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	**DOCKET NO. 09-035-23** **Exhibit No. DPU 1.0 SR** **Surrebuttal Testimony and Exhibits** **Charles E. Peterson**

FOR THE DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE
STATE OF UTAH

Surrebuttal Testimony of

Charles E. Peterson

October 22, 2009

Q. Please state your name and occupation?

A. My name is Charles E. Peterson. I am employed by the Utah Division of Public Utilities ("Division" or "DPU") as a Technical Consultant.

Q. Have you submitted Direct Testimony on cost of capital in this proceeding?

A. Yes. I submitted Direct Testimony on September 17, 2009.

Q. What is the purpose of your testimony?

A. My purpose is to respond to comments made by PacifiCorp witnesses testifying in behalf of PacifiCorp's division Rocky Mountain Power (the Company): Dr. Samuel C. Hadaway in his Rebuttal Testimony and to his rebuttal exhibits identified as RMP Exhibits SCH-1R through SCH-6R; and Bruce N. Williams in his Rebuttal Testimony.

I. GENERAL COMMENTS

Q. Do you have general comments regarding the Rebuttal Testimony of Messrs. Hadaway and Williams?

A. Yes. Dr. Hadaway's Rebuttal Testimony summarizes parts of my testimony and analyses and shows how my analyses can be "corrected" to support his original Direct

Testimony or his updated testimony.[1] He spends much of his rebuttal testimony trying to undercut the long-term growth rates used in my two-stage DCF models.

Dr. Hadaway continues to insist on a long-term growth rate based upon a weighted average of the historical growth in U.S. gross domestic product (GDP). I demonstrated in my Direct Testimony that that was unrealistic. Dr. Hadaway has failed to present new evidence or argument that his historical GDP growth is better or even relevant to electric utility growth expectations. Finally, Dr. Hadaway continues to support his cost of equity calculations with historical authorized rates of return granted other companies in other jurisdictions.

Q. In your testimony here do you intend to respond in detail to all of Dr. Hadaway's comments?

A. No. I plan to respond to a few of the more important issues raised by Dr. Hadaway and Mr. Williams. Omission of a specific comment on the various issues raised by Dr. Hadaway and Mr. Williams should not be construed as agreement with their positions on those issues.

Q. Do you find any of Dr. Hadaway's criticisms persuasive?

A. No. Dr. Hadaway's Rebuttal Testimony amounts to a reassertion of his original position as being correct and that contrary positions are not. He does not present any new information that is substantially different from his Direct Testimony. His

[1] Dr. Hadaway's Rebuttal Testimony, Sch-4R.

criticisms of my long-term growth rates amount to assertions with no supporting evidence.

Q. How does your own Direct Testimony differ from that of Dr. Hadaway's Rebuttal Testimony?

A: In my testimony I attempted to discuss and present to the Commission a wide range of options. I also explained that there are differing views among both academics and practitioners regarding the application of those models. I highlighted some of the problems and controversies with particularly the CAPM. Rather than being merely descriptive, I gave my guidance to the Commission regarding what I believe to be the better, more "middle of the road" positions to take and used this guidance to arrive at my recommended range and point estimate. However, I did not avoid presenting data on applications that were either higher than, or lower than, my recommended range and point estimate.

Q. What comments do you have regarding Mr. Williams' rebuttal testimony?

A Generally Mr. Williams is critical of my reduced common equity percentage in the Company's capital structure. The main issue is that the difference between the Company's budgeted forecast net income that will accumulate as retained earnings over the test year period and my forecast of income is that my forecast was based upon recent actual results. Mr. Williams does not present a persuasive case that the

Company's budget forecast is superior to, or even as good as, incorporating the Company's historical results through June 30, 2009 into the analysis.

Q. Has any of the Company's witnesses' Rebuttal Testimony altered your conclusions?

A. No. As detailed below the Company's witnesses are not persuasive in their critique of my testimony. My recommended point estimate for cost of equity remains 10.5 percent along with a capital structure equity percentage of 50.5 percent.

II. COMMENTS ON DR. HADAWAY'S REBUTTAL TESTIMONY

Q. What do you see as the main differences between you and Dr. Hadaway?

A. The primary difference is what is the correct growth rate, or range of growth rates, to use. Secondarily, we have differences of opinion about the construction of risk premium models and the use of published authorized returns as a basis for cost of equity calculations. We also have some differing views on various applications of all of the models and on our interpretations differ somewhat regarding the effect of the current economy on cost of equity.

Q. Are these essentially some of the same issues that you and Dr. Hadaway have debated in recent rate cases?

A. Generally, yes. Each rate case has had of its own issues. However, a review of our testimonies filed in Docket Nos. 07-035-93 and 08-035-38 will show some common themes. I will not be addressing here all of the criticisms Dr. Hadaway has for my analysis, however, as indicated above, silence on a given criticism does not mean I agree with that criticism.

