Docket No. 10-035-124

Utah Office of Consumer Services Witness:

Daniel J. Lawton

Exhibits OCS 1.1 through 1.9

May 11, 2011

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 Service Rates in Utah and For Approval of its Proposed Electric Service Schedules and Electric Service Regulations.	**§** **§** **§** **§** **§** **§** **§** **§** **§** **§** **§**	**Docket No. 10-035-124** **Direct Rate of Return Testimony of Daniel J. Lawton For the Utah Office of Consumer Services**

May 11, 2011

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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, and in court proceedings. 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 my 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 Company's ("Company" or "RMP") cost of capital request and financial integrity metrics and issues on behalf of the Utah Office of Consumer Services ("OCS").

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 capital, preferred stock and long-term debt, which is presented in the direct testimony of Company cost of capital witnesses, Dr. Samuel Hadaway and the direct testimony of Mr. Bruce Williams. In addition, I am addressing financial integrity and cash flow issues related to return of and on capital. Lastly, I will be addressing the impacts on RMP's risks of surcharge mechanisms for plant investment, fuel cost recovery, future test year, rate design and tax law changes related to bonus depreciation.

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

A. I have reviewed the Company's current direct and previous testimony, Company responses to interrogatories, Value Line Investment Survey ("Value Line"), financial reports of the Company, along with other utility companies of comparable risk and various other financial information available in the public domain. When relying on other sources, I have referenced such sources in my testimony and/or 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 9.5% return on equity for shareholders and an overall return to be earned on rate base investment of 7.73%. 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 8.25% overall cost of capital and 10.50% return on equity indicate that the Company request is overstated and is not consistent with just and reasonable rates for consumers 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 9.5%;

(ii) The Company's overall cost of capital to be earned on rate base investment should be set at 7.73% for setting just and reasonable rates for Utah customers in this proceeding;

(iii) The Company's proposed 10.50% return for equity shareholders is an overstatement of the required return on equity to hold and attract equity capital;

(iv) The Company's proposed 8.25% overall return on investment is overstated and should not be adopted as representative of the Company's cost of capital requirements; and

(v) A return of 7.73% is more than adequate for the Company to maintain its financial integrity.

SECTION II: OVER VIEW OF COMPANY'S REQUEST

Q. HOW WOULD YOU DESCRIBE THE COMPANY'S RATE INCREASE REQUEST IN THIS CASE?

A. I would describe the Company's $232.4 million rate increase request as aggressive in terms of imposing costs and potentially hardship on customers. The Company's $232.4 million rate increase request is a record setting rate increase request in terms of dollars and comes on the heels of recent individual major plant addition proceedings,[1] that increased revenue requirements about $64 million annually.

While the Company asserts that the "…Application includes only those elements of the revenue increase request necessary to maintain and provide safe and reliable service to its customers…," (emphasis added) the underlying facts show this is not a correct statement. Instead, the facts show that at a time when the Company is asking that customers absorb the biggest rate increase in the history of Utah regulation, the Company is proposing to pay itself dividends in the amount of $850 million over the period these rates are to be implemented. These $850 million in dividends will

[1] See Company Docket No. 10-035-124 Application at 5 paragraph 11

eventually flow upstream to MidAmerican Energy Holdings Company ("MEHC") and Berkshire Hathaway ownership.

The Company takes the position that recent tax legislation enacting 100 percent bonus depreciation will significantly increase the Company's cash flow over the next two years – and absent payment of dividends, common equity ratios could increase beyond levels necessary to support current credit ratings.[2]

Q. IS THE COMPANY'S RATE INCREASE REQUEST AGGRESSIVE IN OTHER RESPECTS?

A. Yes. The Company's cost of equity capital is overstated and fails to consider the risk reducing impacts of the Company's (i) major plant additions cases (which reduces regulatory lag), (ii) use of a forward test period (which limits regulatory lag), (iii) the risk reduction impact of fuel cost reconciliation and true-up, (iv) and RMP's lower financial risks given a 51.9% equity ratio relative to the comparable risk company average of 49%, (v) increased cash flows resulting from bonus depreciation and (iv) a proposed rate design that removes risk of recovery. All of these factors mitigate risk and were ignored in the Company's analyses and rate request.

Had the Company considered the risk reduction impacts of the above factors and cash flow expectations, an equity return at the lower end of the ROE range would lower the requested revenue request many millions of dollars.

The Company cannot support its equity return request given the risk reduction measures authorized by this Commission and the Company's expected cash flow and dividend payments. Instead, the Company's equity return should be at the lower end of the range to reflect lower risk.

[2] Direct Testimony Bruce N. Williams at 4:76-86.

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 8.25%.[3] As is discussed later, a small change in return requirements can have a large impact on revenue requirements.

Q. WHAT REGULATORY AND COST OF CAPITAL ISSUES ARE IMPORTANT TO UNDERSTAND AS BACKGROUND TO YOUR ANALYSIS?

A. It is useful to understand the following concepts:

- Cost of capital as it relates to the regulatory process;
- The components of cost of capital and their determination;
- The calculation of the cost of debt and preferred stock; and
- The cost of equity concept and methodology

I will explain each of these concepts in the following section. Then, I will explain the Company's request broken out into the various components.

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 8.25%.[4] As is discussed later, a small change in return requirements can have a large impact on revenue requirements.

[3] Company Direct Testimony Bruce Williams at 2:34-35
[4] Company Direct Testimony Bruce Williams at 2:34-35

Q. WHAT ARE THE COMPONENTS OF COST OF CAPITAL?

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, both of which are included in the capital structure, are 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.

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

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 CALCULATION OF THE COST OF DEBT AND PREFERRED STOCK.

A. As stated earlier, the cost of debt and preferred stock is contractually set at a rate or sometimes a variable rate. These contractual rates are costs that are included in the return requirements.

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. I have employed all these modeling methods to arrive at my recommendations in this case.

