Docket No. 09-035-23

Utah Office of Consumer Services Witness:

Daniel J. Lawton

Exhibits OCS 1.1 through 1.10

September 17, 2009

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power for Authority to Increase Its Retail Electric Utility Services Rates In Utah and for Approval of its Proposed Service Schedules and Electric Service Regulations	**§**	**Docket No. 09-035-23** **Direct Rate of Return Testimony of Daniel J. Lawton For the Utah Office of Consumer Services**

September 17, 2009

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DIRECT TESTIMONY OF
DANIEL J. LAWTON

SECTION I: INTRODUCTION/BACKGROUND/SUMMARY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 701 Brazos, Suite 500, 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 for reviewing and setting rates. 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 OCS 1.1.

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 OCS 1.1.

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

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

In addition, I will address the risk reduction impacts associated with the proposed Energy Cost Adjustment Mechanism (ECAM) filed in Docket No. 09-035-15, and the impact of new legislation (Utah Code Anno. §54-7-13.4) allowing specific investment recovery for major plant additions.

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

In addition, I will be addressing other factors that impact the Company's risk and return. These issues are raised in the direct testimony of Mr. A. Richard Walje. These factors include (i) fuel cost recovery and (ii) rate mechanisms for including incremental investment recovery. These factors impact the Company by lowering investor risks by assuring revenue recovery, eliminating risk associated with volatile natural gas and wholesale power cost recovery and eliminate or limit regulatory lag and earnings erosion through accelerated investment recovery through single-issue rate recovery proceedings.

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

A. I have reviewed the Company's testimony, 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 on attached schedules and included copies or summaries in my attached schedules or workpapers.

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

A. My analysis of the Company's required cost of capital results in a recommendation of a 10% return on equity for shareholders and an overall return to be earned on rate base

investment of 8.03%. In my opinion, these return levels are consistent with current capital costs and consistent with reasonable rates for consumers. My analyses of the Company's 8.54% overall cost of capital and 11.0% return on equity indicate that the Company request is overstated given current market costs of capital.

Based on my analyses (which are fully explained in the following pages), I make the following conclusions and recommendations:

(i) The Company's required return on equity is 10.0%;

(ii) The Company's overall cost of capital to be earned on rate base investment should be set at 8.03% for setting just and reasonable rates for Utah customers in this proceeding;

(iii) The Company has failed to consider the risk reduction impacts associated with fuel cost recovery and incremental capital cost recovery. When these factors are considered, the equity return consideration should reflect the lower end of the reasonable return range;

(iv) RMP's proposed 11.0% return for equity shareholders is an overstatement of the required return on equity to hold and attract equity capital; and

(v) 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.

SECTION II: CRITIQUE OF COMPANY'S POSITION

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED RATE REQUEST IN THIS CASE.

A. Based on a review of the testimony and the Company's "Application For General Rate Increase", RMP's request can be summarized as an annual increase of about $66.884 million[1] for Utah customers. The request is based on a forecasted test year for the twelve months ending June 30, 2010.[2] The Company has requested an overall cost of

[1] Company "Application for General Rate Increase" at 3.
[2] *Id.*

capital of 8.538%[3] to be earned on a rate base investment level of $4,690,862,116.[4] The Company is requesting a return for equity shareholders of 11.0%.[5]

The Company asserts that the need for the rate increase is driven by the "…significant level of capital investment the Company is making…" on the system.[6]

Q. IN YOUR REVIEW OF THE COMPANY'S FILING, HAVE YOU FOUND THE COMPANY'S REQUEST TO BE OVERSTATED?

A. Yes. Keeping in mind my analyses are limited to the Company's cost of capital, my review indicates that the Company's return request is overstated and if adopted would lead to excessive charges to consumers. Specifically, the Company's requested equity return of 11.0% contained in Dr. Hadaway's testimony exceeds the current cost of equity capital in the market.

Q. DO YOU HAVE ANY GENERAL COMMENTS ON DR. HADAWAY'S ANALYSES?

A. Yes. First, Dr. Hadaway's recommendation in this case of an 11.0% return on equity is an overstatement of the cost of equity. Dr. Hadaway's return is overstated due to reliance on outdated data and his reliance on overstated GDP growth data. Such a return if adopted would lead to excessive, unjust and unreasonable rates for customers.

As I discuss below, Dr. Hadaway's results are overstated for the following reasons:

1. The growth rates employed for the constant growth DCF averaging 6.02% are overstated, outdated and fail to take into account declining expectations of growth during an economic slowdown or recession.

2. The growth rate employed for the long-term GDP growth DCF of 6.2% fails to reflect investor expectations and should be in the range of 5.0% reflecting more recent history.

[3] Direct Testimony of Bruce Williams at 2.
[4] Exhibit RMP_(SRM-2) Page 1.1.
[5] Application at 4.
[6] Direct Testimony of A. Richard Walje at 5:225-227.

3. The long-term growth rates employed in Dr. Hadaway's two-stage DCF suffer from the same infirmities as discussed in (2) above.

4. Dr. Hadaway's risk premium analyses ranging from 10.77% to 11.97% are significantly overstated. These estimates are overstated due to his extremely high estimates of single-A debt costs. When corrected for a realistic risk premium level and/or corrected for a more reasonable estimate of single-A rated debt yield – these risk premium results like the DCF analyses are dramatically reduced.

Overall, despite Dr. Hadaway's attempts to support an equity return estimate of 11.0% the facts just do not support his analysis.

Q. EARLIER YOU STATED THAT DR. HADAWAY'S CONSTANT GROWTH DCF ANALYSIS INCLUDES OVERSTATED GROWTH ESTIMATES. PLEASE EXPLAIN.

