harris-Martson Risk Premium	11.5%

The key problem with Dr. Hadaway's risk premium analyses is his reliance on forecasted interest rates to estimate debt costs.[18] Dr. Hadaway's forecasted single-A utility bond interest rate is 6.4 percent.[19] While Dr. Hadaway relied on a three-month average interest rate for this CAPM analysis, his risk premium approach relies entirely on forecasted rates. Given the changes in capital markets and continued decline in interest rates, Dr. Hadaway's analysis once again substantially overstates cost of equity.

Q. BASED ON CURRENT MARKET DATA HOW OVERSTATED IS DR. HADAWAY'S RISK PREMIUM ESTIMATES?

A. Employing Dr. Hadaway's method of estimating single-A utility bond costs, utilizing current rather than forecasted long-term Treasury rates, indicates a single-A utility rate of 5.5% and not the 6.4% estimated by Dr. Hadaway. Moreover, reliance on the recent three-month average interest rate is consistent with Dr. Hadaway's CAPM analysis and captures the current downturn in interest rates. A more appropriate risk premium calculation is in the 10.0% to 10.3% range.

Q. DO YOU HAVE ANY COMMENTS REGARDING THE HARRIS AND MARSTON (H&M) RISK PREMIUM?

A. Yes, it is irrelevant and produces unreliable results. In every case over the last few years where Dr. Hadaway presents the H&M study, he consistently ignored the results. The pattern is repeated in this case: Dr. Hadaway presents the H&M study results, but does not rely on them in his risk premium analysis. This Commission should also ignore the H&M results as nothing more than an outlier.

[17] Direct Testimony Samuel Hadaway at 33:711-35:755.
[18] *Id.* at 33:715-716 and RMP_ (SCH-6) p. 1 of 2 notes.
[19] *Id.*

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS ON DR. HADAWAY'S ANALYSIS?

A. Yes. In interpreting his own results Dr. Hadaway stated the following:

> "Caution should be exercised in interpreting the basic quantitative DCF and risk premium results, because they are based on recent historically low points in the economic cycle. Under such conditions, economic projections should also be considered. Continuing economic growth and higher expected interest rates show that less weight should be given to recent economic history."[20]"

Given the current decline in expected economic growth, potential for further economic decline and falling interest rates, Dr. Hadaway's analysis and conclusion are incorrect. This Commission's Order on the test year issued on February 14, 2008, explicitly recognized "…greater uncertainty of economic conditions…," as a factor in determining the appropriate test period so as to "ensure just and reasonable rates."[21] I recommend that this Commission decline Dr. Hadaway's recommendation to rely on outdated forecasts or to grant a 10.75% cost of equity in this case.

SECTION V: COST OF CAPITAL

I. Cost of Equity Capital

Q. WHAT IS THE PURPOSE OF THIS SECTION OF YOUR TESTIMONY?

A. In this section of my testimony, I present my analysis used in estimating the Company's cost of equity in this case. In addition, I discuss the details of the analysis and conclusions resulting from my analysis.

Q. PLEASE DESCRIBE HOW YOU CONDUCTED YOUR DCF ANALYSIS.

A. The Company does not have publicly traded common stock or other market data that is required to estimate the cost of equity directly. I applied the DCF method employing market data, as well as forecasted data of various financial parameters for a comparable group of 15 electric utility companies. The comparable group of 15 utility companies

[20] Dr. Hadaway Direct Testimony at 36:479 – 783.
[21] Commission Order on Test Year, Docket No. 07-035-93 at 4, (February 14, 2008).

employed in my analysis comes from the same group of companies used by Company witness Dr. Hadaway in this case and is provided in my Exhibit CCS 3.2. Given that I am basing my analysis on the same group of comparable companies as employed by Dr. Hadaway, the equity cost calculation issue is narrowed to the methodology of estimation.