Q. PLEASE DESCRIBE THE RISKS IMPACTING THE COST OF EQUITY REFERENCED ABOVE.

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

Q. WHAT IS THE BREAKDOWN OF RETURN ON CAPITAL AND PROFIT BEING REQUESTED IN THIS CASE?

A. The overall return on rate base investment being requested in this case is shown in the following table.

Table 1[5]
Capital Structure and Return

Description	Ratio	Cost Rate	Weighted Cost	Requested Return[6]
Debt	47.80%	5.81%	2.77718%	$152,600,897
Preferred	0.30%	5.43%	0.01629%	$895,105
Common	51.90%	10.50%	5.44950%	$299,439,931
Total	100.00%	----	8.24297%	$452,935,933

As can be seen from the above table, the Company is requesting that rates be set to allow the Company to earn an 8.24297% overall return on a claimed test year investment level of $5,494,814,744, which translates into $452,935,933 of total return dollars. The total return dollars can be broken down to $152,600,897 of interest return to cover claimed debt costs, $895,105 of preferred dividend return and a Company request of $299,439,931 of profit for shareholders or equity return.

It is important to note that the $299,439,931 of shareholder profit being requested is an after tax request. In other words, customers also must pay through rates return and income (state/federal/revenue related) taxes such that the $299,439,931 profit request is available after all taxes are paid. Federal income taxes alone at a 35% rate would add $161,236,886 to customer rates.[7] Thus, to have $299,439,931 of profit available for shareholders – customers must pay through rates $460,676,817 or $161,236,886 for income taxes and $299,439,931 for shareholder profits.

Q. GIVEN THE COMPANY'S REQUESTED CAPITAL STRUCTURE, REQUESTED COST RATES FOR CAPITAL AND RATE BASE LEVEL, WILL A SMALL CHANGE IN RETURN HAVE A SIGNIFICANT IMPACT ON REVENUE REQUIREMENTS?

A. Yes, a small change in return will have a significant impact on revenue requirements, especially if a change is made to the equity return which impacts both return and income taxes. As an example, if return on equity is adjusted downward by 25 basis points from

[5] Capital Structure and cost rates per Exhibit RMP__(SRM-3) at page 2.1.
[6] Weighted cost times rate base investment of $5,494,814,774 per Exhibit RMP__(SRM-3) at page 1.1.
[7] Tax Factor equals 1/(1-tax rate), which is 1/(1-.35) which equals 1.53846154. This tax factor of 1.53846154 times the requested shareholder profit level requested equals taxes and profits.

the requested 10.50% to a level of 10.25%, return decreases by about $7.1 million and return and federal income taxes on revenue requirement will decline by about $10.97 million per annum.

SECTION IV: CURRENT CAPITAL MARKET CONDITIONS

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

A. In my opinion, no. While the financial markets, and the economy in general, have experienced periods of uncertainty and turmoil since September 2008, government intervention has had an impact on financial markets. 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 in the autumn of 2008. Moreover, the cost of capital continues to decline as evidenced by a review of historical bond yields, authorized equity returns set by regulatory authorities and the Company's testimony in this case. Quite simply, bond yields have declined over recent periods and equity returns authorized by regulatory authorities have also continued to decline in recent years.

Q. ARE ECONOMIC CONDITIONS IMPROVING IN 2011?

A. Yes, there certainly is improvement. The impacts of the global recession continued through 2009 and into 2010. The U.S. and more so foreign economies (certain Economic Union members) did struggle with financial issues following the collapse of the 2008 subprime mortgage markets. The Federal Reserve and central banks around the world continue to ramp up lending in an effort to keep the financial markets improving.

Recent financial problems in Europe continue to impact the global economic growth prospects. 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 continue to be 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 April 2011.

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 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 fall 2008 liquidity crisis in the financial markets. 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.

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 April 2011, the national unemployment rate continues at about 8.8%. The stock market for 2009 hit a low in March, but has since substantially rebounded from March 2009 levels. The change in course regarding commodity prices and the market downturn from early 2009 levels is evidence that the downward economic slide is over. While unemployment figures lag other economic indicators, growth of GDP continues, but at a slower than expected rate.

In response to the economic crisis, the Federal Reserve has taken 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 was 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 April 2011, BBB corporate rated bonds have averaged about 6.02%[8] or are at levels seen prior to the liquidity crisis.

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 is in a slow recovery. Economic recovery is expected to gain momentum slowly with some economic segments and geographic regions growing more slowly than others.

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 DOES THE FEDERAL RESERVE'S MOST RECENT ECONOMIC ASSESSMENT INDICATE?

A. Minutes of the Federal Open Market Committee ("FOMC") meeting of March 15, 2011 indicate that the Federal Reserve believes that the empirical evidence (at least since January 2011) suggests that economic recovery is on firmer footing. Household spending and business investment in equipment and software continue to expand. Nonresidential construction is weak while the residential construction market remains depressed.

While commodity prices have increased significantly since last summer, primarily driven by the sharp run up of oil prices, the Federal Reserve concludes that "…longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued."[9] The FOMC went on to state, "To promote a stronger pace of economic recovery and to help ensure that inflation…is at levels consistent with its mandate…the Committee is maintaining its existing policy of reinvesting principal payments from its securities holdings and intends to purchase $600 billion of longer-

[8] www.federalreserve.gov/releaseh15date/weekly
[9] Federal Reserve Press Release www.federalreserve.gove/newsevents

term Treasury securities by the end of the second quarter of 2011."[10] The FOMC further stated at the March 2011 meeting that "…the target federal funds rate at 0 to ¼ percent and …are likely to warrant exceptionally low levels for the federal funds rate for an extended period."[11] Current expected growth in GDP over the 2011 to 2012 period is expected to remain moderate with unemployment levels to decline slightly, but remain elevated at the end of 2012.[12]

While the Federal Reserve current forecasts do not project an economic downslide into a double-dip recession, these new estimates are more cautious concerning expected pace of economic recovery.