A. Dr. Hadaway has relied on earnings per share forecasts of growth from Value Line, Zacks and Yahoo Finance/Thomson to arrive at his 6.02% average growth estimate. At this time, the Zacks and Thomson forecast estimates are overstated by about 20 basis points. Given the economic slowdown one would expect growth forecasts to decline. I expect these growth estimates will continue to decline over the next few months. Further, Dr. Hadaway's dividend yield estimates of 5.5% are also overstated by about 50 basis points.

Q. YOU STATED THAT DR. HADAWAY'S USE OF A 6.20% GDP GROWTH RATE OVERSTATES THAT COST OF CAPITAL. PLEASE EXPLAIN.

A. 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 5.1% 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 5.1%, Dr. Hadaway now takes an average of six different GDP growth period averages as illustrated in Table 1 below:

TABLE 1[7]

SUMMARY GDP GROWTH AVERAGES

10-year GDP average	4.8%
20-year GDP average	5.1%
30-year GDP average	6.1%
40-year GDP average	7.1%
50-year GDP average	7.0%
60-year GDP average	6.9%
Average of periods	**6.2%**

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 5.1% to 6.2%, a 90 basis point increase.

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 60 year averages. It could be argued that more recent GDP growth data is more important, and the 10-year GDP average of 4.8% would be the best GDP proxy of growth. This may be

[7] Dr. Hadaway Direct Testimony Exhibit RMP_ (SCH-3).

especially true given recent Federal Reserve projections of a much lower and declining GDP growth. In my opinion, if the GDP average is to be used as one of the growth rate estimates, then the 20-year average of 5.1% is a reasonable compromise for consideration in this case. This growth estimate is consistent with analyst estimates for earnings and reflects current expectations of declining GDP growth.

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 11.5% - 11.6%.[8] The problem with this analysis is his primary reliance on the faulty 6.2% GDP growth measure. When Dr. Hadaway's results are corrected for a lower GDP growth rate, the results are in the 10.2% range.

Q. PLEASE COMMENT ON DR. HADAWAY'S RISK PREMIUM ANALYSES.

A. Dr. Hadaway presents three risk premium results at page 9 of his Second Supplemental Testimony as follows:

TABLE 2

DR. HADAWAY RISK PREMIUM MODEL RESULTS

Model	Interest Rate	Risk Premium	ROE
Forecasted Interest Rate and Risk Premium	7.99%	3.67%	11.66%
October Interest Rate and Risk Premium	6.47%	4.30%	10.77%
New Debt Interest Rate and Risk Premium	6.47%	3.7% - 5.5%	10.17%-11.97%

As to methods 1 and 2, Dr. Hadaway employs two estimates for single A debt. First, his 7.99% estimate is based on a three month average credit spread (March 09 – May 09) of

[8] Exhibit RMP_ (SCH-4) p.4.

2.59%,[9] which is added to the 5.4% 30 year Treasury Bond forecast.[10]

For his second model, Dr. Hadaway's interest rate (single-A corporate debt) of 6.47% is the actual average March – May 2009 cost rate as shown in his Exhibit RMP__ (SCH-2) page 2.

The problem with these analyses is the overstatement of the single-A debt cost.

I will demonstrate in a subsequent section that the single-A debt cost is in the 5.8% range. If a more reasonable cost of single-A debt were used, such as the 5.8% estimate explained later, Dr. Hadaway's risk premium results would support an equity return of 10%.

Q. PLEASE SUMMARIZE YOUR COMMENTS REGARDING DR. HADAWAY'S EQUITY RETURN PROPOSALS.

A. Dr. Hadaway's analyses overstate the cost of equity and should not be accepted by this Commission to set rates in this case. In my opinion, when Dr. Hadaway's analyses are adjusted to reflect more realistic and normalized estimates – the results indicate a 10% return on equity is appropriate.

SECTION III: REGULATORY ISSUES AND COST OF CAPITAL

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

A. The overall rate of return to be earned on rate base investment is an essential element in the regulatory and rate setting process. The overall return to be earned on rate base investment is typically a major part of overall revenue requirements. For example, in this case the Company's requested overall return is 8.54%.[11]

A small change in return requirements, can have a large impact on revenue requirements. For example, a 50 basis point reduction to the equity return to a level of

[9] Exhibit RMP__ (SCH-2) p.2.
[10] *Id*. at 3.
[11] Direct Testimony Bruce Williams at 2.

10.5% results in about a $19.3 million reduction to revenue requirements. That is almost one third of the entire $66 million rate increase in this case.

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, 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 will 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.

Two U.S. Supreme Court decisions are often cited as the legal standards for rate of return determination. The first is *Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia*, 262. U.S. 679 (1923). The *Bluefield* case established the following general standards for a rate of return: The return should be sufficient for maintaining financial integrity and capital attraction and a public utility is entitled to a return equal to that of investments of comparable risks.

The second U.S. Supreme Court decision is the *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1942). In the *Hope* decision, the Court affirmed its earlier *Bluefield* standards and found that methods for determining return are not the test of reasonableness rather the result and impact of the result are controlling.

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

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 regulator to determine the utility's cost of capital for debt, preferred stock and equity costs. These calculations of cost rates, 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 ("DCF") 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 Capital Asset Pricing Model ("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.

SECTION IV: CURRENT CAPITAL MARKET CONDITIONS

Q. DO CURRENT ECONOMIC CONDITIONS WARRANT HIGHER RETURNS FOR UTILITY COMPANIES?

A. In my opinion, no. While the markets have been struggling since September 2008, government intervention has had an impact. I discuss this issue in the following pages. The end result is that cost of capital today is not higher as a result of the economic turmoil that impacted the global markets.

Q. ARE CURRENT ECONOMIC CONDITIONS CONTINUING TO DECLINE IN 2009?

A. The impacts of the global recession continue through 2009. The U.S. and global financial markets continue to struggle with liquidity issues following the collapse of the subprime mortgage markets. The Federal Reserve and central banks around the world have been ramping up lending in an all out effort to keep the financial markets functioning.

