Introduction and Summary of Rebuttal Testimony

Q. Please state your name and affiliation.

A. My name is Samuel C. Hadaway. I previously filed direct testimony in this proceeding on behalf of Rocky Mountain Power (hereinafter RMP or the Company).

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the return on equity (ROE) recommendations of Division of Public Utilities (Division) witness Mr. Charles E. Peterson and Office of Consumer Services (OCS) witness Mr. Daniel J. Lawton. In my analysis, I will evaluate their rate of return recommendations and demonstrate that their recommendations are below the cost of equity for RMP. I will also respond to these witnesses' comments on the methodology that I used in my direct testimony to estimate RMP's cost of equity, and I will update my ROE analysis for current market costs and conditions.

Q. What are the parties' ROE recommendations?

A. Mr. Lawton recommends an ROE of only 10.0 percent. His ROE is more than 50 basis points below the ROE established in RMP's previous rate case from 2008 and 52 basis points lower than the most recent average ROE allowed by other regulators around the country during the second quarter of 2009. (See my Table 3 below.)

Mr. Peterson recommends an ROE of 10.5 percent, but he combines that ROE with a reduction to the equity percentage of capital in RMP's capital structure. That combination reduces the overall allowed rate of return, which

effectively reduces the Company's opportunity to earn the ROE he recommends. RMP witness Mr. Bruce N. Williams will address Mr. Peterson's proposed adjustment to the common equity ratio.

I continue to support an ROE of 11.0 percent. My updated discounted cash flow (DCF) analysis indicates an ROE range of 11.0 percent to 11.5 percent, as compared to the DCF range in my June 23, 2009 direct testimony of 11.5 percent to 12.0 percent. My updated risk premium analysis indicates a range of 10.47 percent to 11.21 percent, as compared to my initial risk premium range of 10.77 percent to 11.66 percent. This analysis shows that my initial ROE recommendation was extremely conservative, given then existing market conditions, and that 11.0 percent remains a conservative estimate of PacifiCorp's cost of equity capital.

Q. What is your general assessment of the other parties' rate of return positions?

A. The other parties' recommendations are below RMP's cost of equity capital. Their ROEs appear to be based on a mistaken belief that the cost of equity has declined directly with the yields on high quality debt (Lawton at 3-4, Peterson at 9). While it is true that utility interest rates have dropped from the high levels they reached in late 2008, the Company's requested ROE was below my DCF estimates and was never based on those extreme data. Even though my initial DCF analysis, prepared in May of 2009, indicated an ROE range of 11.5 percent to 12.0 percent and portions of my risk premium analysis produced ROE estimates above 11.5 percent, I estimated and the Company requested an ongoing cost of equity capital

at 11.0 percent. Additionally, my updated analysis shows that utility stock prices remain depressed, that dividend yields remain high, and that the DCF model based on these factors indicates higher, not lower, ROEs than existed a year ago. [1]

Although Mr. Lawton recommends an ROE of only 10.0 percent, his own analysis supports a significantly higher result. Without any adjustments or technical corrections, his DCF analysis supports an ROE range of 10.25 percent to 10.5 percent (See Lawton direct testimony Table 3 at 23). Additionally, his basic bond-yield-plus-equity-risk- premium analysis supports an ROE of 10.39 percent (Lawton at 24, line 634). Only by resorting to the geometric mean risk premium in an "alternative" risk premium analysis and a so-called "empirical" capital asset pricing model (ECAPM) can Mr. Lawton point to lower estimates of ROE. Even with his alternative risk premium analysis, based on the arithmetic mean equity risk premium in that analysis, the estimated ROE is 11.32 percent (Lawton at 25, line 643). Mr. Lawton's attempt to average these results down by offering low alternative risk premium and ECAPM estimates is misleading and should be rejected. I will show that Mr. Lawton's midpoint ROE estimate, with no adjustments or technical corrections of any kind, should have been at least 10.4 percent. With more reasonable growth rate assumptions in his DCF analysis, I will show that his ROE estimate should have been near 11.0 percent.

Similarly, the reliable portions of Mr. Peterson's DCF analysis support an ROE estimate higher than the 10.5 percent he recommends. His constant growth

[1]The DCF range from my Supplemental Exhibit RMP___(SCH-SS3), Docket No. 08-035-38, November 2008, was 10.7 percent to 11.2 percent. My updated DCF range in the present case, as shown in Exhibit RMP___(SCH-5R), is 11.0 percent to 11.5 percent.