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 investment grade corporate bond rates (BBB) increased substantially during the liquidity crisis – such increases do not appear to be a trend, but rather the direct impact of an atypical event in the capital markets. Current BBB bond rates are at about the 6.0% level. The economic slowdown or recession, and modest growth in recovery, will cause general investor expectations of growth to be lower. 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: <u>COST OF EQUITY CAPITAL DCF ANALYSIS</u>

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 twenty company comparable risk group of companies

[10] *Id*
[11] *Id*
[12] FOMC March 15, 2011 Minutes at 5.

because there is no market financial data for RMP. The Company is not publicly traded, thus, without financial data a DCF analysis cannot be computed directly on the Company. The comparable risk group of companies, for which there is market data available, serves as a proxy for the Company.

Q. GIVEN THERE IS NO MARKET DATA FOR ESTIMATING THE COMPANY'S EQUITY COST, HOW DID COMPANY WITNESS DR. HADAWAY APPROACH THIS ISSUE?

A. Dr. Hadaway relied on this same twenty company comparable group where market data is available as a proxy for the Company in his analysis.[13] Dr. Hadaway started with companies designated as electric utilities by Value Line Investment Survey and used screens to eliminate (i) non-dividend paying companies, (ii) companies with a bond rating below mid A levels, (iii) and eliminate all companies not having at least 70% of its revenues from electric utility operations.[14] This resulted in 20 companies for the comparable group data base that are listed in Dr. Hadaway's Exhibit RMP__(SCH-1_ page 1.

Q. DO YOU HAVE ANY CONCERNS REGARDING DR. HADAWAY'S COMPARABLE GROUP ANALYSES?

A. I have no problems with his screen/selection process which is commonly used to select comparable or proxy group companies for these types of analyses. Given we are both using the same group of companies – differences in our analyses are limited to the data period employed and application of the DCF and equity cost measurement models.

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

[13] Direct Testimony Samuel Hadaway at 2:45-3:64
[14] *Id*

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 utilities are owned and controlled by a single parent holding company, which is the case with the Company.

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 companies in each of the two comparable groups, along with additional data of company Beta and historical 2009 along with projected equity ratio for 2010, 2011, 2012, and 2014-2016, and bond rating by Standard & Poor's along with Moody's.

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

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

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

$$K = D/P + G$$

where:

K = required return on equity,

D = dividend rate,

P = stock price,

D/P = dividend yield, and

G = growth in dividends.

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

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

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

The price and dividend data used for each of the companies in each of the comparable groups is contained in my Exhibit OCS 1.4.

I have examined weekly closing stock prices for the period January 1, 2011 through April 29, 2011 for 6 week, 12 week, along with 52 week, and spot intervals to calculate a representative price for the dividend yield calculation. For this analysis, I have employed the 6 week average price in calculating the dividend yield.

To calculate dividends, I employed the current annualized dividend increased for ½ the growth rate. The resulting base (unadjusted) dividend yield is shown on my Exhibit OCS 1.4 for each of the comparable groups.

Q. HOW DOES YOUR RECOMMENDED DIVIDEND YIELD COMPARE TO THE DIVIDEND YIELD ESTIMATE OF DR. HADAWAY?

A. Dr. Hadaway's dividend yield average and median estimate for the electric utilities comparable group companies is 4.6% and 4.7% respectively.[15] The base and adjusted dividend yields I have computed based on more recent data for the comparable group are

[15] Direct Testimony of Samuel Hadaway Exhibit RMP__(SCH-4)

about 4.4% and 4.6%, and are about the same as the levels estimated by Dr. Hadaway.

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, a two page schedule, 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 as reported by Value Line. The second set of growth rates is the Value Line forecasted growth rates including the current Value Line forecast of earnings 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) at page 2.

The growth rates described above provide a range of estimates for each of the comparable companies in the two comparable groups. The resulting range of average forecasted earnings growth rates for the electric utility comparable group is from 4.8%

to 5.5%. Relying on the combined forecasted earnings per share estimates and internal growth rate estimates, the growth rate average range can be narrowed to 4.8% to 5.1% as shown in Exhibit OCS 1.5, page 1.

Q. HOW DO YOUR COMPARABLE GROUP GROWTH ESTIMATES COMPARE TO DR. HADAWAY'S GROWTH ESTIMATES FOR THE CONSTANT GROWTH DCF ANALYSIS?

A. Dr. Hadaway's growth estimate for the electric utilities in the comparable group ranges from 5.5% - 6.0%.[16] My current median and mean estimates for this group are 4.85% to 5.1%, and a midpoint of 4.9%. Thus, about 85 basis points lower than Dr. Hadaway's midpoint 5.75% estimate.

While my growth rate analyses are more current (as we both relied on Value Line and Zacks EPS forecast estimates), my analysis looks to other earnings estimates along with a sustainable growth calculation. Therefore, in my opinion, my analysis covers a wider array of growth estimates and is not as limited as Dr. Hadaway's proposal. I will discuss specific problems in Dr. Hadaway's analysis later.

Q. PLEASE SUMMARIZE YOUR CONSTANT GROWTH DCF ANALYSIS.

A. I have summarized these results in my Exhibit OCS 1.6. For the twenty company electric utility comparable group, based on an average yield and a growth rate, the ROE estimate range is 9.3% - 9.7%.

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 companies in each of the comparable groups.

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

[16] See Direct Testimony Dr. Hadaway Exhibit RMP__(SCH-4)

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 electric utility comparable group, 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)[17] employs an earnings growth estimate based on the comparable group forecast EPS average of mean and median of 5.2%. The 5.2% growth estimate is the average of EPS growth estimates.

In the two-stage model the dividend cash flows are discounted equal to the price[18] 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 9.6%.