Q. PLEASE EXPLAIN THE DCF METHODOLOGY YOU HAVE EMPLOYED IN YOUR ANALYSIS.

A. The foundation of the DCF model is in the theory of security valuation. The price that an investor is willing to pay for a share of common stock today is determined by what income stream the investor expects to receive from the investment. The return the investor expects to receive over the investment time horizon is composed of: (i) dividend payments, and (ii) the appreciated sale value of the investment. A proper analysis adds dividends to the gain on the final sale value, and discounts these expected future earnings to a present value.

To determine or estimate investor requirements using the DCF model, one computes a cost of capital requirement, or discount rate from the current market data and the expected dividend stream. The DCF model stated as a formula is as follows:

$$K = D/P + G$$

where:

K = required return on equity,

D = dividend rate,

P = stock price,

D/P = dividend yield, and

G = growth in dividends.

Q. PLEASE EXPLAIN HOW YOU CALCULATED THE DIVIDEND YIELD FOR THE COMPARABLE COMPANIES.

A. The dividend yield is the ratio of the dividend rate to the stock price. When calculating the dividend yield, one must be cautious and not rely on spot stock prices. One must be equally cautious not to rely on long periods of time as the data becomes unrepresentative of market conditions. The objective is to use a period of time such that the resulting dividend yield is representative of the prospective period when rates will be in effect.

While there is no fixed period for selecting the denominator of the dividend yield (i.e., stock price), the key guideline is that the yield not be distorted due to fluctuations in stock market prices. On the other hand, dividends, the numerator of the yield calculation, are relatively stable, as opposed to the stock prices, which are subject to daily and cyclical market fluctuations. The selection of a representative time period will dampen the effect of stock market changes.

The price and dividend data for each of the companies in the comparable group is contained in my Exhibit CCS 3.3. I have utilized a six-week average of closing prices for the period ending March 20, 2008. In my opinion, the six week average price reflects current market conditions and the impacts of such conditions on market prices.

As can be seen in my Exhibit CCS 3.3 page 1, the six week average price for the 15 company comparable group is $34.59. The more recent period has resulted in the general level of prices to decline.

The dividend for each of the comparable companies was calculated by employing the six week average price and the Value Line estimate of the 2008 dividend payment. The resulting dividend yield range is 4.73% to 4.74% based on an average and median calculation.

Also, on Exhibit CCS 3.3 page 2, I have updated Dr. Hadaway's constant growth DCF employing three months of price data.

I have utilized the average of the monthly high and low prices for the period December 2007 through February 2008 for calculating average price. As can be seen from Exhibit CCS 3.3 the December 2007 – February 2008 price data is consistent with the past 52 week average as well as Value Line's report of recent prices for these entities.

As shown in my Exhibit CCS 3.3, the average price used by witness Dr. Hadaway for the 15 company comparable group is $37.85,[22] while I have calculated a $37.36 average price based on more current data.

[22] Direct Testimony Samuel Hadaway (SCH-5) p. 2 of 5.

The dividend for each of the comparable companies was calculated by employing average price and the Value Line estimate of the 2008 dividend payment. The resulting dividend yield range is 4.4% for the group, as shown in Exhibit CCS 3.3, page 2.

II. Growth Rates

Q. PLEASE EXPLAIN HOW YOU HAVE CALCULATED THE EXPECTED GROWTH RATE IN YOUR DCF ANALYSIS FOR THE COMPANIES IN THE COMPARABLE GROUP.

A. Like dividend yields, there exists no single or simple method to calculate growth rates. The calculation of investor growth expectations is the most difficult part of the DCF analysis. To estimate investor expectations of growth, I have examined historical growth and forecasted growth rates, and other financial data for each of the companies in the comparable group.

Q. PLEASE EXPLAIN YOUR GROWTH RATE ANALYSIS.

A. I have included in my Exhibit CCS 3.4 the growth rates I have reviewed and/or relied on in my analysis. The first set of growth rates examined is the historical growth rates in earnings per share, dividends per share, and book value per share as reported by Value Line Investment Survey. The second set of growth rates are the Value Line forecasted growth rates in earnings per share, dividends per share, and book value per share for each company of the comparable group. The third set of growth rates examined is the Zacks forecasted growth rates in earnings. The fourth growth estimate I examined is the First Call growth rate from Yahoo Finance. The First Call growth rates like Zacks and Value Line are readily available to investors at no charge.