DCF model, based on his earnings growth rate projections, supports an ROE range of 10.71 to 10.89 percent (DPU Exhibit 1.5). His constant growth DCF model based on his adjusted dividend growth forecast supports an ROE of 10.74 percent (DPU Exhibit 1.5). His two-stage DCF model, with growth based on projected earnings and dividends, supports an ROE range of 10.58 percent to 10.74 percent (DPU Exhibit 1.5). Only when Mr. Peterson injects much lower growth rates from less traditional growth rate sources ("PacifiCorp IRP" growth at 4.14 percent; his estimate of GDP growth at 4.51; and his estimate of "average utility" GDP growth at 4.08 percent) into the second stage of his two-stage analysis does he produce lower ROE estimates. I will explain in more detail below that these near-term growth rates are currently low because they are based on real growth rates that are depressed by current economic conditions and inflation rates that are far below historical averages for the U.S. economy. I will show that if more reasonable growth rates had been used, Mr. Peterson's midpoint ROE would have been at least 10.75 percent.

Overview of Current Capital Markets

Q. Why do you say that the other parties' ROE recommendations are not consistent with current capital market conditions?

A. The other parties seem to hold a mistaken belief that equity capital costs for utilities have decreased, not increased, over the past several months. This contention is simply wrong. While governmental policies and "flight to safety" issues have driven down short-term interest rates for banks and yields on higher grade debt securities, the cost of equity for utilities has not declined over the past

year.[2] I will show that PacifiCorp's required ROE has increased and that the other parties have not reasonably included current capital market conditions in their recommendations.

Q. In your direct testimony, you provided capital market data through May 2009, which demonstrated wider corporate interest rate spreads relative to treasury bond interest rates and increased corporate borrowing costs. What do the most recent data show?

A. The month-by-month interest rate data updated through August 2009 are presented in Exhibit RMP___(SCH-1R), page 1. Those data are summarized below in Table 1.

[2] The term "flight to safety" refers to the tendency for investors, during periods of market turbulence, to remove money from more risky investments, such as corporate bonds and stocks, and to put the money into government securities such as Treasury bills and bonds. The effect causes a reduction in the supply of funds to corporations and an increase in funds invested in government securities. The result is wider "spreads" between corporate bond and government bond interest rates and higher capital costs for corporations.

Table 1
Long-Term Interest Rate Trends

Month	Single-A Utility Rate	30-Year Treasury Rate	Single-A Utility Spread
Jan-07	5.96	4.85	1.11
Feb-07	5.90	4.82	1.08
Mar-07	5.85	4.72	1.13
Apr-07	5.97	4.87	1.10
May-07	5.99	4.90	1.09
Jun-07	6.30	5.20	1.10
Jul-07	6.25	5.11	1.14
Aug-07	6.24	4.93	1.31
Sep-07	6.18	4.79	1.39
Oct-07	6.11	4.77	1.34
Nov-07	5.97	4.52	1.45
Dec-07	6.16	4.53	1.63
Jan-08	6.02	4.33	1.69
Feb-08	6.21	4.52	1.69
Mar-08	6.21	4.39	1.82
Apr-08	6.29	4.44	1.85
May-08	6.28	4.60	1.68
Jun-08	6.38	4.69	1.69
Jul-08	6.40	4.57	1.83
Aug-08	6.37	4.50	1.87
Sep-08	6.49	4.27	2.22
Oct-08	7.56	4.17	3.39
Nov-08	7.60	4.00	3.60
Dec-08	6.52	2.87	3.65
Jan-09	6.39	3.13	3.26
Feb-09	6.30	3.59	2.71
Mar-09	6.42	3.64	2.78
Apr-09	6.48	3.76	2.72
May-09	6.49	4.23	2.26
Jun-09	6.20	4.52	1.68
Jul-09	5.97	4.41	1.56
Aug-09	5.71	4.37	1.34
3-Mo Avg	**5.96**	**4.43**	**1.53**
12-Mo Avg	**6.51**	**3.91**	**2.60**

Mergent Bond Record (Utility Rates); www.federalreserve.gov (Treasury Rates).

Three month average is for June 2009 through August 2009.

101 The data in Table 1 vividly illustrate the market turmoil that has occurred.

102 During the extreme market conditions that existed in late 2008 and earlier in

2009, single-A utility interest rate spreads (the difference between single-A yields and yields on U.S. Treasury bonds) widened to unprecedented levels. While such spreads have narrowed in recent months for higher quality single-A bonds, the effects of the market crisis continue for lower quality issuers and in the market for utility stocks. In fact, increased risk aversion and market volatility continue to increase the cost of equity. While the effects of market turbulence may not be easily captured in financial models for estimating the rate of return, the market's turbulence and continuing elevated risk aversion should be considered in estimating the cost of equity capital.

Q. What do forecasts for the economy and interest rates show for the remainder of 2009 and for 2010?

A. Exhibit RMP___(SCH-1R), page 2, provides Standard & Poor's (S&P) most recent economic forecast from its *Trends & Projection*s publication for July 2009. S&P forecasts significant economic contraction through the first three quarters of 2009. For all of 2009, S&P forecasts that real GDP will decline by 3.0 percent. S&P expects real GDP growth to become positive during the 4th Quarter of 2009 and for GDP to increase in real terms (before inflation) during 2010 by 1.2 percent.