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

Q. PLEASE SUMMARIZE YOUR DCF ESTIMATES.

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

TABLE 2

SUMMARY OF COMPARABLE GROUP

DCF ANALYSES

DESCRIPTION	COMPARABLE GROUP ELECTRIC UTILITIES
Constant Growth DCF	9.3 - 9.7%
Non-Constant Growth Two Stage DCF	9.6%

This range of estimates of 9.3% to 9.7% indicates an average cost of equity of about 9.5%.

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.[19] 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 consist 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 starting at page 31. This analysis is updated and corrected, employing a more recent single A corporate bond yield of 5.40%. The current Single "A" bond yield of 5.40% is as reported for composite bond yields by Yahoo Finance.

Q. DESCRIBE YOUR RISK PREMIUM ANALYSIS?

A. I examined authorized electric utility return on equity returns relative to Moody's average public utility bond yields. This analysis, similar to Dr. Hadaway's authorized return risk premium approach, is set forth in my Exhibit OCS 1.8. In this analysis I

[19] 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.

estimate equity risk premiums by comparing authorized electric utility returns with average public utility bond yields as reported by Moody's for the period 1980-2010. The resulting risk premium is combined with the current single A corporate bond yield to arrive at a cost of equity estimate.

I have provided a range of results by calculating or adjusting risk premium results by adjusting for the impact of the inverse relationship between interest rates and risk premiums.[20] The alternative risk premium estimate does not include this interest rate / risk premium adjustment.

The resulting range of risk premium equity return estimates is 8.7% to 10.14%.

Q. DID YOU CALCULATE ANY ADDITIONAL ANALYSES TO CHECK THESE RESULTS?

A. Yes. Relying on the results of the Morningstar Stocks, Bonds Bills and Inflation Market Report for December 2010, I calculated risk premiums for stocks relative to long-term corporate bonds for the period January 1, 1926 to December 31, 2010.[21] The risk premiums are shown in the following table:

Table 3
Risk Premiums for Stocks Versus Long-Term Corporate Bonds 1926 - 2010

	Geometric AVG Return	Arithmetic AVG Return
Stocks	9.9%	11.9%
Corporate Bonds	5.9%	6.2%
Risk Premium	4.0%	5.7%
Midpoint	4.85%	

Combining the 4.85% risk premium with current single "A" corporate bond yields of 5.40% results in a risk premium estimate of 10.25%. I would expect this check to be slightly higher than specific utility results discussed above. But overall the check indicates the equity return estimate should not be higher than the lower 10% levels.

[20] See Schedule (DJL-8)
[21] The Morningstar December 2010 Market Report is included in my workpaper with the OCS 1.8 backup material.

CAPITAL ASSET PRICING MODEL ANALYSIS

Q. WHY DID YOU EMPLOY THE CAPITAL ASSET PRICING MODEL?

A. The Capital Asset Pricing Model ("CAPM") is a fundamental truism of finance. The basic or underlying assumption is that risk-averse investors demand higher returns for assuming additional risk, and higher risk securities are priced to produce or yield higher returns than lower-risk securities. Thus, by employing the CAPM one seeks to estimate the risk premium or added return required for bearing incremental investment risk.

Q. PLEASE EXPLAIN HOW YOU CALCULATED THE EQUITY RETURN ESTIMATE EMPLOYING THE CAPM.

A. Employing the basic CAPM formula denoted as follows:

$$\text{ROE} = R_f + \beta(R_m - R_f)$$

Where:

R_f= risk free rate;

β=Beta;

R_m= market return; and

$R_m - R_f$= market risk premium or MRP

This is the typical model structure employed by most financial analysts in estimating equity returns.

Q. WHAT RISK FREE (R_f) VALUE DID YOU EMPLOY IN YOUR CAPM ESTIMATE?

A. I employed the most recent three month average of the 30 Year U.S. Treasury Bond rates. This three month average from Exhibit OCS 1.2 is:

February 2011	4.65%
March 2011	4.51%
April 2011	4.50%
3 Month Average	4.55%

Q. WHAT VALUE DID YOU EMPLOY FOR BETA IN YOUR CAPM ANALYSIS?

A. I employed a beta estimate of 0.69, which is the average beta for the comparable group, as shown in my Exhibit OCS 1.3.

Q. WHAT VALUE HAVE YOU EMPLOYED FOR THE MARKET RISK PREMIUM ("MRP")?

A. I have employed a MRP of 5.2% based on the following calculation:

DESCRIPTION[22]	GEOMETRIC AVG	ARITHMETIC AVG
Large Company Stock Returns (1/1/26 - 12/31/10)	9.9%	11.9%
Long Term Government Bonds	5.5%	5.9%
Risk Premium	4.4%	6.0%
Midpoint	5.2%	

Q. WHAT IS THE RESULT OF YOUR CAPM ANALYSIS?

A. Employing a beta value of 0.69, a risk free rate of 4.55%, and a MRP of 5.2% results in a CAPM estimate of:

$$K = 4.55\% + 0.69(5.2\%)$$

$$K = 4.55\% + 3.588\%$$

$$K = 8.14\%$$

[22] Stocks, Bonds, Bills and Inflation Market Report, December 2010 at 12 on Table 7, see workpapers at OCS 1.8.

Q. IN YOUR ANALYSES, HAVE YOU INCLUDED A CALCULATION OF THE ECAPM RETURN ESTIMATE FOR THIS CASE?

A. Yes. Like the CAPM analysis discussed above, the ECAPM estimate of equity return relies on basic financial theory – wherein to correct for biased beta estimates, an adjustment is made so as not to understate the cost of equity.

Q. PLEASE EXPLAIN THE REASON FOR EMPLOYING THE EMPIRICAL CAPITAL ASSET PRICING MODEL.

A. A number of empirical studies testing the quality of CAPM estimates have concluded that the risk return trade-off for investors is not as steeply sloped as is predicted by CAPM results. In other words, low-beta securities earn more than CAPM predicts while high beta securities earn less than CAPM predicts. Thus, the plain or base CAPM overstates the sensitivity / relationship of the cost of capital to beta. The bottom line is that empirical studies find the risk return relationship is flatter or has a lower slope than what the CAPM estimates predict.