The comparable group average growth rates described above provide a range of estimates ranging from 2.8% to 5.95%. Relying on an earnings per share forecast, the growth rate range represented by the mean and median for the group can be narrowed to 4.7% to 5.34% in Exhibit CCS 3.4.

In my opinion, the growth rate range of 4.7% to 5.34% in Exhibit CCS 3.4 provides a reasonable estimate of investor expectations of growth for each of the companies in the

group. In contrast, Dr. Hadaway's constant growth DCF analysis employed a 5.56% growth rate average for the comparable group.[23]

Q. PLEASE SUMMARIZE YOUR CONSTANT GROWTH DCF COST OF EQUITY ESTIMATE FOR THE COMPARABLE GROUP.

A. The results are presented in my Exhibit CCS 3.5 at page 1 and indicate a cost of equity of 9.82% to 10.08%. These results are comparable to witness Hadaway's constant growth DCF results of 9.6% to 9.9%.[24] In addition, I have updated Dr. Hadaway's constant growth DCF using a more recent three month period for calculating stock prices. The results of this update is contained in my Exhibit CCS 3.5 at page 2 and shows a return range of 9.42% to 9.74%.

Q. HAVE YOU CALCULATED ADDITIONAL DCF ANALYSES FOR THE COMPARABLE GROUP COMPANIES?

A. Yes. I have recalculated each of Dr. Hadaway's DCF analyses to reflect more current data and corrections to errors in his analyses, which I discussed earlier in my testimony. These analyses are summarized in Exhibit CCS 3.6. Each of the DCF, CAPM and risk premium analyses are updated in Exhibit CCS 3.6. Each of Dr. Hadaway's DCF analyses are updated in Exhibits CCS 3.7 and CCS 3.8 CAPM and risk premium analyses are in Exhibits CCS 3.9 and 3.10, respectively.

Q. PLEASE DESCRIBE THE UPDATED CONSTANT GROWTH DCF ANAYSIS.

A. Exhibit CCS 3.5 page 2 reflects the update to Dr. Hadaway's constant growth DCF analysis. Again an update of the constant growth DCF produces an equity return range of 9.4% to 9.7%.

Q. PLEASE DESCRIBE THE UPDATE OF DR. HADAWAY'S CONSTANT GROWTH DCF ANALYSIS EMPLOYING LONG-TERM GDP GROWTH PRESENTED IN EXHIBIT CCS 3.7.

A. This constant growth DCF analysis employs GDP growth as the sole growth rate estimate for calculating investor expectation. Dr. Hadaway's comparable analysis is shown in his Exhibit RMP_ (SCH-5) at page 3 of 5.

[23] Dr. Hadaway Direct at Schedule (SCH-5).
[24] See Direct Testimony of Samuel Hadaway at Exhibit RMP-(Sch-5) p. 2 of 5.

Updating the price and dividend data using a 5.5% GDP growth rate rather than Dr. Hadaway's proposed 6.6% GDP growth rate indicates investor return requirements in the 9.9% range as shown in Exhibit CCS 3.7.

Q. PLEASE DESCRIBE YOUR DCF RESULTS CONTAINED IN EXHIBIT CCS 3.8.

A. This analysis updates and corrects Dr. Hadaway's non-constant growth, Two-Stage DCF estimates in his Exhibit RMP (SCH-5) at page 4 of 5. I have updated the data and changed the long-term GDP growth rate to 5.5% for the reasons discussed earlier. The results of this analysis indicate investor return requirements of 9.7% to 9.8% based on the non-constant growth, Two-Stage DCF model.

Q. PLEASE SUMMARIZE THE VARIOUS DCF ANALYSES YOU HAVE DESCRIBED.

A. The following table summarizes the constant growth DCF analysis as well as the updates to Dr. Hadaway's three DCF models.