S&P also forecasts that long-term government and high grade corporate interest rates will rise significantly from recent levels. The summary interest rate data are presented in the following table:

Table 2
Standard & Poor's Interest Rate Forecast

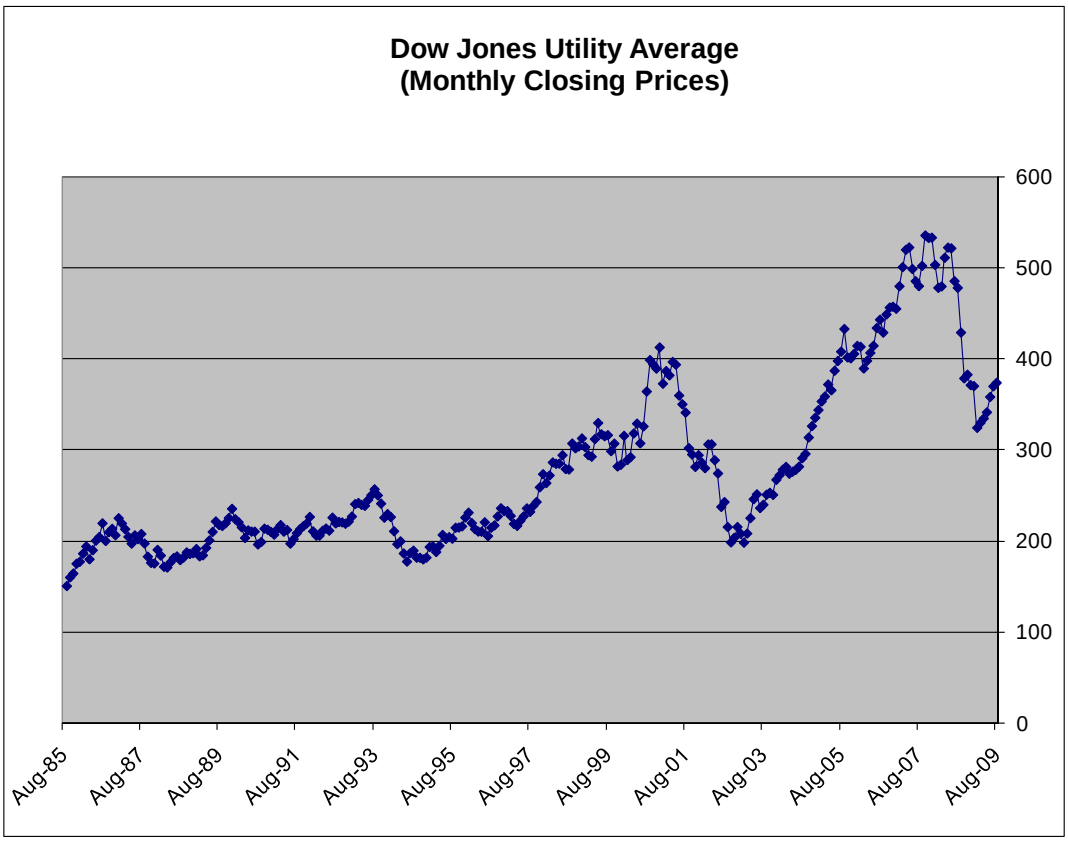
	Aug. 2009 Average	Average 2009 Est.	Average 2010 Est.
Treasury Bills	0.2%	0.2%	0.6%
10-Yr. T-Bonds	3.6%	3.5%	4.9%
30-Yr. T-Bonds	4.4%	4.3%	5.7%
Aaa Corporate Bonds	5.3%	5.7%	6.7%

Sources: www.federalreserve.gov, (Current Rates). Standard & Poor's *Trends & Projections*, July 2009, page 8 (Projected Rates).

Table 2 updates the data found in Table 2 in my direct testimony. The data in Table 2 show that long-term Treasury interest rates during 2010 are projected to increase over 100 basis points from current levels. The rate on Aaa corporate bonds is also expected to increase by about the same amount. Although in the recently turbulent market environment it has been difficult to project rates for lower rated securities, these market data offer important perspective for judging the cost of capital in the present case.

Q. Have utility stock prices recovered from the large declines that occurred in late 2008 and early 2009?

A. No. The following graph, which updates the Dow Jones Utility Average (DJUA) provided in my direct testimony, shows that the recovery for utilities has been modest. The current level of the DJUA remains over 30 percent below the levels attained in 2007.



In this environment, investors' return expectations and requirements for providing capital to the utility industry remain high relative to the longer-term traditional view of the utility industry. Increased market volatility for utility shares causes investors to require a higher rate of return.