To correct for this CAPM beta related measurement error, an adjustment to the base CAPM formula to introduce a means to correct the risk return relationship is required.

The empirical version of the CAPM, or ECAPM, is often employed because empirical research has found low beta securities actually earn higher returns than levels estimated by CAPM and high beta securities earn lower returns than the levels predicted by CAPM.[23] To correct for this prediction error, the ECAPM formula includes a slight adjustment as follows:

$$ECAPM = R_f + aMRP + (1 - a)\beta MRP$$

Where: all the terms are the same as described in the CAPM above and the term (a) = 0.25% and (1-a) = 0.75% to make up a 1% adjustment factor.

[23] New Regulatory Finance, *Public Utility Reports 2006*, at 175-209.

The basic ECAPM formula is as follows:

ECAPM[24]

$$K = R_f + 0.25(R_m - R_f) + 0.75\beta(R_m - R_f)$$

$$K = 4.55\% + 0.25(5.2\%) + 0.75 \times 0.69(5.2\%)$$

$$K = 4.55 + 1.3\% + 2.691\%$$

$$K = 8.54\%$$

Q. PLEASE SUMMARIZE YOUR COST OF EQUITY CAPITAL RESULTS FOR THIS CASE.

A. The DCF results both constant and two-stage DCF for the comparable group companies, the CAPM and ECAPM, along with the updated risk premium and alternative risk premium analysis are summarized in the following table:

Table 4
Summary of Cost of Equity Modeling

Description	**Range**	
DCF Constant Growth Electric Utility Group	9.3%	9.7%
DCF Two-Stage Electric Utility Group	9.6%	9.6%
Average DCF	9.45%	9.65%
CAPM	8.1%	
ECAPM	8.5%	
Historical Risk Premium Authorized Electric Utility Returns	8.7%	10.1%
CAPM/RP Average	8.4%	10.1%

The DCF results range from 9.45% to 9.65%. The CAPM and risk premium approaches range from 8.4% to 10.1%. Relying on the DCF 9.45% and 9.65% range along with the risk premium range of 8.7% to 10.1% produces an overall range of about 9% to 10%. The DCF midpoint is about 9.55% while the risk premium midpoint is slightly lower at 9.48%. All of these results lead to a 9.5% point estimate as reasonable.

[24]Stocks, Bonds, Bills and Inflation Market Report, December 2010 at 12 on Table 7.

Q. HOW DO YOUR RANGE OF RESULTS COMPARE TO COMPANY WITNESS DR. HADAWAY'S SUMMARY OF EQUITY ESTIMATES?

A. Dr. Hadaway's results average about 10.28%.[25] Thus, the Company's, albeit somewhat stale, analysis is somewhat close to current market results. My analysis indicates a 9.5% equity return. Thus, we are within 78 basis points before consideration of risk adjustments (which Dr. Hadaway ignored) to reflect the lower risk of RMP relative to the comparable group.

SECTION VII: RISK MITIGATION FACTORS

Q. ARE THERE FACTORS THAT TEND TO MITIGATE RMP'S RISK THAT THIS COMMISSION SHOULD CONSIDER IN SETTING THE EQUITY RETURN IN THIS CASE?

A. Yes. In setting the equity return and balancing the interests of customers and shareholders, the Commission should consider a number of factors in arriving at a specific equity return in this case. I have compiled a number of factors below that should be considered in evaluating shareholder risks in setting equity returns:

Risk and other Factors impacting RMP and Customers:

1) The Company's proposed capital structure with a 51.9% equity ratio provides the Company lower financial risk than the comparable group companies that have an average forecasted equity ratio of 49.0% or less;

2) On or about March 3, 2011, this Commission issued a Corrected Report and Order in Docket No. 09-035-15 authorizing the "Rocky Mountain Power Energy Balancing Account" ("EBA"). Rating agencies in particular view fuel factor adjustment clauses such as the EBA recently adopted on a four year Pilot basis as a risk reduction mechanism.

3) Forecasted Test Period in this case has been approved by the Commission on March 30, 2011. The test period will cover the twelve month period ending June 30, 2012. This test period reflects forecasted plant additions

[25] Direct Testimony Dr. Hadaway at 32:669

and allows the Company to recover investment through rates more quickly avoiding regulatory lag risks.

4) Since the last case, the Company has implemented two filings under Utah Code §54-7-134 for major plant additions. Specifically, in Docket No. 10-035-13 (MPA I), the Company filed for a revenue requirement adjustment of $33.7 million reflecting cost recovery of Company investments in transmission facilities and generation plant improvement measures.[26] This Commission issued a June 15, 2010 Report and Order approving a Settlement Stipulation authorizing a revenue requirement increase of $30.8 million. Also, in Docket No. 10-035-89 (MPA II), the Company filed for a revenue requirement increase of $39 million related to transmission facilities and the Dunlap I wind project. In its December 21, 2010 Report and Order approving a Settlement Stipulation the Commission authorized a revenue requirement increase of $33.29 million for MPA II and allowed the Company to begin collecting the authorized revenue for both MPA I and MPA II on January 1, 2011. Again, regulatory lag is mitigated by affording cost recovery through stream-lined rate recovery mechanisms.

5) Cash flow and financial metrics are improved through opportunities flowing from use of bonus depreciation. RMP has more opportunities and benefits resulting from bonus depreciation because of the size and timing of its investment additions relative to other utilities.

6) An additional factor is rate design. In this case RMP is proposing a $10 customer charge for residential customers – a substantial increase to the current customer charge levels. Such a rate design assures revenue recovery and removes risk associated with sales revenues. Thus, to the extent this Commission adopts such rate design or decoupling proposals[27] (as proposed in the last rate case), RMP's revenue recovery risk is

[26] See Docket No. 10-035-13 Application.