A. DCF Models

Q. Dr. Hadaway disagrees with your use of forecast dividend growth rates, specifically mentioning the 75 percent/25 percent weighting between earning growth and dividend growth. Is it correct to ignore dividend growth forecasts?

A. No. As I have said before,[2] the DCF model is based upon dividend payments. Thus dividend forecasts are theoretically the most correct growth rate that should be used. I would agree with Dr. Hadaway that earnings growth rates will likely drive growth in dividends in the long-term. However, to the extent that near-term dividend growth is expected to be higher, or lower, than earnings growth, then the departure of the growth in dividends from the growth in earnings will affect the stock price either up or down under this model. As I said in my testimony in the Company's 2007 general rate case, the Commission's 2002 decision in Questar Gas Company's general rate case to weight earnings growth 75 percent and dividend growth 25 percent is a reasonable compromise of the earnings vs. dividend growth rate issue.

[2] Peterson, surrebuttal testimony, Docket No. 07-035-93, p. 7.

B. DCF Model Growth Rates

Q. Do you have a response to Dr. Hadaway's comments in his Rebuttal Testimony regarding forecast rates of growth for the economy, as represented by the Gross Domestic Product?

A. Yes. This is the issue between Dr. Hadaway and me that has the greatest impact on our cost of equity conclusions. Dr. Hadaway continues to advocate the use of a weighted average historical GDP growth rate. Dr. Hadaway has yet to provide any basis for the weighted average historical GDP growth rate's relevance to expected future growth rates for regulated electric utilities.

Q. What are your comments with respect to Dr. Hadaway's rejection of the two forecast GDP growth estimates by the federal government agencies?

A. Dr. Hadaway asserts that because the U.S. Congressional Budget Office (CBO) and the Energy Information Administration (EIA) forecasts "are not consistent with historical growth rates in the U.S. economy"[3] and that while such forecasts "may be useful for projecting a balanced budget, protecting Social Security, and other government purposes they are not consistent with actual capital market data."[4]

My response is twofold. First, Dr. Hadaway apparently believes that investors do not contemplate any deviation of the future from the past, and the future is always a linear projection of the past (weighted average) growth rate, or that no better forecasting

[3] Dr. Hadaway's Rebuttal Testimony at lines 485-486.
[4] Ibid., lines 497-499.

method is available. The use of a weighted average, putting more weight on recent years, is a tacit admission that the historical period used is not a reflection of the future. However, given the significant and growing economic competition from places like China and India, and prospects for higher energy prices in the future, it is easy to imagine that future economic growth in the United States will not reflect the past. Specifically with regard to future electric energy use and prices, environmental concerns and related legislation could additionally slow the growth in the electric industry, if not the economy as a whole. The economic world faced by the United States today is much different from the economic situation it faced for at least the first 20 years of Dr. Hadaway's post World War II historical period.

Second, Dr. Hadaway suggests that political motives drive the EIA and CBO forecasts. If the goal of the EIA or CBO forecasts were for "projecting a balanced budget" or for "protecting Social Security," I would have expected the EIA and CBO forecasts to be relatively rosy. Instead we see fairly mediocre real growth rates of about 2.5 percent.

Besides his opinion, Dr. Hadaway presents fails to demonstrate that long-term growth rates lower than his historical GDP-based growth rate are neither contemplated nor expected by investors.

C. Risk Premium Models

Q. Dr. Hadaway says that one of the two principal areas of disagreements includes "[Mr. Peterson's] failure to provide a basic bond-yield-plus-equity-risk-premium analysis as a check of reasonableness for his primary DCF results."[5] Do you have any comments on that criticism?

A. Yes. Those data were readily available for Dr Hadaway to perform his own test. Comparing the Company's long-term borrowing rate of approximately 5.5 to 6.0 percent as evidenced by the debt issuance in January 2009, or the 5.71 percent "Single-A Utility Rate" for August 2009 set forth on Dr. Hadaway's Sch-1R, with my recommended 10.50 percent cost of equity yields risk premiums of 5.0 percent, 4.5 percent, and 4.79 percent, respectively. These risk premia appear to me to be quite generous compared with Dr. Hadaway's data on Sch-6R which indicates an average risk premium of 3.19 percent between utility bond yields and authorized common equity rates of return. While I may not have explicitly done this analysis in my direct testimony, this analysis would have indicated that I did not understate the Company's cost of equity.

D. Authorized Rates of Return

Q. Do you have any further comments, beyond what you said in your Direct Testimony and alluded to above regarding Dr. Hadaway's adherence to historical authorized rates of return by various commissions as a major indicator on what PacifiCorp's cost of equity should be?

[5] Dr. Hadaway's Rebuttal Testimony at lines 401-403.