TABLE 6

SUMMARY OF COMPARABLE GROUP DCF ANALYSES

Description	Low	High
Update of Dr. Hadaway Models		
Traditional DCF Constant Growth	9.4%	9.7%
Non-Constant Growth Two Stage DCF	9.7%	9.8%
Constant Growth DCF w/GDP Growth	9.9%	9.9%
Average of Hadaway updates	9.4%	9.9%

Q. PLEASE SUMMARIZE THE RESULTS OF UPDATING AND CORRECTING DR. HADAWAY'S DCF ANALYSES.

A. Updating the data and correcting the growth rate calculation methodology to be consistent with Dr. Hadaway's previous testimony indicates an average cost of equity based on the DCF analyses in the 9.4% to 9.9% range, as shown on my Exhibit CCS 3.6.

My DCF analysis, based on a recent six weeks of stock prices contained in Exhibit CCS 3.5 page 1, shows a DCF range of 9.8% to 10.1%. My analysis indicates an equity return at the upper end of Dr. Hadaway's updated and corrected DCF calculations. Thus, a DCF

estimate in the 9.85% range is a reasonable point estimate for the DCF analysis. The average of Dr. Hadaway's corrected and updated results is about 9.7%. The midpoint of my DCF analysis is about 9.95% (9.8% to 10.1%). Averaging my results with the updated and corrected results presented by Dr. Hadaway indicates a 9.85% DCF estimate.

SECTION VI: CAPITAL ASSET PRICING MODEL ("CAPM")

Q. DR. HADAWAY PRESENTED TWO CAPM ANALYSES FOR THE COMPARABLE GROUP, DO YOU HAVE ANY COMMENTS ON HIS CAPM ANALYSES?

A. Yes. Like the risk premium method discussed below, the CAPM attempts to measure investor equity cost requirements based on measurable differentials in debt and equity investments. In Dr. Hadaway's first analysis he employed 30-year Treasury Bonds as the risk free asset and concluded a 9.83% equity return was appropriate.[25] In his second CAPM analysis, Dr. Hadaway employed a three-month average 90-day Treasury Bill rate on the risk free asset and concluded an equity return of 10.61% was appropriate.[26] Both analyses are included in Mr. Hadaway's Exhibit RMP ___ (SCH-7) where he presents the midpoint of his CAPM analysis as 10.22%.

Q. ARE DR. HADAWAY'S CAPM ESTIMATES OUT OF DATE?

A. Yes. As can be seen from Dr. Hadaway's Exhibit RMP__ (SCH-7) footnote 1, the interest rate data is based on the August through October 2007 period. As I discussed earlier, interest rates have declined. Employing more recent three-month averages changes the CAPM results to 9.0% and 9.31% as shown in my Exhibit CCS 3.9. The midpoint of the CAPM is 9.17%, rather than the 10.22% claimed by Dr. Hadaway. Moreover, my updated CAPM results employing all of Dr. Hadaway's assumptions, supports an equity return in the 9.2% range.

[25] See Direct Testimony Samuel Hadaway at 33:696-701.
[26] *Id.* at 33:703-705.

SECTION VII: RISK PREMIUM METHODOLOGY

Q. DR. HADAWAY CALCULATED A RISK PREMIUM METHOD TO ESTIMATE A RETURN ON EQUITY REQUIREMENT. DO YOU HAVE ANY COMMENTS ON HIS RISK PREMIUM ANALYSES?

A. Yes, I do. The risk premium method attempts to measure investor cost of equity requirements based on the risk differentials between debt and equity investments. Essentially, the risk premium required to induce investors to purchase equity versus less risky debt investments is measured over some historical time period. Once determined, the risk premium is added to a measure of current debt cost to arrive at a risk premium measure of equity costs.