[27] My understanding is that the OCS does not generally support rate designs that include decoupling or high customer charges and will be providing evidence supporting alternatives in the COS/rate design portion of this case.

decreased and is a factor that should be considered in evaluating RMP's risks and equity return.

Q. HOW DO EACH OF THE FACTORS IMPACT RMP'S RISKS?

A. Starting with items (2) – (4), these factors, while generally not specifically quantifiable, all tend to reduce the Company's risks by minimizing regulatory lag in terms of cost recovery. While the Company is likely to assert that comparable companies have these same opportunities, (especially with regard to fuel cost recovery) that does not minimize the fact that RMP's risks are declining.

Further, the forecasted test year in this case, coupled with the opportunities for limiting regulatory lag through single issue or major plant addition filings put RMP's regulatory lag well below the industry average of about 11 months.

Q. IF THESE FACTORS CANNOT BE SPECIFICALLY QUANTIFIED, HOW SHOULD THEY BE VIEWED IN EVALUATING AND SETTING EQUITY RETURN?

A. When setting an equity return, experts and regulatory authorities often identify a "reasonable range" of equity returns. Factors such as risk reduction mechanisms associated with fuel recovery, major plant additions cost recovery, forecasted test years and minimizing regulatory lag are helpful in setting a specific return within a reasonable range. Thus, if risk is higher for a specific utility – then specific equity returns in the upper half of the range are more appropriate. Alternatively, if risks are lower, as they are in this case for RMP, the specific equity returns in the lower end of the range are more appropriate.

Q. EARLIER YOU STATED THAT THE COMPARABLE GROUP EQUITY RATIO AVERAGES ABOUT 49% WHILE RMP'S REQUESTED TEST YEAR EQUITY RATIO IS ABOUT 52%. HOW DOES THIS IMPACT RISK?

A. RMP has less debt and therefore less financial risk than the comparable group. Given that the DCF results are based on the comparable group – these estimates must be adjusted downward to reflect RMP's higher equity ratio and lower financial risk. I

estimate about a 25 basis point downward adjustment is necessary to RMP's equity costs to adjust for the Company's lower financial risk.

Q. HOW DID YOU ESTIMATE A 25 BASIS POINT ADJUSTMENT FOR CAPITAL STRUCTURE?

A. First, a review of empirical studies evaluating the effects of leverage (debt) on common equity indicates about 7.6 basis points equity return reduction for every 1 percent change in debt. A list of these studies is contained in my workpapers. Given the 3% difference between the comparable group equity ratio and RMP's requested 52% level; the equity return should be reduced by 22.8 basis points (3 x 7.6). I have rounded this to 25 basis points.

As a check I analyzed the overall return employing the comparable group 51% debt 49% equity and adjusted RMP's equity level to equalize the overall returns. The equity adjustment necessary was about 28 basis points. This calculation is also included in my workpapers.

The bottom line is that about a 25 basis point adjustment is justified because of the higher RMP equity ratio.

Q. WHAT ISSUES ARE YOU ADDRESSING REGARDING BONUS DEPRECIATION?

A. I am addressing the cash flow impacts that result from bonus depreciation. These cash flow impacts are significant in relation to this case given the size of the capital additions RMP is adding to the system. I am aware that this Commission has previously set up a separate proceeding to address bonus depreciation issues and I am also aware specific revenue requirement issues related to bonus depreciation have been raised and addressed in previous cases. The consideration of bonus depreciation on return does not impact the appropriate revenue requirement treatment which will be addressed in Docket No. 11-035-47. My testimony only addresses the cash flow impact and results of certain financial metrics related to bonus depreciation.

Q. WHAT IS BONUS DEPRECIATION?

A. Quite simply, bonus depreciation is the acceleration or front-loading of depreciation expenses for tax purposes. As part of the most recent federal tax legislation (extension of the Bush tax cuts) under the "U.S. Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("2010 Tax Relief Act") that was signed into law December 17, 2010, this legislation allows U.S. companies to depreciate 100% of the cost of eligible, newly installed equipment and assets after September 8, 2010 and before January 1, 2012. Beginning January 1, 2012, the first year depreciation rate will fall to 50 percent for the eligible equipment entering service in 2012.

Q. DOES BONUS DEPRECIATION IMPACT EARNINGS?

A. No, bonus depreciation does not impact the total amount of depreciation only the timing of the depreciation deduction, therefore there is no impact on Company earnings – only cash flow is impacted.

Q. PLEASE PROVIDE A SIMPLE EXAMPLE OF HOW BONUS DEPRECIATION PROVIDES INCREASED CASH FLOW TO A COMPANY.

A. Assume a firm makes an investment of $1 million in new equipment that has a typical tax recovery life of 7 years. Under current depreciation schedules (assuming half year convention for MACRS[28] Property) the first year deduction for depreciation would be 14.29% or $142,900.[29] At a 35% income tax rate business taxes would be reduced by $50,015 (35% x $142,900). By contrast, under bonus depreciation employing the immediate 100% expensing of the asset, this hypothetical firm could deduct the entire $1 million in year 1, saving $350,000 (35% x $1 million) in taxes. This results in increased cash from tax savings of about $300,000 ($350,000 - $50,015).

Q. HOW DO CREDIT RATING AGENCIES VIEW THE BONUS DEPRECIATION IMPACTS ON CREDIT QUALITY?

[28] Modified Accelerated Cost Recovery System (MACRS) is the current tax depreciation system used to calculated annual tax deductible depreciation expenses by asset.
[29] Department of Treasury, Internal Revenue Service, Publication 946.