The Federal Reserve Chairman, Ben Bernanke, predicted that the global financial markets crisis will restrain U. S. economic growth through 2009. That prediction continues to be accurate. Thus, while inflation issues have receded, economic

conditions have limited prospects of economic growth. The Federal Reserve has taken numerous steps to address financial market liquidity issues including the cut in the federal funds rate to a target range of 0% to 0.25% as of December 16, 2008. These rates were recently reaffirmed by the Federal Reserve. I have included in my Exhibit OCS 1.2, monthly bond yields for various securities showing changes by month since January 2006 through August 2009.

Q. DO YOU HAVE ANY GENERAL OBSERVATIONS CONCERNING THE RECENT TRENDS IN ECONOMIC CONDITIONS AND THE IMPACT ON CAPITAL COSTS?

A. Yes. As a general matter the U.S. economy has enjoyed growth, prosperity and stability since the early 1990's. Over this time period there has been a general level of economic expansions accompanied by historical low levels of inflation and interest rates.

Now, the economy has slowed significantly at least initially as a result of the "sub-prime" mortgage problems and more recently as a result of the liquidity crisis in the financial markets. Moreover, the economic slow down is having global impacts as can be seen in declining energy prices (natural gas, oil) as well as general commodity prices. The financial sector crisis intensified through the last quarter of 2008, following the collapse and/or bailout of such institutions as Bear Stearns, Lehman Brothers, Merrill Lynch, Freddie Mac, Fannie Mae, AIG and Citigroup, Inc. The U.S. Government and governments around the world have been and continue to employ unprecedented monetary actions to minimize the impacts of the financial crisis on economic growth. While the impacts of these government rescue efforts and other monetary policy actions have not yet resolved all the tight credit market problems – that does not mean there has been no impact or continued impact.

The one sure thing is that an economic slowdown has occurred and is expected to continue. For this reason economic growth will be lower than past forecast estimates have suggested. This is true across all economic sectors including the utility industry. Thus, while utility stock prices may be lower and dividend yields higher – the other side of the coin shows lower economic growth expectations by investors.

Q. PLEASE DISCUSS THE FINANCIAL MARKETS, THE ECONOMY AND THE GENERAL RESPONSE OF THE U.S. GOVERNMENT.

A. There is no question that the mortgage market collapse, subprime mortgage crisis, credit/liquidity crisis, economic recession and the subsequent bailout and restructuring of financial institutions has not only had tremendous impacts on the U.S. national economy, but global economic implications as well. After initial problems developed in the mortgage market, these problems associated with the subprime developed into a crisis which led to the collapse and need for bailout of certain financial institutions. The turmoil in the U.S. markets peaked in the third-quarter of 2008. During the summer of 2008 commodity prices increased sharply with a barrel of oil increasing to over $150 and natural gas exceeding $12 mmbtu.

The U.S. economy entered the current recession in late 2007 and unemployment figures have been increasing. As of August 2009, the unemployment rate is at about 9.5% and 10% or more unemployment rate is forecast by many analysts. Commodity prices have declined, but have rebounded from first quarter 2009 lows. The stock market for 2009 hit a low in March, but has since rebounded from March 2009 levels. The change in course regarding commodity prices and the market downturn from early 2009 levels is some evidence that the downward economic slide is over. While unemployment figures lag other economic indicators.

In response to the economic crisis, the Federal Reserve has taken extraordinary and substantial measures to stabilize financial markets and address the significant resulting liquidity crisis. Among the numerous Federal Reserve measures is the opening of lending facilities to numerous banking and investment firms to free up tight credit markets. The development of the Troubled Asset Relief Program ("TARP") is designed to provide over $700 billion in government funds into the banking system through capital infusions. In addition, the federal government has added billions of additional dollars to bail out and stabilize such prominent financial institutions as AIG, Citigroup and Bank of America. The federal government has expended substantial sums to bailout other industries such as the auto industry with cash for General Motors and Chrysler.

As part of the overall budget process, we have seen the federal government provide

almost $800 billion of economic stimulus – including tax cuts and additional government spending aimed at creating jobs and addressing the overall economic slowdown.

Q. HOW HAVE THE FINANCIAL MARKETS RESPONDED TO THE ACTIONS OF THE FEDERAL RESERVE AND OTHER STIMULUS ACTIONS?

A. The long-term credit market response has been significant over the first two quarters of 2009. The credit/liquidity crisis is associated with concerns and reluctance by credit providers to provide needed capital due to concerns over the weak economy. As shown in Exhibit OCS 1.2, interest rates on BBB corporate rated bonds increased substantially, about 7.0% in June 2008 to over 9.0% in November 2008. Since the November 2008 peak in the midst of the liquidity crisis, BBB corporate rated bonds have steadily declined. Now, for August 2009, BBB corporate rated bonds have averaged about 6.58%[12] or are at levels seen just prior to the liquidity crisis. Current BBB corporate bond yields in early September are between 6.3% and 6.5% as of September 9, 2009, and have continued at or around the 6.5% level into September.

Further, yields on Treasury Bonds, for 30 year, 20 year and 10 year are at levels in August 2009 that the market experienced in May and June 2008 – just prior to the economic credit squeeze. Also, like BBB corporate bonds, the AAA corporate bond yields are back to the pre-credit/liquidity crisis levels. These historical bond yields are shown in Exhibit OCS 1.2.

In summary, the market evidence appears to demonstrate that the massive government response has had the desired effect on credit markets. Actions by the Federal Reserve and the current administration show a continued commitment to restoring the economic health quickly. But, while the worst of the credit crisis may be over, the U.S. economy has continued to contract, albeit at a slower rate of decline. Economic recovery is expected to gain momentum slowly with some economic segments growing more slowly than others.