Value Line notes the utility industry's relatively poor stock price performance but also gives the sector credit for the resulting high dividend yields:

> **Value Line Investment Survey**
>
> The Value Line Composite Average is up 18% so far this year, but the Value Line Utility Average is down 1%. This divergent performance has made electric utility equities relatively more attractive. This group's average dividend yield, at about 5%, is more than twice the median of all dividend-paying stocks under our coverage. There are numerous stocks in this industry that offer

> a high, secure yield and good 3- to 5-year dividend growth potential. (Value Line Investment Survey, Electric Utility Industry, August 7, 2009, page 2232).

Credit market gyrations and the volatility of utility shares demonstrate the increased uncertainties that utility investors face. These uncertainties translate into a higher cost of capital for utilities than has been experienced in recent years.

Q. How do the other parties' ROE recommendations compare to the rates of return authorized by other state utility commissions around the country?

A. Mr. Lawton's recommendation is 50 basis points lower than the most recent average for the second quarter of 2009. Mr. Peterson's recommendation is approximately equal to the most recently allowed average ROEs.[3] Table 3 below shows the average rates of return for each quarter over the past five years. It updates Table 3 in my direct testimony to include the first two quarters of 2009.

Table 3
Authorized Electric Utility Equity Returns

	2005	2006	2007	2008	2009
1st Quarter	10.51%	10.38%	10.27%	10.45%	10.29%
2nd Quarter	10.05%	10.68%	10.27%	10.57%	10.52%
3rd Quarter	10.84%	10.06%	10.02%	10.47%	
4th Quarter	10.75%	10.39%	10.56%	10.33%	
Full Year Average	10.54%	10.36%	10.36%	10.46%	10.41%
Average Utility Debt Cost	5.67%	6.08%	6.11%	6.65%	6.77%
Indicated Average Risk Premium	4.87%	4.28%	4.25%	3.81%	3.64%

Source: *Regulatory Focus*, Regulatory Research Associates, Inc., Major Rate Case Decisions, July 2, 2009. Utility debt costs are the "average" public utility bond yields as reported by Moody's.

[3] The RRA averages include allowed ROEs for both integrated electric utilities and delivery-only transmission and distribution (T&D) companies. Because the allowed returns for the T&D companies have generally been lower than those for the integrated companies, the RRA averages, which include both types of utilities, represent a conservative estimate of the cost of equity for the integrated companies like RMP.

Rebuttal of OCS Witness Mr. Daniel J. Lawton

Q. What specific comments do you have concerning Mr. Lawton's ROE analyses?

A. Mr. Lawton's analysis does not support an ROE as low as the 10.0 percent he recommends. His consistent use of low-end assumptions and his introduction of lower "alternative" risk premium and CAPM analyses seem related to his efforts to mischaracterize RMP's risk profile. For example, in his opening summary he states:

> 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. (Lawton at 3, lines 62-65.)

My basic review of Mr. Lawton's DCF and traditional risk premium results above shows that he has selected a number that is below even the lower end of his own reasonable range.

Q. Is Mr. Lawton correct about RMP's cost recovery mechanisms requiring the lower end of the range?

A. No. Most important, the comparable companies that I (and Mr. Lawton) use to estimate ROE have their own cost recovery mechanisms. Therefore, to make a downward adjustment to ROE, when the ROE estimate is based on these companies, would double count any benefits the mechanisms may provide. Exhibit RMP___(SCH-2R) lists, by operating company and regulatory jurisdiction, the cost recovery mechanisms that the comparable companies have. This listing shows that all the companies have fuel and purchased power cost recovery mechanisms, like the ECAM that RMP is requesting. In addition, Mr.

Lawton's recommendation appears to assume that the ECAM has already been approved and implemented. While, I am certain that RMP hopes that the proposed ECAM will be approved, the docket is still ongoing and approval has not yet been received. With respect to the capital cost recovery rider, it is my understanding that the mechanism would not decrease RMP's risk of recovery, because the Company would be required to file a capital investment rate case and would remain subject to full prudence reviews of all capital expenditures. The process would only change the timing of recovery slightly and perhaps reduce rate case costs for all participants. Based on these facts, Mr. Lawton's low-end recommendation is without merit.

Q. How does Mr. Lawton develop his ROE estimate?

A. He relies on two versions of the DCF model and he presents risk premium and CAPM estimates as well.

In his DCF analysis, he provides both constant growth and multi-stage growth results. His constant growth model consists of an average dividend yield of 4.95 percent and an average growth rate of 5.66 percent, which produces an average ROE estimate of 10.62 percent. The corresponding "median" result of his constant growth analysis is 10.43 percent. His two-stage DCF results are lower because he applies a lower 5.30 percent long-term growth rate. On page 22, he says that "the 5.3% growth estimate is the average of the EPS estimates and internal growth estimates," but he does not show this calculation in his exhibits. I will demonstrate later that Mr. Lawton's two-stage DCF estimates would have been significantly higher if he had used a more reasonable estimate of long-term

growth in the second stage of his two-stage model.