A. A recent (March 7, 2011) Fitch Rating Special Report on "Bonus Depreciation in the U.S. Utility Industry" concluded, that from "…a credit ratings perspective, one of the key considerations relating to bonus depreciation is how related cash is utilized. If the cash is used to reduce debt issuance, pre-fund the pension plan, or partially fund capital spending for the core business, that would be considered neutral to positive for credit. [But]…credit rating concerns may emerge if cash is used…for shareholder-friendly initiatives as eventually the tax bills will become due."[30]

The Company's proposal to pay $850 million in increased shareholder dividends is the type of (shareholder-friendly) credit rating negative Fitch was describing above. Thus, the Company's proposals in the case may have added negative impacts on consumers if credit rating agencies act on these "shareholder-friendly" $850 million dividend payment Company proposals.

Q. HOW MUCH IN REVENUE CASH FLOW DOES THE COMPANY EXPECT TO GENERATE FROM BONUS DEPRECIATION FOR THE YEARS 2010, 2011 AND 2012?

A. Based on the Company's response to UIEC Data Request 1.69, the Company expects to generate cash flow of approximately $554.5 million for 2010, $411.3 million for 2011, and $137.6 million for 2012. Thus, a total three year cash flow generation of $1,103.4 million.

Q. IS THE INCREASED CASH FLOW FROM BONUS DEPRECIATION ANOTHER FACTOR THAT THE COMMISSION SHOULD CONSIDER?

A. Absolutely. While the increased cash flow is not earnings – such cash flow does impact financial metrics (cash flow based) and perceptions of risk and ability to fund investment. Like other unquantified risk reduction factors – the increased cash flow warrants returns towards the bottom half of the equity return range.

Q. HAD DR. HADAWAY TAKEN THESE RISK REDUCTION IMPACTS INTO CONSIDERATION, WOULD HIS EQUITY RETURN RESULTS BE LOWER?

[30] Fitch Ratings Special Report, "Bonus Depreciation in the U.S. Utility Industry", March 7, 2011 at 2.

A. Absolutely. Dr. Hadaway's analysis ignores these factors when assessing equity return in this case – as a result his recommended return is overstated.

Q. IS IT YOUR OPINION THAT A 9.5 PERCENT EQUITY RETURN IS SUPPORTED IN THIS CASE?

A. Yes. A 9.5% equity return is consistent with the return ranges from the comparable group analyses. A 9.5% equity return is consistent with current market data. A 9.5% equity return is consistent with the lower risks faced by the Company's Utah operations as discussed above.

SECTION VIII: CAPITAL STRUCTURE

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

A. Based on the direct testimony of Company witness Bruce Williams, the Company is proposing the following capital structure, cost rates and overall cost of capital to be earned on rate base investment as follows:

TABLE 6[31]

ROCKY MOUNTAIN POWER COMPANY

OVERALL REQUESTED COST OF CAPITAL

Description	Percent	Cost	Weighted Cost
Long-Term Debt	47.8%	5.81%	2.78%
Preferred Stock	0.3%	5.43%	0.02%
Common Equity	51.9%	10.50%	5.45%
Total	100.00%	---	8.25%

Thus, the Company requests an overall cost of capital to be earned on rate base investment of 8.25% in this case.

[31] DirectTestimony Bruce Williams

Q. WHAT IS THE SIGNIFICANCE OF CAPITAL STRUCTURE?

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

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

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

In summary, it is not possible to determine with precision the exact proportion of debt and equity that minimizes the overall cost of capital without imposing undue financial risk upon the Company. There does exist some range of capital structure that generally, 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 financial 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. ARE YOU RECOMMENDING AN ADJUSTMENT TO THE COMPANY'S PROPOSED CAPITAL STRUCTURE?

A. No. I have adjusted my equity return recommendation to reflect the lower financial risk of RMP with its 51.9% equity ratio relative to the Comparable Group.

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

A. 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 7
RECOMMENDED OVERALL COST OF CAPITAL
ROCKY MOUNTAIN POWER

Description	Ratio	Cost	Weighted Cost
Long-term Debt	47.8%	5.81%	2.78%
Preferred Stock	0.3%	5.43%	0.02%
Common Equity	51.9%	9.50%	4.93%
Total	100.00%	---	7.73%

As can be seen from the above table when the Company proposed long-term debt and preferred stock cost rates and common equity cost rates reflecting current market conditions is employed, the Company's overall cost of capital is 7.73%.

SECTION IX: FINANCIAL INTEGRITY

Q. HAVE YOU REVIEWED CREDIT RESEARCH REPORTS FOR THE COMPANY REGARDING CREDIT QUALITY AND CORPORATE FINANCIAL METRICS?

A. The Company's credit quality is not threatened or under significant pressure of downgrade. Instead, the Company continues to benefit from the current ownership structure and backstop of capital. Current bonus depreciation impacts on cash flow will cause rating agencies to focus more on earnings or EBITA metrics as pure cash flow measures are temporarily influenced by current tax law impacts. In my opinion, these are the cash flow metrics rating agencies will consider.

An equity return of 9.5%, combined with all the risk mitigation benefits discussed earlier, allows the Company to maintain reasonable cost recovery.

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 9.5% equity return) 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 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 Moody's and 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 are calculated in my Exhibit (OCS 1.9) employing my recommendations in this proceeding. The results of my analyses indicate strong financial metrics, supporting the current bond rating.

The resulting financial metrics at a 9.5% equity return are consistent with a solid single A bond rating.

SECTION X: <u>ISSUES RAISED IN DR. HADAWAY'S DIRECT TESTIMONY</u>

Q. DO YOU HAVE ANY GENERAL COMMENTS REGARDING DR. HADAWAY'S ANALYSIS AND RECOMMENDATION IN THIS CASE?

A. Yes, I have a few general comments. First, Dr. Hadaway's 10.5 percent return on equity recommendation is biased upwards due to his failure to include his risk premium results – and his total failure to consider risk mitigation factors that benefit RMP relative to his comparable group analysis.