[12] www.federalreserve.gov/releaseh15date/weekly

Thus, while the economy is slowly changing course in terms of economic growth, the upheaval in financial markets is an event of the past as we see interest rates and capital costs moving to pre-financial crisis levels.

Q. WHAT CONCLUSIONS DO YOU DRAW FROM CURRENT ECONOMIC CONDITIONS IN PROVIDING GUIDANCE IN SETTING EQUITY CAPITAL COSTS IN THIS PROCEEDING?

A. As a general matter capital costs remain low in comparison to historical levels. While the bottom tier of corporate bond rates (BBB) increased since September 2008 – such increases do not appear to be a trend, but rather the direct impact of an atypical event in the capital markets. The economic slowdown or recession will cause general investor expectations of growth to decline. The bottom line is that the general economic data does not support increasing capital costs. Further, it is not sound ratemaking to establish revenue requirements and rates on atypical or abnormal events – especially when such events (continuation of the financial liquidity crisis) are not likely to continue to be repeated.

SECTION V: COST OF EQUITY CAPITAL DCF ANALYSIS

Q. YOU STATED ABOVE THAT YOU RELIED ON A DCF ANALYSIS. PLEASE DESCRIBE HOW YOU CONDUCTED YOUR DCF ANALYSIS.

A. For my DCF analyses I employ a comparable risk group of companies because there is no market financial data for RMP. The Company is a division of PacifiCorp which is a wholly owned subsidiary of MidAmerican Energy Holding Company. Thus, without financial data a DCF analysis cannot be computed directly on RMP or for that matter PacifiCorp. The comparable risk group of companies for which there is market data available serves as a proxy for RMP.

I applied the DCF method employing market data, as well as forecasted data of various financial parameters to a comparable group of nineteen electric utility companies. The comparable group of nineteen utility companies employed in my analysis comes from the same group of companies used by RMP's witness Dr. Hadaway in this case. 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. I discuss in detail in Section II the problems I have with Dr. Hadaway's specific cost of equity analyses.

Q. WHY HAVE YOU EXAMINED COMPARABLE ELECTRIC COMPANIES?

A. There are several reasons why the estimate of a cost of capital requires an analysis of a group of comparable risk companies rather than the single firm subject of the analysis:

(1) A comparable risk group analysis is consistent with the requirements of a fair and reasonable return addressed in the *Hope* and *Bluefield* cases. The return on investment should be commensurate with returns earned by firms with comparable risk. Thus, there is a need to examine firms of comparable risk to identify the fair and reasonable comparable returns being earned. In addition, the equity returns of comparable firms are viewed as opportunity costs of forgone investments in the market which, like other investment opportunities, will directly impact the cost of equity of the Company.

(2) The reliability of the cost of equity estimate is enhanced when the calculation is based on equity capital estimates from a variety of risk equivalent companies. A group of comparable companies can be employed as a check on a single company analysis. Further, the comparable group analysis, whether employed as a check or the primary analysis, mitigates any distortions resulting from measurement errors in dividend yield and expected growth measures and estimates. For example, the average growth rate estimate based on forecasts of several comparable firms is less likely to deviate from investor expectations of growth than an estimate for a single firm. Moreover, the general assumptions underlying the DCF model are more likely to be met for a group of companies than for a single firm.

(3) An analysis of a comparable group also avoids circularity problems. In the analysis of investor-owned utilities, the stock price (that is, the cost of capital) is a direct function of an investor's growth rate expectations, which is also a function of an investor's perception of the regulatory environment. The bottom line is that the cost of equity depends in part on the anticipated regulatory

environment and actions. Thus, both the components of the DCF model – dividend yield and growth expectations – are influenced by the regulatory process.

(4) Extending the sample size of comparable companies beyond a single regulatory influence will mitigate the regulatory circulatory problem. Specific conditions concerning a subject utility often requires that a comparable company analysis be employed. One of the most common conditions is the lack of market data necessary to perform a DCF analysis. In times of utility consolidation and merger, many electric utilities are owned and controlled by a single parent holding company, which is the case with RMP.

Q. HAVE YOU PROVIDED A LISTING OF THE COMPANIES IN THE COMPARABLE GROUP?

A. Yes. Contained in my Exhibit OCS 1.3 is a list of the nineteen companies in the comparable group along with additional data of company Beta and projected equity ratio for 2009, 2010 and 2014.

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 percent 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 used for each of the companies in the comparable group is contained in my Exhibit OCS 1.4.

As I discussed earlier there has been substantial volatility in the market during the first part of October 2008 through March 2009 due to impacts associated with the current financial market crisis. For these reasons I have examined stock prices for 6 week, 8 week, 12 week, 52 week, and spot intervals to calculate a representative price for the dividend yield calculation.

To calculate dividends, I employed the current annualized dividend increased for ½ the growth rate. The resulting dividend yield is shown on my Exhibit OCS 1.4 for the comparable group.

Q. HOW DOES YOUR DIVIDEND YIELD CALCULATION COMPARE TO DR. HADAWAY'S ESTIMATES?

A. As shown on my Exhibit OCS 1.4 the comparable group average dividend yield is between 4.95% and 5.1%. Dr. Hadaway's analysis shown in his Exhibit RMP (SCH-4) shows a dividend yield range for the comparable group of 5.52% to 5.57%.

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.

Implementation of the DCF model requires the exercise of considerable judgment with regards to estimating investor expectations of growth and it is a difficult task, but such difficulties are not insurmountable. Many factors affect capital markets in general and individual stocks specifically, investors are aware and informed of current economic conditions and expectations. Such economic variables entail the current state of the economy, the trade deficit, federal budget uncertainty, fiscal policy, inflation and Federal Reserve Board policies on interest rates.

