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 Exhibit No. DPU 4.0-R Cost of Capital Rebuttal Testimony and Exhibits Charles E. Peterson

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

Rebuttal Testimony of

Charles E. Peterson

June 8, 2011

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1 **Rebuttal Testimony of Charles E. Peterson**

2

3 **I. INTRODUCTION AND SUMMARY**

4

5 **Q. Please state your name, business address and title.**

6 A. My name is Charles E. Peterson; my business address is 160 East 300 South, Salt Lake City,
7 Utah 84114; I am a Technical Consultant in the Utah Division of Public Utilities (Division,
8 or DPU).

9

10 **Q. On whose behalf are you testifying?**

11 A. The Division.

12

13 **Q. Did you previously file testimony regarding cost of capital in this Docket?**

14 A. Yes.

15

16 **Q. What is the purpose of your testimony in this matter?**

17 A. My testimony comments on the pre-filed direct testimony of intervenor witnesses who filed
18 testimony regarding the cost of capital of the Company.[1] Specifically, I provide comments on
19 the direct testimony of Wal-Mart Stores, Inc., and Sam's West, Inc. (Wal-Mart) witness

[1] Rocky Mountain Power (RMP) is an operating division of PacifiCorp primarily performing the retail distribution operations of PacifiCorp in the eastern part (i.e. Utah, Wyoming and Idaho) of PacifiCorp's system. RMP runs no electric generators, and more importantly for my purposes, it has no debt, no preferred stock and no common stock. The fact that PacifiCorp files with the Commission under the name Rocky Mountain Power, doesn't change the fact that any cost of capital calculations are necessarily of the whole company (i.e. PacifiCorp) and not its local division. Therefore, throughout this testimony I will primarily refer to PacifiCorp, rather than RMP.

20 Steve W. Chriss, Office of Consumer Services (OCS) witness Daniel J. Lawton, and Federal
21 Executive Agencies (FEA) witness Michael Gorman.
22
23 While I am making relatively few comments concerning the direct testimony of these
24 witnesses, silence on my part regarding any of the methods, analyses, and conclusions of
25 these witnesses does not necessarily imply my agreement, or disagreement, with those
26 methods, analyses, and conclusions.
27
28 **Q. Do you have some general, overall comments regarding the direct testimony and**
29 **conclusions of Messrs. Lawton and Gorman?**
30 A. Yes. As with the Company's witness, Dr. Samuel Hadaway, the primary difference between
31 my conclusions and the conclusions of Messrs. Lawton and Gorman is in the growth rates
32 assumed for the various guideline companies. Although, in the case of Dr. Hadaway, the
33 estimated growth rates that I used were generally lower than his growth rates, my growth
34 rates were generally somewhat higher than those used by Messrs. Lawton and Gorman. Part
35 of the difference in growth rates is due to the somewhat different lists of comparable, or
36 guideline, companies used by Messrs. Lawton and Gorman, which were based upon Dr.
37 Hadaway's list; my independently constructed list of companies were included in the other
38 analysts' list, but they included additional companies that I concluded were less useful.
39
40 Mr. Gorman's 9.80 percent point estimate for the cost of equity is not significantly outside
41 the reasonable range of values that I suggested (i.e. 9.85 to 10.15 percent), and his reasonable
42 range of 9.60 percent to 10.0 percent overlaps with my reasonable range. However, because

43 of concerns with certain inputs he used, I am uncomfortable with Mr. Lawton's relatively
44 low point estimate of 9.50 percent; although unlike Dr. Hadaway's 10.50 percent point
45 estimate, Mr. Lawton's point estimate is within the range of values that I considered.[2]
46
47 Finally, in the last general rate case, Docket No. 09-035-23, Dr. Hadaway asserted that11.0
48 percent was the appropriate authorized return on equity (ROE) for the Company,[3] my
49 recommended ROE was 10.50 percent,[4] and Mr. Lawton's ROE recommendation was 10.0
50 percent;[5] for this Docket the recommendations are 10.50 percent, 10.00 percent and 9.50
51 percent respectively, i.e. each witness has reduced his recommended ROE by 50 basis points
52 *vis ά vis* their recommendations about one and one-half years ago.[6] This suggests general
53 agreement as to the direction and the magnitude of the change in the cost of equity since
54 Docket No. 09-035-23.
55
56
57 **II. COMMENTS ON INTERVENOR COST OF CAPITAL WITNESSES**
58
59 Steve W. Chriss
60 **Q. What did Mr. Chriss recommend to the Commission?**
61 A. Mr. Chriss does not make any numerical recommendations regarding PacifiCorp's cost of
62 equity. Instead, his testimony focuses on the reduction in risk faced by the Company's

[2] See Direct Testimony of Charles E. Peterson, DPU Exhibit 4.3; Docket No. 10-035-124, May 11, 2011.
[3] Docket No. 09-035-23, Direct Prefiled Testimony of Samuel C. Hadaway, lines 38-43.
[4] Docket No. 09-035-23, Direct Testimony of Charles E. Peterson, DPU Exhibit 1.0, September 17, 2009, lines 62-63.
[5] Docket No. 09-035-23, Direct Testimony of Daniel J. Lawton, OCS Exhibit 1.0D, September 17, 2009, lines 50-52.
[6] Mr. Gorman did not participate in Docket No. 09-035-23.