In this case, Dr. Hadaway calculated three risk premium estimates. Dr. Hadaway compared authorized electric utility return on equity ("ROE") to contemporaneous long-term interest rates on utility bonds.[27] The difference between the authorized ROE's and utility bonds for the period 1980-2006 averaged 3.13%.[28] The 3.13% risk premium was further adjusted to reflect the inverse relationship between risk premiums and interest rates.[29] Dr. Hadaway concluded that as interest rates change by one percentage point, the risk premium changes by about 0.4218 percentage points.[30] Dr. Hadaway's resulting adjusted risk premium in this case is 4.37%.[31] Dr. Hadaway then adds the 4.37% adjusted risk premium to the forecast estimate of single-A rated utility debt cost of 6.4%, to arrive at 10.77% ROE estimate.[32]

Q. DO YOU AGREE WITH DR. HADAWAY'S RESULTS?

A. No. First, as discussed above in the CAPM section, interest rates have declined. Second, rather than employ a recent three-month historical interest rate, Dr.Hadaway employs a projected long-term Treasury rate of 5.30% and adds an average single-A spread of 110 basis points to arrive at a projected single-A bond estimate of 6.40%.[33] This is not a

[27] Dr. Hadaway Direct at 33.
[28] Dr. Hadaway Direct at RMP (SCH-6) p. 1 of 2.
[29] *Id*. at 34.
[30] *Id*. at 34 and (SCH-6) p. 2 of 2.
[31] Hadaway Direct, Exhibit RMP (SCH-6) p. 1 of 2.
[32] *Id*.
[33] Exhibit RMP_(SCH-6), p. 1 of 2, footnote 2.

reliable estimate. The projections are out of date and interest rate projections have been consistently high. Employing current market data (like the recent three-month average for the CAPM analysis) is the most reasonable proxy for the future. This is especially so given the Federal Reserve ongoing campaign to reduce short-term rates given economic trends.

Q. DID YOU CORRECT DR. HADAWAY'S RISK PREMIUM ANALYSIS?

A. Yes. The most recent three-month long-term Treasury average is 4.46% and declining. Adding 110 basis points single-A risk spread to the 4.46% results in a single-A projected bond result in a single-A projected bond yield of 5.5%. Correcting Dr. Hadaway's calculations result in a risk premium estimate of about 10.25%. This calculation is shown in my Exhibit CCS 3.10.

Q. PLEASE DESCRIBE DR. HADAWAY'S SECOND RISK PREMIUM ANALYSIS.

A. In his second risk premium analysis, Dr. Hadaway employed the risk premium measured for the period 1926 – 2006 as reported by Morningstar.[34] The resulting risk premium of 4.5% was added to the forecasted single-A rated utility debt estimate of 6.4% to arrive at a 10.9% risk premium ROE estimate.[35]

Q. ARE THE RESULTS OF DR. HADAWAY'S SECOND RISK PREMIUM ACCURATE?

A. No, again his 6.40% estimate of a single-A utility bond is overstated. As I discuss above, a more accurate single-A bond estimate based on current data is about 5.5%. Thus, employing a 4.5% risk premium and a 5.5% bond rate results in an ROE estimate of 10%.

Q. PLEASE DESCRIBE DR. HADAWAY'S THIRD RISK PREMIUM ANALYSIS.

A. The third risk premium estimate is based on the Harris and Marston ("H&M") study that measured risk premium based on an expectational approach (i.e., analysts' growth forecasts using the S&P 500 as a proxy for the market portfolio[36]). The H&M study

[34] Hadaway Direct at 34.
[35] *Id*. at 35.
[36] Robert S. Harris and Felicia Marston, "Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts," Financial Management, Summer 1992, at 63.

estimated risk premiums for the period 1982 – 1991 and concluded a 5.13% risk premium above yields on corporate bonds.[37] Dr. Hadaway then combines a 5.13% risk premium with a forecasted A-rated utility bond rate of 6.49% to arrive at an 11.53% risk premium ROE calculation.[38]

Q. DO YOU HAVE ANY COMMENTS ON THIS THIRD RISK PREMIUM?

A. Yes. Dr. Hadaway apparently ignored the results of his H&M risk premium study as it never factors into his recommendation. In my opinion, a study that measures risk premiums for the period 1982-1991 has little value when attempting to measure the current cost of equity for the Company.