Investors generally have good information on the economic and financial variables outlined above. All of this information is available quickly, especially in recent decades with easy access to the worldwide web. This information influences return expectations and, as a result, the maximum price an investor will pay for various securities.

Like the information available on the general economy, investors also have access to a wealth of information about particular types of securities, industries and specific company investments. This information is also factored into investor expectations and therefore the stock price individuals are willing to pay.

Common earnings growth rate forecasts and historical growth rate data may be found in the Value Line Investment survey ("Value Line") publication. These Value Line earnings estimates are five year projections in annual earnings. Again, Value Line is widely available to the public, and is a good source of earnings projections. Other earnings estimates are forecasted by Zacks as well as First Call projections, widely available on the internet at Zacks.com and Yahoo Finance respectively. Those earnings projections along with other stock specific financial data provide a range of estimates of earnings and are readily available at no cost.

Another growth estimate is referred to as the sustainable growth or retention ratio growth estimate. To project future growth in earnings under the sustainable growth method, one multiplies the fraction of a firm's earnings expected to be retained (not paid out as dividends) by the expected return on book equity. As a formula:

(growth = b x r)

Where:

b =1-(dividends per share/earnings per share)

r =earnings per share / net book value share

All the data necessary to calculate the elements of the sustainable growth method are available on a forecasted basis in Value Line.

Q. PLEASE EXPLAIN YOUR GROWTH RATE ANALYSIS.

A. I have included in my Exhibit OCS 1.5 the growth rates I have reviewed in my analysis. The first set of growth rates examined is the five year and ten year historical growth rates in earnings per share, dividends per share, and book value per share as reported by Value Line. The second set of growth rates is the Value Line forecasted growth rates in earnings per share, dividends per share, and book value per share for each company in the comparable group. The third set of growth rates examined is the Zacks forecasted growth rates in earnings. The fourth growth estimate considered is the First Call growth rates which are readily available to investors at Yahoo Finance.

In addition, I have examined the growth rates based on the forecasted retention ratio growth estimate discussed above. These calculations are included in my Exhibit OCS 1.5.

The growth rates described above provide a range of estimates for each of the comparable companies. The resulting range of average growth rates for the group is from 4.75% to 5.92% when looking at internal growth forecasts and earnings per share ("EPS") forecast estimates for the comparable group. Relying on the combined forecasted earnings per share estimates and internal growth rate estimates, the growth rate average range can be narrowed to 5.66% to 5.79% as shown in Exhibit OCS 1.5.

Q. HOW DO THESE GROWTH RATES COMPARE TO GROWTH ESTIMATES EMPLOYED BY DR. HADAWAY?

A. Reviewing Dr. Hadaway's Exhibit RMP (SCH-4) page 2 of 5, it appears Dr. Hadaway has relied upon a 6.02% growth average for the comparable group. Recent estimates for Value Line, Zacks and Yahoo Finance indicate Dr. Hadaway's estimates are both outdated and overstated. The end result is Dr. Hadaway's estimates should not be relied on in this case.

Q. PLEASE SUMMARIZE YOUR CONSTANT GROWTH DCF ANALYSIS.

A. I have summarized these results in my Exhibit OCS 1.6. For the comparable group based on an average yield and a growth rate, the ROE estimate based on the comparable group is 10.4% to 10.6%. Employing the midpoint of the range for these estimates results in an ROE estimate of 10.5%.

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

A. Yes. I have calculated a two stage non-constant growth DCF analysis for the comparable group companies.

Q. PLEASE DESCRIBE YOUR TWO-STAGE NON-CONSTANT GROWTH DCF.

This analysis calculates equity cost using a non-constant growth Two Stage DCF Model. The constant growth DCF model is often adjusted to reflect multiple growth

assumptions because the constant growth rate assumption is often not consistent with investor expectations. As an example, it is often the case where short-term growth estimates are not consistent with long-term sustainable growth projections. In those instances, where more than one growth rate estimate is appropriate, a multi-stage non-constant growth model can be employed to derive a cost of capital estimate. In other words, the constant growth model is adjusted to incorporate multiple growth rate periods, assuring a constant growth (long-term) rate is estimated for a longer period.

For the first growth stage (years 1-4) of the model, the Value Line growth in dividends is employed and an annual dividend is calculated. The second stage (years 5 and beyond)[13] an earnings growth estimate based on the comparable group average of 5.3% is employed. The 5.3% growth estimate is the average of the EPS estimates and internal growth estimates. This long-run earnings estimate is based on the average of the endpoint estimates for Value Line, Zacks, and First Call earnings forecasts along with the internal growth estimate.

In the two-stage model the dividend cash flows are discounted equal to the price[14] paid for the stock. The calculated discount rate or internal rate of return is the cost of equity capital estimate.

Q. WHAT ARE THE RESULTS OF THE TWO-STAGE NON-CONSTANT GROWTH DCF ANALYSIS?

A. The results of the two-stage non-constant growth DCF analysis are shown in Exhibit OCS 1.7. The comparable group average indicates a cost of equity of 10.2% and 10.25%.

Q. PLEASE SUMMARIZE YOUR DCF ESTIMATES.

A. The table below is a summary of the DCF results:

[13] The model is ended at year 150.
[14] Price is based on the 6 week average discussed earlier.

TABLE 3

SUMMARY OF COMPARABLE GROUP DCF ANALYSES

Description	COMPARABLE GROUP	MIDPOINT
Constant Growth DCF	10.4-10.6	10.5
Non-Constant Growth Two Stage DCF	10.2-10.25	10.25

This range of estimates of 10.2% to 10.6% indicates a cost of equity of about 10.4% for the group.