Q. Why should a long-term GDP growth estimate be used in the second stage of the two-stage growth DCF model?

A. The long-term GDP growth rate should be used because it is the forecast most consistent with the requirements of the DCF model. GDP forecasts and economic forecasts in general are difficult and are often dominated by current data and very recent experience. I used the very long-term St. Louis Federal Reserve Bank data to mitigate this well-known forecasting deficiency, which I will discuss in more detail in my rebuttal of Mr. Peterson.

Q. How are Mr. Lawton's risk premium and CAPM estimates calculated?

A. He presents two versions of each model. In his Exhibit OCS 1.8, for his basic risk premium model, he adopts the same approach I used in my direct testimony Exhibit RMP___(SCH-5). In his analysis, however, he substitutes a lower projected single-A utility interest rate, which produces an ROE estimate of 10.39 percent. While I disagree with his method for estimating the single-A utility interest rate--he uses interest rate spreads only from 2007 and early 2008 (Lawton at 25, line 649)--his result is near the lower end of the updated risk premium estimates I am providing with this testimony in Exhibit RMP___(SCH-6R). As I will discuss later, my updated risk premium range, based on data through August 2009, is 10.47 percent to 11.21 percent. Mr. Lawton carefully avoids mentioning the upper end of his "alternative" risk premium range, which is shown in his Exhibit OCS 1.8 to be 11.32 percent. Mr. Lawton's discussion of his risk premium results is an extreme exercise in selectivity that should be evaluated

accordingly.

Mr. Lawton's CAPM analysis is presented in Exhibit OCS 1.9. That analysis produces a range of ROE estimates from 7.11 percent to 8.56 percent. Regardless of the technical merits, or lack thereof, of this analysis, the results are on their face unreasonable. As shown by comparison to the RRA data in my Table 3, even the top end of his CAPM range is approximately 200 basis points lower than the average ROE allowed by state commissions during the 2nd Quarter of 2009. These results should be dismissed and not averaged with other ROE estimates.

Q. Why should Mr. Lawton's CAPM results be dismissed?

A. First of all, Mr. Lawton himself dismisses his basic CAPM results and one of his ECAPM estimates as too low (Lawton at 27, line 709). He finally accepts a second ECAPM estimate (8.6 percent) and later averages this result with his other higher estimates. However, Mr. Lawton's alternative ECAPM is no more reliable than his basic CAPM because it suffers from all the same data issues and broad assumptions that the original CAPM suffers from. Since the Public Service Commission of Utah has rejected the use of the CAPM previously, there is no reason to now embrace a variation of that same model that incorporates further assumptions without really correcting any of the problems of the original version. With a balanced view of his risk premium analysis, and with the rejection of his CAPM/ECAPM estimates, Mr. Lawton's analysis supports an ROE of at least 10.4 percent.

Q. What average ROE is produced by Mr. Lawton's analysis when the low and high ends of his risk premium estimates are included and when his ECAPM estimate is excluded?

A. The following table shows that result.

LAWTON COST OF EQUITY SUMMARY WITH HIGH AND LOW END RISK PREMIUM SHOWN AND ECAPM EXCLUDED

Model	Range	Midpoint
Constant Growth DCF	10.43% - 10.62%	10.53%
Two-Stage DCF	10.20% - 10.25%	10.23%
Risk Premium	9.52% - 11.32%	10.42%
Average ROE Result		**10.4%**

Q. Does this summary mean that 10.4 percent is the correct estimate of RMP's cost of equity capital?

A. No, not at all. This summary simply shows what Mr. Lawton's analysis produces when the full range of his results is included and when his entirely unreliable ECAPM estimate is excluded. We continue to disagree about the growth rates in our DCF models, and I will show that the lower end of his "alternative" risk premium analysis is suspect. The summary table is presented to show that Mr. Lawton's analysis, without any corrections or any technical adjustments, supports a significantly higher ROE than his 10.0 percent recommendation.

Q. What is the ROE estimate from Mr. Lawton's two-stage DCF model if your long-term GDP growth estimate is used as the growth rate in the second stage of that model?

A. In Exhibit RMP___(SCH-3R), page 1, I have redone Mr. Lawton's two-stage DCF analysis substituting my long-term 6.2 percent estimate of GDP growth in place of his long-term growth estimate. This adjustment increases his two-stage ROE estimate to 11.0 percent.