Q. PLEASE SUMMARIZE THE RESULTS OF UPDATING AND CORRECTING DR. HADAWAY'S CAPM AND RISK PREMIUM ANALYSES.

A. Updating the risk premium and CAPM to reflect current market data and eliminating Dr. Hadaway's unsupported single-A Bond interest rate forecast results in a range of 9.0% to 10.3%. The midpoint of this range is 9.65%.

The CAPM/risk premium range overlaps the DCF range of 9.4% to 9.9%. Moreover, both the DCF analysis range and risk premium/CAPM check have the same midpoint of 9.65%. Thus, a 9.85% point estimate cost of equity for the Company is supported by current market data.

Q. BASED ON YOUR DCF ANALYSIS, AND UPDATING/CORRECTING DR. HADAWAY'S DCF, CAPM AND RISK PREMIUM, ANALYSES, WHAT IS YOUR CONCLUSION REGARDING THE COST OF EQUITY IN THIS CASE?

A. The following table summarizes the results of the various analyses discussed in my testimony:

[37] *Id*.
[38] Dr. Hadaway Direct at 35.

Table 7

DCF ANALYSES	
Update of Dr. Hadaway	Low High
DCF Traditional Growth	9.4% 9.7%
DCF GDP Growth	9.9% 9.9%
DCF Two-Stage Growth	9.7% 9.8%
DCF Range Midpoint DCF	9.4% 9.9% 9.65%
Risk Premium	10.0% 10.3%
CAPM	9.0% 9.3%
CAPM/Risk Premium Range Midpoint CAPM Risk Premium	9.0% 10.3% 9.65%

In my opinion, a cost of equity of 9.85% is reasonable. The DCF analyses indicates a cost of equity in the 9.4% to 9.9% range, while the risk premium approach indicates about a 9.0% - 10.3% equity return. A 9.85% equity return is the approximate average or midpoint of my DCF analysis and the updates of Dr. Hadaway's analyses as verified by the CAPM and risk premium results.

SECTION VIII: CAPITAL STRUCTURE

Q. WHAT CAPITAL STRUCTURE AND COST RATES IS THE COMPANY REQUESTING IN THIS CASE?

A. The Company is requesting the following capital structure, costs rates, and overall return for establishing revenue requirements in this proceeding.

TABLE 8[39]

ROCKY MOUNTAIN POWER CAPITAL STRUCTURE AND COST RATES

DESCRIPTION	RATIO	COST	WEIGHTED COST
Long-Term Debt	49.2%	6.30%	3.10%
Preferred Stock	.4%	5.41%	0.02%
Common Equity	50.4%	10.75%	5.42%
Total	100.0%	_____	8.54%

Q. WHAT IS THE SIGNIFICANCE OF CAPITAL STRUCTURE?

A. The overall cost of capital is the sum of the weighted average cost rates of various sources of capital. The quantity or portion of each type of capital, combined with the cost rate of capital determines the overall rate of return that the Company should be allowed to earn in this proceeding. The most significant relationship in any capital structure is the debt to equity ratio.

Q. DOES THERE EXIST SOME SET RELATIONSHIP OR IDEAL MIX OF DEBT AND EQUITY CAPITAL?

A. There exists no set debt/equity relationship for all firms or all industries in terms of leveraging. However, the ideal capital structure is one that minimizes the overall cost of capital to the firm, while still maintaining financial integrity so as to maintain the ability to attract capital at reasonable costs to meet future needs. Because the cost of debt is generally lower than the cost of equity, and also because the cost of debt represents a tax deductible expense, any increase in the quantity of debt capital tends to decrease the overall cost of capital relative to equity financing. One must keep in mind that increases in the quantity of debt financing can cause the financial risk of the Company to increase. In other words, there is a cost for the savings associated with increased debt leveraging. That cost is increased financial risk to the firm.

In summary, it is not possible to determine with precision the exact proportion of debt and equity that minimizes the overall cost of capital without imposing undue financial risk upon the Company. There does exist some range of capital structure that, generally,

[39] Supplemental direct testimony of Bruce N. Williams at 3:46-50.

meets the goal of minimizing the overall cost of capital while maintaining the firm's financial integrity.