SECTION VI: RISK PREMIUM/CAPM COST OF EQUITY ESTIMATE

Q. PLEASE DESCRIBE THE RISK PREMIUM ANALYSIS.

A. Debt instruments such as bonds (long-term debt) are less risky than common equity when both classes of capital are issued by the same entity. Bondholders have a prior contractual claim to the earnings of the corporation and returns on bonds are less variable and more predictable than stocks. The bottom line is that debt is less risky than equity. There are numerous return studies of capital market investments, all of which show lower returns with lower risks and higher returns with higher risk investments. These financial truisms provide a sound theoretical basis and foundation for the risk premium method for estimating equity costs. The risk premium approach is useful in that the analysis is based on current market interest rates, that is, the current observable cost of debt capital. But, the risk premium approach is not without its problems and drawbacks. In practice, there is considerable debate as to the time period to analyze in the determination of the bond/equity return risk spread. Historical debt/equity risk spreads measured over many decades may not be relevant to current capital market requirements. Others argue that a long-term analysis is necessary, since the goal is to measure investors' long-term expectations.

Another version of the risk premium method is the capital asset pricing model ("CAPM"). Generally, the CAPM begins with a theoretically risk-free interest rate such as a three-month Treasury bill rate. The risk premium, or equity spread above and

beyond the risk free rate is adjusted by the stock beta.[15] The risk free return measure is combined with the equity risk premium adjusted for the measure of beta to arrive at a CAPM result.

Like the risk premium discussed above, the CAPM is subject to measurement uncertainties. First, the general problem of how to measure the equity risk premium and the time period for which the premium is analyzed is subject to considerable debate. This problem and associated criticisms is generic to all variants of the risk premium model. Second, measures of beta are often unstable from period to period and may not reflect the equity risk spread measure.

For all of the above reasons, risk premium methods should be viewed with considerable caution. The risk premium analysis and CAPM described below consists of analyses of shorter time horizons and are employed as a check on the DCF results described earlier.

Q. HOW DID YOU CALCULATE YOUR RISK PREMIUM ANALYSIS?

A. For the calculation of risk premium I employed the basic analysis presented in Dr. Hadaway's Direct Testimony at Exhibit RMP__(SCH-5) page 1 of 2. This analysis is updated and corrected for a more reasoned estimate of expected single-A bond yield. I outline the calculations in my Exhibit OCS 1.8. Employing a single-A debt rate of 5.82% and a 4.57% risk premium, results in a risk premium estimate of 10.39%.

Q. DID YOU CALCULATE AN ALTERNATIVE RISK PREMIUM?

A. Yes. An alternative analysis entailed calculating a risk premium based on the difference between returns on stocks (9.6%) and the returns on long-term corporate bonds (5.90%) for the period covering 1926 – 2008 as reported in the 2009 Stocks, Bonds and Inflation Classic Yearbook published by Morningstar, Inc. The resulting risk premium is 3.70% (9.6% - 5.9%=3.7%) employing the geometric mean average returns. Combining a 3.70% risk premium and a 5.82% single-A debt rate results in a 9.52% ROE based on a risk premium approach.

[15] Beta is a measure of the volatility of the specific stock movement relative to that of a market measure such as the S&P 500. A beta below 1.0 means that a specific stock is less volatile than the market measure, while a beta above 1.0 indicates a specific stock is more volatile than the market measure.

Employing the arithmetic returns the risk premium results are about 11.32% as shown in my Exhibit OCS 1.8.

Q. HOW DID YOU ARRIVE AT AN ESTIMATE OF THE SINGLE-A DEBT RATE?

A. To arrive at the single-A debt rate I combined a 139 basis point spread for single-A debt to the 30-year U.S. Treasury rate. To estimate the single-A utility spread of 139 basis points, I employed the average spread for the January 2007 through May 2008 period. This period is just prior to the liquidity crisis and represents a sufficient period without abnormal market conditions. I then combined this 139 basis point spread with the current three month average 30-year U.S. Treasury average of 4.43% to arrive at a 5.82% estimate for single-A bonds.

CAPITAL ASSET PRICING MODEL ANALYSIS

Q. PLEASE DESCRIBE THE CAPITAL ASSET PRICING MODEL.

A. The Capital Asset Pricing Model ("CAPM") is a version of the risk premium approach described above. The CAPM measures the relationship between a specific security's investment risk and its return. The general mathematical form of the CAPM can be described as follows:

$$K=RF+B(RM-RF)$$

Where: K = cost of equity
Rf=risk free return
Rm=return on market
B=Beta
Rm-Rf= market risk premium

Q. HOW HAVE YOU CALCULATED YOUR CAPM ESTIMATES?

A. I have applied the CAPM to each company in the comparable risk group as is shown in my Exhibit OCS 1.9. For the risk free rate, I have employed a three month average yield (June 2009 – August 2009) for 30 year U.S. Treasury bonds which is shown in my

Exhibit OCS 1.2. Over the 3 month period 30 year Treasury bonds had an average yield of 4.43%.

The market risk premium component (Rm-Rf) represents the investor expected risk premium over the risk free return. For this calculation I have relied on the 2009 Morningstar yearbook which provides long-term (1926-2008) market and government bond returns. The market return over this time horizon is 9.6%[16] while the long-term government bond return is 5.7%[17] resulting in a risk premium of 3.9% based on the geometric average return calculation. I also ran the calculation employing arithmetic average returns which show a market return (1926 – 2008 of 11.7%[18] and a long-term government bond return of 6.1%[19] resulting in a risk premium of 5.6%.

Q. PLEASE DESCRIBE THE BETA YOU EMPLOYED IN YOUR CAPM ANALYSIS.

A. Beta is a measure of specific stock volatility relative to a market index. Betas less than 1.0 move less than the market while Betas greater than 1.0 have more movement or volatility relative to a market index. For this case I employed the Value Line Betas for each company in the comparable group. These Value Line Betas are shown in my Exhibit OCS 1.3.