First, in arriving at his 10.5% equity return estimate Dr. Hadaway considered only his comparable group discounted cash flow range of 10.1% to 10.7% and concluded a 10.5% point estimate to be reasonable.[32] Second, Dr. Hadaway's high end of the estimates (10.7%) is the result of employing an overstated and totally unsupported GDP growth estimate of 6.0%. Third, updating Dr. Hadaway's analyses and eliminating unsupported growth estimates results in an average equity return of under 10%. Fourth, taking into consideration this Commission's risk mitigation measures (forecasted test year, fuel reconciliation EBA) single issue rate cases for major plant additions, the lower financial risk of the Company relative to the comparable group, the ROE estimate should be in the 9.5% range.

Q. HAS THE IDAHO PUBLIC UTILITIES COMMISSION RECENTLY EVALUATED THE COMPANY'S RATES AND COSTS IN AN IDAHO RATE CASE?

A. Yes, in a case referenced by Dr. Hadaway,[33] the Idaho Public Utilities Commission authorized an equity return of 9.9%.[34] In arriving at a 9.9% equity return, the Idaho Commission stated: "In authorizing a 9.9% return on common equity, this Commission reaffirms its desire to maintain PacifiCorp as a financially viable utility with credit ratings at or above the current level."[35]

While Dr. Hadaway sponsored the Rocky Mountain Power Idaho return on equity request of 10.6% with analyses similar to what have been presented in this Utah case – the Idaho Commission found a much lower equity return to be reasonable.[36] Further, there is no evidence that the numerous risk mitigation factors[37] present in the current Utah case were present in the Idaho case. Thus, a lower equity return is supported for the Company's Utah operations.

[32] Direct Testimony Samuel Hadaway at 1:21-2:29.
[33] Direct Testimony Samuel Hadaway at 2:30-44.
[34] In the Matter of the Application of PacifiCorp DBA Rocky Mountain Power for Approval of Changes to its Electric Service Schedules, Case No. PAC-E-10-07, Order No. 32196, February 28, 2011.
[35] *Id* at 12.
[36] *Id* at 11-12.
[37] *Id* at 2, For example, the test year in the Idaho case was the twelve months ending December 31, 2009, adjusted for known and measurable changes through December 31, 2010. In the current Utah case, the test period is forward looking through June 30, 2012.

THE UTAH COMMISSION PROVIDES AN INDEPENDENT ASSESSMENT OF THE COMPANY, WHY WOULD THE FEBRUARY 11, 2011 IDAHO DECISION BE RELEVANT?

A. The very recent Idaho decision does provide this Commission some insight as to how other regulatory authorities are viewing the Company's capital costs and risks. Moreover, even Dr. Hadaway thought the Idaho decision important enough that he attempts to explain the 9.9% ROE away due to the temporary drop in interest rates. Dr. Hadaway is incorrect in his interest rate analysis and the Idaho Commission makes very clear in their February 11, 2011 Final Order that it finds "…the middle ground position advanced by Staff witness Carlock to be reasonable."[38] Further, the Staff testimony and recommendation was supported by DCF and comparable earnings analyses[39] - not, as Dr. Hadaway now claims, a sudden drop in interest rates.

It is also important to note that the Idaho Commission also considered the following factors in setting the equity return:

1) Reduced risk of PacifiCorp for the Energy Cost Adjustment Mechanism (ECAM)
2) Increased cost recovery risk caused by allocation changes of Irrigation Load Control Program Costs;
3) Delays in plant recovery and cash flow impacts; and
4) Ability to fund near term capital expansion.

All of the above, when combined with the evidence in this case, supports a cost of equity in the 9.5% range, well below Dr. Hadaway's 10.5% proposal.

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

A. The overall comment I have is that his GDP 6% growth estimate used in one of the constant growth DCF analyses is overstated and should be ignored by the Commission. Dr. Hadaway's sixty year analysis is out of touch with current market realities and exceeds current analysts' growth projections by at least 80 basis points. Moreover, as

[38] *Id* at 11
[39] *Id* at 9.

noted earlier, the recent Federal Reserve FOMC meeting indicates much more moderate GDP growth for some time. Dr. Hadaway's estimate is inconsistent with market realities. There is no evidence or basis to conclude that investors are relying on a 6% growth in long-run GDP as the basis for their investment decisions.

Q. DID DR. HADAWAY ADJUST HIS RESULTS FOR CAPITAL STRUCTURE DIFFERENCES?

A. No, he ignored RMP's lower financial risk relative to the comparable group.

Q. DID DR. HADAWAY MAKE ANY RISK ADJUSTMENTS?

A. No.

Q. IN THE COMPANY'S LAST GENERAL RATE CASE, DOCKET NO. 09-035-23, DID DR. HADAWAY INCORRECTLY ARGUE THAT EQUITY CAPITAL COSTS WERE INCREASING?

A. Yes. As noted at page 13 of this Commission's Final Order, the following is stated: "…Messrs. Peterson and Lawton conclude capital costs are decreasing, but Dr. Hadaway claims capital costs are increasing." Dr. Hadaway's increasing capital cost claims have been proven incorrect. Now, Dr. Hadaway is recognizing capital costs have declined and continue to decrease. Dr. Hadaway is now recommending a 10.50% equity return down from his previous 11.0% recommendation.

There is no question in this case about whether capital costs are declining; even the Company recognizes that obvious fact. The issue now before the Commission is at what lower level the equity return should be set. As noted earlier, the market operational risks for the Company are lower than the comparable group. Regulatory lag is reduced through forecasted test periods and single issue ratemaking for major plant additions. Risk of fuel cost under-recovery is reduced with the current pilot fuel cost recovery mechanism. Further, RMP's financial risk is lower than the average comparable group given the Company's higher equity ratio – necessitating about a 25 basis point adjustment.

Taking all of the above into consideration, an equity return below 10% is required and a

level of 9.5% is quite reasonable.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.