Q. WHAT CRITERIA SHOULD REGULATORS EMPLOY IN DETERMINING THE APPROPRIATE CAPITAL STRUCTURE TO BE USED FOR RATEMAKING?

A. In my opinion, rate regulation should focus on two criteria to determine the appropriate capital structure. Those factors as outlined below should be economy and safety.

The advantage of debt in the capital structure is that debt costs less than equity. Moreover, interest charges are deductible for income tax purposes and act to reduce taxes. Thus, the more debt in the capital structure the lower the cost of capital will be. The question of economy is addressed by examining whether increases in the debt ratio act to increase the cost rates of both debt and equity so as to over balance the benefits of the larger proportion of debt.

In addition, there is always the overriding question of safety. In other words, financial risk is increased if the proportion of debt is increased by such a magnitude that interest obligations cannot be covered during periods of depressed earnings.

Q. DO YOU HAVE ANY COMMENTS ON THE COMPANY'S PROPOSED CAPITAL STRUCTURE?

A. Yes. It must also be remembered that the Company is being afforded the opportunity to employ a forecasted test period and capital structure. While the Commission has determined the forecast test period is calendar year 2008 and not the 12 months ending June 30, 2009 – the test year is still forward looking. A forecasted test year provides the Company benefits by reducing risks associated with regulatory lag. In other words, future investment and cost changes that are reasonably expected to occur in the rate effective period are reflected in the Company's cost of service and capital structure.

Q. HOW DID THE COMPANY CALCULATE THE COST RATES FOR DEBT AND PREFERRED STOCK?

A. The Company relied on the embedded cost based on averaging the 2007 and 2008 year end cost levels. The Company does include a projected or proforma debt issue of $700 million for December 2008. This $700 million pro forma debt issue is estimated to cost

6.52%.[40] Mr. Williams relies on forecasted Treasury rates for June 30, 2009 to arrive at the projected cost of this debt issue. Mr. Williams combines a forecasted Treasury rate of 4.91% with a 152 basis point risk spread adder[41] along with a 9 basis point issuance cost estimate to arrive at his 6.52% estimate (4.91+1.52+.09). The resulting proposed long-term total debt cost is 6.30%, which includes the impact of the Company's $700 million pro forma debt issue at a 6.52% cost rate.

Q. WHAT CAPITAL STRUCTURE ARE YOU RECOMMENDING?

A. The Company's proposed capitalization levels for debt, preferred and equity are not unreasonable. While the actual levels may change slightly in the 2008 test year, I expect only slight if any change to the capitalization for debt and equity. Regardless of the test year used to set revenue requirement, the Company's debt and equity requirements associated with capital expansion continue. Moreover, most of the Company's added investment in this case will likely be permanently financed by the end of 2008. For these reasons I do not expect any major changes in capital structure.

Q, DO YOU HAVE ANY RECOMMENDED CHANGES REGARDING THE COST RATES FOR THE VARIOUS CAPITAL COMPONENTS IN THE CAPITAL STRUCTURE?

A. Yes. I have already discussed equity cost and it is my recommendation that a reasonable equity is 9.85%. For preferred stock I recommend the Company's requested cost level of 5.41 percent. For long-term debt I recommend a cost rate of 6.27% percent which is slightly lower than the Company's 6.30% estimate.