Q. Why do you say that the low end of Mr. Lawton's "alternative" risk premium range is suspect?

A. That analysis is based on the Morningstar/Ibbotson data for the period 1926-2008. I have previously used this data to provide a very general perspective on the overall capital market cost of equity. While I did not provide those data in the present case, due to criticism from Mr. Peterson (Docket No. 08-035-38 at 22) and others, in my review of those data in the prior RMP case in 2008, I stated the following:

> For example, the most widely followed risk premium data are provided in the Morningstar Ibbotson data studies. These data, for the period 1926-2007, indicate an arithmetic mean risk premium of 6.1 percent for common stocks versus long-term corporate bonds. Under the assumption of geometric mean compounding, the Ibbotson risk premium for common stocks versus corporate bonds is 4.5 percent. Based on the more conservative geometric mean risk premium, the Ibbotson data indicate a cost of equity of 11.06 percent (6.56% forecasted debt cost + 4.5% risk premium = 11.06%). Based on the arithmetic risk premium, the Ibbotson data indicate a cost of equity of over 12 percent (6.56% forecasted debt cost + 6.1% risk premium = 12.66%). Although I do not use the Ibbotson data in my final ROE estimates, I do review the data for their perspective on the overall market cost of equity capital. (Docket No. 08-035-38, Hadaway Direct Testimony at 31-32.)

Mr. Lawton's use of these data as a direct input to his final ROE recommendation is not appropriate because the data, especially the lower geometric mean equity risk premium he selects, cannot closely track current market conditions or current equity costs. While some may continue to find the data useful as a general indication of long-run risk-return relationships, their direct use as a current estimate of the cost of equity capital as Mr. Lawton has done is suspect.

Q. On page 4, lines 93-95, Mr. Lawton says that your ROE recommendation is overstated because you rely on outdated data and overstated GDP growth data. How do you respond to his comments?

A. I disagree with both of his contentions. I will demonstrate that my updated DCF and risk premium analyses fully support an 11.0 percent ROE. With respect to the GDP growth rate, Mr. Lawton provides no analysis or other data to support his contention. As noted above, his 5.3 percent long-term growth rate is 90 basis points lower than the specific GDP growth rate forecast I provided in my direct testimony. I explain in more detail in my rebuttal of Mr. Peterson why a lower long-term growth rate is inconsistent with actual market data. Mr. Lawton's preference for a lower growth rate based on near-term "EPS estimates and internal growth estimates" (Lawton at 22, line 580- 581) is no more consistent with the long-term growth rate requirement of the two-stage DCF model than it is with the long-term requirement of the single-stage DCF model. Both models require stable estimates of long-term expected growth. Mr. Lawton's EPS and internal growth estimates understate that requirement.

Q. On page 4, lines 97-99, Mr. Lawton says that your 6.02 percent average analysts' growth rate forecasts are "overstated, outdated, and fail to take into account declining expectations…." How do you respond to this assertion?

A. Mr. Lawton's comment is at best partially correct in the sense that with the passage of time since I prepared my direct testimony analysts' forecasts have declined slightly. As shown on page two of Exhibit RMP___(SCH-5R), column 7, the average analysts' growth rate in my updated DCF analysis is currently 5.83 percent, and the indicated DCF range based on that growth rate is 11.0 percent to 11.4 percent. Mr. Lawton's criticism of my 11.0 percent ROE recommendation based on this small decline in analysts' growth rate projections is, therefore, misplaced.

Q. On page 4, lines 100-102, Mr. Lawton says that your 6.2 percent long-term GDP growth rate should be in the range of 5.0 percent to reflect more recent history. How do you respond to this comment?

A. I disagree. While again Mr. Lawton provides no analysis to support this contention and he does not use a GDP growth rate in his analysis, I explain in more detail in my rebuttal of Mr. Peterson, who does use a GDP growth rate, why a lower long-term growth rate is inconsistent with actual market data.

Q. On page 5, at lines 120-121, Mr. Lawton says that the dividend yield estimates in your DCF analysis is 5.5 percent and that that yield is overstated by about 50 basis points. How do you respond to this assertion?

A. There are several factors related to Mr. Lawton's statement about dividend yields.

These factors generally illustrate Mr. Lawton's extreme efforts to support his unsupportable ROE recommendation. First, the DCF dividend yield in my direct testimony is shown in Exhibit RMP___(SCH-4), page 2, column 3. The median and average values are 5.52 percent and 5.57 percent, respectively. The 50 basis point "overstatement" that he refers to is apparently a comparison to his own dividend yield estimate of 4.95 percent to 5.11 percent (Exhibit 1.6). My updated dividend yield shown in Exhibit RMP___(SCH-5R), page 2, is 5.19 percent to 5.32 percent.

A careful review of Mr. Lawton's exhibits helps to explain the differences. While we both use the same comparable companies, our analyses were prepared at different times and we used different lengths of time to calculate the dividend yields. My initial stock prices were a three-month average for March-May 2009. My updated analysis uses stock prices for June-August 2009. His lower dividend yields are based on stock prices for a 6-week period from July 27-August 31, 2009. However, a review for Mr. Lawton's DCF spreadsheets provides further information. It shows that in his Exhibit OCS 1.4, page 2, he also calculated, but did not report, average stock prices for an 8-week period (column N); a 12-week period (column M); a 52-week period (column R); and one-day spot price for September 3, 2009 (column S). For his estimated dividend yield, he then selected the highest average price of the five alternatives. This selection, in turn, reduced his dividend yield to the lowest possible of his five alternatives.