Q. WHAT ARE THE RESULTS OF YOUR CAPM ROE ESTIMATES?

A. My analysis for CAPM is contained in my Exhibit OCS 1.9. The CAPM result is in the 7.1% range using the geometric average and 8.07% employing the arithmetic average risk premium. Given current debt costs, I believe the CAPM results are low and not reasonable estimates of equity costs, given current BBB bond rates of 6.6%.

Q. DID YOU ESTIMATE AN ALTERNATIVE CAPM CALCULATION OF EQUITY RETURN?

A. Yes, I calculated an alternative estimate employing an empirical version of the CAPM or

[16] Morningstar at 31
[17] *Id.*
[18] *Id.*
[19] *Id.*

ECAPM. It is argued that the CAPM estimate of equity cost will underestimate the return required for low-beta securities and overstate the required return for high-beta securities.

To address the flaws of the CAPM, the alternative ECAPM estimates the cost of equity employing the following equation:

$$ROE=R_f + \alpha + (\beta\ \alpha\ (R_m-R_f)$$

Where (α) is the measure of the constant of a risk return line. Typically, an (α) value of 1% to 2% is employed in the ECAPM analysis resulting in a more conservative estimate of equity return. Employing a 1% (α) value results in the following ECAPM:

$$ROE=R_f+.25\ (R_m-R_f) + .75\ \beta(R_m-R_f)$$

I have made these calculations in my Exhibit OCS 1.9.

Q. WHAT ARE THE RESULTS OF YOUR ECAPM ANALYSES?

A. The ECAPM estimates employing the geometric average and arithmetic average risk premium estimates are 7.3% and 8.6% respectively. Given current BBB bond rates are in the 6.6% range, only the higher end of these estimates of 8.6% should be considered as reasonable estimates of current equity costs.

Q. PLEASE SUMMARIZE YOUR DCF, RISK PREMIUM AND CAPM ANALYSES?

A. The following table summarized the cost of equity results for each analysis:

TABLE 4

COST OF EQUITY CAPITAL SUMMARY

Model	Range	Midpoint
Constant Growth DCF	10.43% - 10.62%	10.53%
Two-Stage DCF	10.20% - 10.25%	10.2%
ECPAM	8.55% - 8.56%	8.6%
Risk Premium	9.52% - 10.39%	9.96%

The relevant range of results indicates a cost of equity from 9.5% to 10.5% with 10.0% as a midpoint.

SECTION VII: CAPITAL STRUCTURE

Q. WHAT CAPITAL STRUCTURE IS THE COMPANY PROPOSING IN THIS PROCEEDING?

A. Based on the Direct Testimony of Company witness Bruce Williams, RMP is proposing the following capital structure, cost rates and overall cost of capital to be earned on rate base investment:

TABLE 5[20]

ROCKY MOUNTAIN POWER

OVERALL COST OF CAPITAL

Description	Percent	Cost	Weighted Cost
Long-Term Debt	48.7%	5.98%	2.91%
Preferred Stock	0.3%	5.41%	0.02%
Common Equity	51.0%	11.00%	5.61%
Total	100.00%	-	8.54%

Thus, the Company requests an overall cost of capital to be earned on rate base investment of 8.54% in this case.

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

[20] Direct Testimony Bruce Williams at 2:41.

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, 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. HOW DOES THE COMPANY'S PROPOSED CAPITAL STRUCTURE WHICH INCLUDES A 51.0% EQUITY RATIO COMPARE WITH THE CAPITAL STRUCTURE RATIOS OF THE COMPARABLE RISK COMPANIES?

A. The Company's proposed capital structure compares quite favorably to the equity ratios in the comparable risk group. As can be seen from Exhibit OCS 1.3 the comparable group equity ratio averages 48.4% for 2010, while RMP has an equity ratio of 51.0% for

the test year ending June 2010. Thus, RMP has less financial risk than the comparable group companies.

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 the 12 months ending June 30, 2010, the test year is 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 revenue requirement and capital structure.

Q. WHAT CAPITAL STRUCTURE AND COST RATES ARE YOU RECOMMENDING THAT THE COMMISSION ADOPT IN THIS CASE?

A. I am recommending that the Commission approve the Company's proposed capitalization levels for the test period ending June 30, 2010, but I also recommend that the common equity cost rate be reduced to the 10.0% level I recommended earlier in this testimony.

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

TABLE 6[21]

RECOMMENDED OVERALL COST OF CAPITAL

FOR ROCKY MOUNTAIN POWER

TEST YEAR ENDING JUNE 30, 2010

Description	Ratio	Cost	Weighted Cost
Long-term Debt	48.7%	5.98%	2.91%
Preferred Stock	0.3%	5.41%	0.02%
Common Equity	51.0%	10.00%	5.10%
Total	100.0%	__	8.03%

As can be seen from the above table when the long-term debt cost rates and common equity cost rates reflect current market conditions, the Company's overall cost of capital is 8.03%.

SECTION VIII: FINANCIAL INTEGRITY

Q. WILL YOUR RECOMMENDED RETURN PROVIDE THE COMPANY SUFFICIENT CASH FLOW AND FINANCIAL METRICS TO MAINTAIN ITS FINANCIAL INTEGRITY?

A. Yes. Based on the capital structure above, my recommended overall cost of capital (which is based on a 10.0% ROE) provides sufficient financial metrics for the Company.

Q. WHAT FINANCIAL RATIOS OR FINANCIAL METRICS SHOULD THE COMMISSION CONSIDER WHEN EVALUATING COST OF EQUITY?

A. In my opinion, the Commission should consider the financial metrics that bond rating

[21] It should be noted that I have included a 10% equity return without considering that RMP's ECAM proposal will be adopted by this Commission.

agencies consider in evaluating credit risk to a Company. Three key financial metrics involve cash flow coverage of interest, cash flow as a percentage of debt, and debt leverage ratio.