A. Only that Dr. Hadaway has not answered any of the issues raised in my Direct Testimony. For example, he does not rebut the fact that authorized rates of return have been steadily declining for a number of years, or that authorized returns may be based on local laws and customs--or possibly on settlement negotiations.

However, if Dr. Hadaway believes that authorized rates of return in other jurisdictions are valid estimators of cost of equity, then perhaps Dr. Hadaway will now agree to give weight to PacifiCorp's own recent cost of capital settlements in Oregon and Washington.[6]

E. Other Comments Regarding Dr. Hadaway's Rebuttal Testimony

Q. Do you have any final comments regarding Dr. Hadaway's Rebuttal Testimony?

A. Yes. Dr. Hadaway "updates" his cost of capital estimate. I find it a bit curious that he can reduce his estimates by 30 to 50 basis points and conclude the same 11.0 percent result that he gave in his Direct Testimony.[7]

Q. What then is your overall assessment of Dr. Hadaway's rebuttal testimony?

Dr. Hadaway's comments in his Rebuttal Testimony are not persuasive; I continue to maintain my original positions.

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[6] Washington State Utilities and Transportation Commission, Docket UE-090205. Settlement Stipulation dated August 25, 2009.
Public Utility Commission of Oregon, Docket UE-210. Revenue Requirement Stipulation dated September 25, 2009.
[7] Dr. Hadaway's Rebuttal Testimony at lines 27-32.

III. COMMENTS ON MR. WILLIAMS'S REBUTTAL TESTIMONY

Q. Do you have any comments regarding Mr. Williams' Rebuttal Testimony of your adjustment to the Company's capital structure?

A. Yes. Mr. Williams asserts that the Company's calculations based upon a five quarter average of its "adjusted budget" as set forth in the Company's Confidential response to DPU data request 3.1 regarding the Company's calculation of its proposed capital structure is superior to my estimate that the December 31, 2009 balance sheet is reflective of the average for the test year. Furthermore, Mr. Williams correctly points out that a key difference is that my income estimate is [redacted] while the Company's is [redacted] for 2009.

I would note that in the Company's calculations as set forth in its confidential response to DPU data request 3.1, that the December 30, 2009 capital structure is identical to the five-quarter average. This suggests that my use of the December 30, 2009 capital structure is representative of the test year.

The issue I have with the Company's earnings forecast is that it is likely to be optimistic. As evidence, for the first six months of 2009, the actual common equity balance was [redacted] lower than the "adjusted budget figure. Since the Company is not paying common dividends, this suggests that the Company overestimated its net income by an average of [redacted] for each of the first two quarters of 2009.

Assuming that the Company's five-quarter average is superior to my December 31,2009 figure, and that the Company's "adjusted budget" is exactly right after June 30, 2009, then reducing the June 30, 2009 common equity capital to its actual amount results in the exact capital structure that I am advocating: 50.5 percent common equity, 0.3 preferred stock, and 49.2 percent debt.

Q. Is it likely that the Company's forecast after June 30, 2009 is approximately correct? Please explain your answer.

A. No. I believe that it is likely that the Company is optimistic in its net income forecast. Monthly sales in MWh for the Company have consistently declined in 2009 compared to 2008. Revenues are essentially flat for the first six months of 2009 compared to 2008. The latest data from the EIA shows that this trend has continued through July 2009.[8] As described in my direct testimony, the economy, while perhaps resuming some growth, is expected to remain sluggish for some time to come. Thus, I believe it is unlikely that PacifiCorp's earnings will "bounce back" from the depressed, below Company forecast levels to the Company's forecast used in this case.

[8] U.S. Energy Information Administration, "EIA, Form EIA-826, Monthly Electric Utility Sales and Revenues (data through July 2009)." http://www.eia.doe.gov/cneaf/electricity/page/eia826.html last accessed October 22, 2009.

V. CONCLUSION

Q. After reading the Rebuttal Testimony of the Company's witnesses, what conclusions have you reached?

I maintain my point estimate of 10.5 percent as my recommendation for PacifiCorp's cost of equity and 8.26 percent as the overall return on capital as being just and reasonable and supported by substantial market and theoretical evidence.

With regard to the Company's capital structure, I believe that my estimate of 50.5 percent level for common equity is justified and reasonable; indeed it may turn out to be optimistic. The Company's SEC Form 10-Q is expected to be released in the first ten days of November and should shed more light on these earnings forecasts.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes.

CERTIFICATE OF SERVICE

I Hereby certify that on this 22nd Day of October, 2009, I caused to be transmitted electronically (email) a true and correct copy of the Prefiled Sur-Rebuttal PUBLIC Return on Equity Testimony of Charles E. Peterson for the Utah Division of Public Utilities in Docket 09-035-23: In the Matter of the Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of its Proposed Electric Service Schedules and Electric Service Regulations:

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