In Exhibit RMP___(SCH-3R), page 2, I have reproduced Mr. Lawton's constant growth DCF estimate with his 12-week stock price averaging period,

which is similar to the 3-month period I used in my updated DCF analysis. That analysis, with no other adjustments whatsoever, produces a dividend yield of 5.07 percent to 5.27 percent and indicates a ROE range of 10.64 percent to 10.73 percent. Mr. Lawton's efforts to criticize my ROE recommendation and understate RMP's cost of equity are potentially misleading and should be evaluated accordingly.

Rebuttal of Division Witness Mr. Charles E. Peterson

Q. What is the basis for Mr. Peterson's 10.5 percent ROE recommendation?

A. His 10.5 percent recommendation is stated at the bottom of DPU Exhibit 1.5. In that exhibit, Mr. Peterson summarizes the results from seven constant growth DCF models based on alternative growth rate assumptions and nine two-stage growth DCF models (which are shown in detail in DPU Exhibit 1.5a and 1.10). He concludes that these models support a reasonable range of 10.1 percent to 10.8 percent. He also presents the results of a Capital Asset Pricing Model analysis and a Value Line risk premium model, although he appears to give little if any weight to the very low ROE estimates that these models produce.

Q. Is it clear from DPU Exhibit 1.5 how Mr. Peterson arrived at his 10.5 percent recommendation?

A. No. The printed one-page version of that exhibit may be confusing because it shows a "Simple Average" and "Median" value for his estimates of 10.09 percent to 10.15 percent, with his 10.5 percent recommendation shown immediately below those two values. However, the electronic version of the exhibit provides additional information, which shows that his 10.5 percent estimate is not as

generous as it might appear. In fact, in the electronic calculations, Mr. Peterson finds a weighted average of 10.45 percent for his estimates and an average of 10.66 percent for his models based on earnings and dividend growth rate forecasts. He then averages these results to obtain a further average of 10.55 percent. This result, rounded down, appears to be the basis for his final 10.5 percent recommendation.

Q. What are your principal areas of disagreement with Mr. Peterson?

A. I disagree with two aspects of his analysis: 1) his use of extremely low less traditional growth rates in portions of his DCF analysis and 2) his failure to provide a basic bond-yield-plus-equity-risk-premium analysis as a check of reasonableness for his primary DCF results.

Q. Why do you disagree with Mr. Peterson's alternative growth rate calculations?

A. Mr. Peterson offers the following statement about his current use of the two-stage growth rate approach:

> In my analyses in previous dockets I did not conclude that two-stage DCF models added a lot of new information to the estimate of cost of equity for the Company. However, upon further reflection, especially given the continuing issue of using historical GDP growth rates to estimate long-term future growth for electric utilities, I have changed my mind in that the use of two-stage models, with proper inputs, gives better insight to the cost of equity issue than I previously asserted. (Peterson at 24, emphasis added.)

The "proper inputs" that Mr. Peterson refers to are his very low estimates of long-term growth based on PacifiCorp's load growth forecasts (2.2 percent) plus an inflation adjustment (1.9 percent) and his estimates of growth in GDP (4.51 percent) and his so-called utility adjusted GDP (4.1 percent) (Peterson at 39-40).

These growth rates are 150 to 200 basis points lower than the historically based GDP growth rate forecast I provided in my direct testimony on Exhibit RMP___(SCH-3) and 80 to 130 basis points lower than his own 5.33 percent mean of analysts' earnings growth forecasts (DPU Exhibit 1.6). His insertion of "inflation adjusted load growth" into the DCF model as a measure of investors' expected long-term growth is simply incorrect because it bears virtually no relationship to the growth in earnings and dividends that is required in the model. Furthermore, his use of currently depressed GDP forecasts and his further downward adjustment to those forecasts are similarly misplaced. Mr. Peterson's selection of such low GDP growth forecasts is not at all consistent with his optimistic assessment of economic conditions (Peterson at 7-11). While supporting the long-term GDP growth rate as a proper input for the second stage long-term expected growth rate in his two-stage DCF model, Mr. Peterson's efforts to average down his already modest first stage analysts' forecasted growth rates is far off the mark and results in unreasonably low estimates of the cost of equity capital.

Q. If Mr. Peterson had included long-term GDP growth along with his analysts' growth rate forecasts, what would his two-stage DCF models have shown?

A. That analysis is provided in Exhibit RMP___(SCH-4R). In that analysis, I substituted the 6.2 percent estimated long-term GDP growth rate in stage two of his two-stage models. The results indicate an ROE range of 11.25 percent to 11.47 percent.