Q. HOW ARE THESE FINANCIAL RATIOS CONSIDERED AND CALCULATED?

A. Ratings agencies such as Standard & Poor's develop rating guidelines that make explicit general ratings outcomes that are typical or expected given various financial and business risk combinations. A rating matrix or guideline is just that, a guideline, not a rule written in stone that guarantees a particular rating for a particular achieved financial metric level.

Funds from a company's operations, in other words cash flow, are very critical to any rating/risk consideration. Interest and principal obligations of a company cannot be paid out of earnings if earnings are not cash. Thus, analyses of cash flow reveal debt servicing ability.

Debt and capital structure considerations are indicative of leverage and flexibility to address financial changes. The liquidity crisis that hit all markets and industries starting last year is an example of the importance of financial flexibility. Stable and continuous cash flows provide financial flexibility.

Each of these financial ratios is calculated in my Exhibit OCS 1.10 employing my recommendations in this proceeding. The results of my analyses indicate strong financial metrics.

The resulting financial metrics at a 10% equity return are consistent with a solid single A bond rating.

SECTION IX: RISK MITIGATION MEASURES AND MECHANISMS

Q. WHAT ISSUE(S) ARE YOU ADDRESSING IN THIS SECTION OF YOUR TESTIMONY?

A. In this section I address two specific risk mitigation measures that, if employed by the Company, will result in lower risk and capital cost going forward. I have previously addressed the Company's capital costs and concluded a 10% equity return is appropriate given known and measurable facts, but as I discuss below, the Company may employ risk mitigation measures going forward. The impact of such risk mitigation measures, if approved by this Commission and employed by the Company, will lower the Company's risk and lower the Company's cost of capital.

Q. PLEASE DESCRIBE THE TYPE OF RISK MITIGATION MECHANISM THE COMPANY IS PROPOSING ON A FORWARD LOOKING BASIS?

A. First, at page 17 of Mr. Walje's testimony he discusses opportunities for RMP to include major plant additions in rates without the need of filing a complete rate proceeding. Such single issue proceedings would be filed under the newly-enacted Utah Code Ann.§54-7-13.4 "Alternative cost recovery for major plant addition."

Second, in RMP's filing in Docket No. 09-035-15, the Company is requesting an ECAM or fuel and purchased power adjustment mechanism. Currently, the Company collects fuel and purchased power costs through a Net Power Cost factor which is based on an estimate or forecast of future costs.

Q. DOES THE COMPANY CLAIM IT FACES RISKS UNDER THE CURRENT METHOD OF FUEL AND PURCHASED POWER COST RECOVERY?

A. Yes. In Docket No. 09-035-15, RMP witness Bruce Williams states:

> …the Company's net power costs are exposed to substantial volatility. This volatility could result in significant under recovery of costs. …for example nearly $400 million during 2007 and 2008… This under-recovery has contributed to what is generally seen by rating agencies as "weak" cash flow

metrics.[22]

Mr. Williams goes on to state: "…the right type of fuel and purchased power adjustment mechanism would go a long way in controlling the risk of volatility in net power costs, earnings and resulting cash flow."[23]

Thus, the Company has proposed a recovery mechanism for fuel and purchased power, ECAM, that will assure recovery of these costs – no matter the sales or energy prices.

Q. PLEASE DESCRIBE HOW THE NEW STATUTE, UTAH CODE 57-7-13.4, WILL LOWER RISK.

A. The Company will have the ability to include the costs associated with major plant additions in rates without the need of filing a major rate proceeding. Such plant addition mechanisms allow the matching of cost recovery with in-service dates and eliminate the impacts of regulatory lag and earnings erosion that may occur when plant additions are completed. Again, this reduces the Company's risk of regulatory lag and earning erosion.

Q. WHAT FACTORS WILL BE CONSIDERED REGARDING CREDIT QUALITY IF THE ECAM AND OTHER RISK MITIGATION MEASURES ARE APPROVED?

A. The key factor that will be considered as it relates to credit quality is that risk associated with regulatory lag and earnings erosion will be shifted from shareholders to customers.

Q. WILL THE IMPLEMENTATION OF THE PROPOSED ECAM AND MAJOR PLANT ADDITIONS GUARANTEE THAT THE AUTHORIZED EQUITY RETURN WILL BE EARNED?

A. No. If approved by the Commission the implementation of the proposed ECAM and major plant additions would assure that the authorized revenues subject to these mechanisms, which include the Company's authorized return on investment, will be collected.

[22] Docket No. 09-035-15, Supplemental Direct Testimony of Bruce Williams at 3:67-4:73.
[23] *Id.* at 5:100-103.

Q. HOW SHOULD THE COMMISSION CONSIDER THESE RISK MITIGATION MEASURES IN SETTING EQUITY RETURN?

A. In my opinion, when setting the equity return in this proceeding the Commission should be mindful of these factors. For example, Mr. Walje makes clear in his testimony that the Company fully intends to take advantage of section 54-7-13.4 for at least two projects.[24] Further, given Mr. Walje's testimony at pages 23-24, the Company fully anticipates taking full advantage of the ECAM for collecting future fuel costs.

Given the risk reduction impacts that will inure to the benefit of the Company when such risk reduction mechanisms are employed – an equity return at the lower end of the reasonable estimates may be most appropriate when setting rates in this case.

SECTION X: CONCLUSION

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

A. The Company's requested 11.0% return on equity is overstated. A more reasoned cost of equity analysis results in a required return on shareholder equity of 10%. These recommended adjustments results in an overall cost of capital of 8.03% in this case.

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 8.03% overall cost of capital provides coverage ratios of 3.71x and 2.76x for pretax and after-tax interest coverage respectively. In my opinion, these coverage ratios are sufficient for the Company to maintain financial integrity.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[24] Direct Testimony of A. Richard Walje at 17:387-394.