Q. HOW DID THE COMPANY ESTIMATE THE COST OF NEW LONG TERM DEBT ISSUES?

A. As described earlier the Company estimated the interest rate spread between twenty year corporate debt on long-term Treasury issues as of November 2007 and concluded the interest rate spread to be 1.52 percent.[42] The Company also estimated issuance costs (all-in cost) to be nine basis points or 0.09 percent.[43] Next, the forward long-term Treasury

[40] Bruce Williams Direct Testimony at 10:224-229.
[41] The risk spread is the average yield difference between corporate debt and long-term Treasury rates.
[42] Direct Testimony of Bruce Williams at 10:225-226.
[43] *Id*. at 10:227-228.

rate for June 30, 2009, (Company original proposed test year end) of 4.91 percent was acquired.[44] To arrive at the projected debt cost for the $700 million of estimated debt to be issued, the debt spread, issuance cost and future June 30, 2009, Treasury rate were combined to arrive at a 6.52% (4.91 + 1.52 + 0.09) interest rate estimate.[45]

Q. DO YOU AGREE WITH THE COMPANY'S INTEREST COST ESTIMATE?

A. I do not agree with the result for two basic reasons. First, the interest rate estimate assumes a June 30, 2009 ending test year. Second, the estimate relies on interest rate forecasts. Given changes in capital markets in recent months, declining short-term interest rates and projections of additional interest rate reductions, it is my opinion that current or actual interest rates should be employed rather than reliance on outdated and incorrect interest rate forecasts.

Q. BASED ON CURRENT MARKET RATES WHAT INTEREST RATE LEVEL DO YOU RECOMMEND FOR THE PRO FORMA $700 MILLION LONG-TERM DEBT SERIES IN THIS CASE?

A. I would recommend use of the average of the most recent three months of the long-term Treasury rate. The following Table 8 is a summary of the 30-year Treasury rate for the December 2007 and February 2008 period.[46]

Table 9

Long-Term Treasury Yields

December 2007	4.52%
January 2008	4.33%
February 2008	4.52%
Average	4.46%

Employing a 4.46% long-term Treasury rate, a 152 basis point interest rate spread and a nine basis point issuance adjustment results in a pro-forma interest rate estimate of 6.07% rather than the Company's 6.52% estimate. The net result is a reduction in annual

[44] *Id. at 10:226.*
[45] *Id.* at 10:228-229; Also see Exhibit RMP _(BNW-1) p. 5 of 6, line 22).
[46] www.federalreserve.gov/releases/h15/data.

interest payment obligations of $3,150,000. The resulting long-term debt rate is 6.27% rather than the requested 6.30%. Thus, I am recommending a long-term debt cost of 6.27%.

Q. PLEASE SUMMARIZE YOUR OVERALL COST OF CAPITAL RECOMMENDATION IN THIS CASE.

A. The Company's requested 10.75% return on equity is overstated in current capital markets. Updating the Company's discounted cash flow equity return analysis for current data, correcting the flawed long-term growth rate assumption and relying on current interest rates, results in a DCF range of 9.4% to 9.9% with a midpoint of about 9.70%. My alternative DCF analysis results in a range of 9.82% to 10.08% with a midpoint of about 9.95%.

The midpoint of Dr. Hadaway's corrected and updated results is about 9.7%. The midpoint of my DCF analysis is about 9.95% (9.8% to 10.1%). Averaging my results with the updated and corrected results presented by Dr. Hadaway indicates a 9.85% DCF estimate. Applying the market updates to the Company's CAPM and relevant risk premium analyses indicate a cost of equity range of 9.0% to 10.3% and also supports a 9.85% cost of equity.

Based on the analyses and results discussed above, I am recommending the following capital structure, cost rates, and overall cost of capital:

TABLE 10

RECOMMENDED OVERALL COST OF CAPITAL
AND CAPITALIZATION LEVELS

DESCRIPTION	RATIO	COST	WEIGHTED COST
Long-term Debt	49.2%	6.27%	3.085%
Preferred Stock	0.4%	5.41%	0.02%
Common Equity	50.4%	9.85%	4.964%
Total	100.00%	____	8.07%

Q. WILL YOUR RECOMMENDED RETURN PROVIDE THE COMPANY SUFFICIENT INTEREST COVERAGE TO MAINTAIN ITS FINANCIAL INTEGRITY?

A. Yes. Based on the capital structure above, my recommended 8.07% overall cost of capital provides coverage ratios of 3.49x and 2.62x for pretax and after-tax interest coverage, respectively. These coverage ratios are sufficient for the Company to maintain financial integrity.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.