Q. On page 23, Mr. Peterson refers to the Commission's 2002 Questar Gas Company decision as support for his 75 percent/25 percent weighting of earnings and dividend growth in his single-stage DCF model. Did the Commission's Questar decision adopt this weighting scheme as its only growth rate approach?

A. No. In the Questar case, the Commission found that a 75 percent earnings/25 percent dividends growth rate was a reasonable approach for setting the low end of the range. The Commission also recognized projected earnings growth rates for establishing the entire DCF growth rate range. In fact, in that case the Commission used the weighted average as the bottom of the DCF range only and applied a 100 percent earnings approach to set the top end of the range. (*Questar Gas Company*, Docket No. 02-057-02 at 34-35 (Dec. 30, 2002)). From a policy perspective, reliance on dividend growth instead of earnings growth is problematic because, over the long-term horizon measured by the DCF model, earnings growth drives dividend growth, not the opposite.

Q. On pages 44 and 46, Mr. Peterson points to his CAPM range of ROE estimates (7.66 percent to 9.1 percent) and criticizes your lack of a CAPM analysis. How do you respond to this portion of Mr. Peterson's testimony?

A. I have two responses. First, in his spreadsheet for Exhibit 1.5, cell k35, in the weighted average of his ROE estimation methods, Mr. Peterson gives exactly zero percent weight to his CAPM results. Second, the Commission addressed and rejected application of the CAPM in the 2002 Questar case, which Mr. Peterson cites in his DCF growth rate discussion, stating flatly: "[W]e cannot rely on the

CAPM." *Re Questar Gas Company*, Docket No. 02-057-02 at 34 (Dec. 30, 2002) Mr. Peterson's continuing efforts to inject the CAPM into this Commission's ROE deliberations is not supported by economic facts or the Commission's prior findings.

Q. On page 47, lines 1021-1023, Mr. Peterson says that you gave "little or no weight" to your constant growth DCF results based on analysts' forecasts. Is this statement accurate?

A. In my direct testimony DCF analysis, Exhibit RMP___(SCH-4), the first model that I offer is a constant growth DCF model based on analysts' growth rate estimates. The results from that model were 11.6 percent to 12.0 percent, which formed the upper end of my DCF range. In my updated DCF results with this testimony, Exhibit RMP___(SCH-5R), I continue to present that version of the DCF model, which now supports an ROE range of 11.0 percent to 11.4 percent. It is not clear why Mr. Peterson says that I did not rely on this version of the DCF model.

Q. On page 48, Mr. Peterson criticizes your GDP growth rate forecast and points to much lower growth rates in forecasts published by the Congressional Budget Office (CBO) and the Energy Information Administration (EIA). How do you respond to these criticisms?

A. Recent GDP growth forecasts from CBO and EIA are not consistent with the historical growth rates in the U.S. economy. They are based on an assumption of slower real growth and permanently low inflation at rates that are about 50 percent below actual long-term experience. For example, the CBO and EIA

forecasts that Mr. Peterson uses have nominal GDP growth rates of 4.17 percent and 4.47 percent, respectively. Those nominal growth rates include GDP inflation rates of 1.5 percent and 2.0 percent, respectively. These projected long-term inflation rates compare to the actual 3.4 percent GDP inflation rate that has occurred over the past 60 years in the U.S. economy. (See Exhibit RMP___(SCH-3). Exhibit RMP___(SCH-3) also shows that there has not been one 10-year period in the past 60 years (including the most recent 10-year low-inflation era) with an average inflation rate lower than 2.4 percent per year. While Mr. Peterson's low Government projections of nominal GDP growth may be useful for projecting a balanced budget, protecting Social Security, and other governmental purposes, they are not consistent with actual capital market data. As such, the much lower growth rates discussed by Mr. Peterson are not appropriate in the DCF model.

Update of ROE Analysis

Q. Have you updated your ROE analysis to take into account recent data and the current conditions in the capital markets?

A. Yes. Consistent with my customary practice, I have updated my ROE analysis for current conditions using the same methodologies that I employed in my previous analysis.

Q. What are the results of your updated DCF analyses?

A. My updated DCF results are shown in Exhibit RMP___(SCH-5R). The indicated DCF range is 11.0 percent to 11.5 percent.

Q. What are the results of your updated bond yield plus equity risk premium analysis?

A. My updated equity risk premium analysis is presented in Exhibit RMP___(SCH-6R). That analysis indicates and ROE range of 10.47 percent to 11.21 percent.

Q. What do you conclude from your updated ROE analyses?

A. My updated analyses show that RMP's current cost of equity capital is in the range of 10.5 percent to 11.5 percent, with a midpoint estimate of 11.0 percent. My updated analysis confirms that my original recommendation of 11.0 percent is reasonable and that the other parties' recommendations, as discussed herein, are low.

Q. Does that conclude your rebuttal testimony?

A. Yes.