63 stockholder due to the implementation of the energy balancing account (EBA). He asks the
64 Commission to consider reducing the Company's ROE, by some unspecified amount, as a
65 result of the reduction risk to the Company afforded by the EBA.
66
67 **Q. Do you agree with Mr. Chriss?**
68 A. Yes, in principle, I agree that the EBA will reduce the variability of recovery of net power
69 cost expense and hence reduce the risk to the Company and its stockholder. However, Mr.
70 Chriss does not attempt to quantify how much the authorized ROE should be reduced,
71 leaving it up to the Commission to decide an amount.
72
73 The Division dealt with a similar issue in the Questar Gas Company (QGC) rate case, Docket
74 No. 07-057-13, wherein it was argued that because the revenue decoupling afforded to QGC
75 reduced its risk, the authorized ROE should be reduced. Again while the Division agreed in
76 principle with that assertion, quantifying the reduction in ROE was problematic, and was
77 likely in the zero to 30 basis points range. Given the inherent uncertainty with cost of equity
78 estimates to begin with, the Division declined to recommend a reduction in QGC's
79 authorized ROE.[7] The Division is unaware of any progress being made in developing
80 reliable procedures to estimate such reductions; therefore, the Division declines to
81 recommend such a reduction in this Docket.[8]

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[7] See in Docket No. 07-057-13: Prefiled Direct Testimony of William Powell, Ph.D., DPU Exhibit 3.0, March 31, 2008; Prefiled Rebuttal Testimony of William A. Powell, Ph.D., DPU Exhibit 3.0R, April 28, 2008.
This issue was also discussed in the recent ECAM (now re-named EBA) Docket No. 09-035-15. For a summary see the transcript of the testimony of Dr. Samuel Hadaway, November 1, 2011, lines 151-168.

[8] At the April 15, 2011 annual conference of the Society of Utility and Regulatory Financial Analysts, Richard A. Michelfelder, Ph. D., Clinical Associate Professor of Finance, Rutgers University School of Business – Camden, gave a presentation titled "Decoupling: Impact on the Risk of Public Utility Stocks." In this presentation he concluded that the study he made was not statistically significant, but did show a reduction in utility company betas of 0.08. Ignoring the issue of statistical significance, applying the 0.08 point reduction in beta to a typical market

82

83 Daniel J. Lawton

84 **Q. You discussed above that Mr. Lawton's growth rates were lower than your own. Would**

85 **you elaborate?**

86 A. Yes. Mr. Lawton compiles growth forecasts made by Wall Street analysts that average 5.40

87 percent (see Mr. Lawton's OCS Exhibit 1.5, page 1), which is similar to the 5.48 percent that

88 I derived from Wall Street analysts. He then estimates the "sustainable growth" rates from

89 Value Line data that average 4.82 percent and averages the "sustainable growth" rates with

90 the analyst growth rates, to arrive at an average growth rate of 5.11 percent. He also

91 computes the median growth rates that average 4.85 percent. Thus Mr. Lawton's growth rates

92 are roughly 35 to 50 basis points below mine. This difference in growth rates accounts for

93 most of the difference between my recommended cost of equity and that of Mr. Lawton.

94

95 **Q. The main driver in the difference in growth rates is Mr. Lawton's use of the**

96 **"sustainable growth" estimates. Do you have comments about "sustainable growth"?**

97 A. Like any calculation, the results are only as good as the inputs. The "sustainable growth"

98 formula used by Mr. Lawton does have a theoretical basis. But the assumption he makes is

99 that the Value Line data and forecasts he uses to construct his "sustainable growth" rates are

100 the correct long-term inputs for these growth rates; in fact he implicitly assumes that the

101 Value Line forecasts that went into his "sustainable growth" calculations are better than

102 Value Line's actual growth forecasts, and better than the analyst forecasts he obtains from

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risk premium used in CAPM, would result in an ROE reduction of about 40 basis points. This study is suggestive that the reduction in ROE due to risk reduction mechanisms is likely in the 40 basis points or less range as suggested in the Division's earlier testimony.

103 Zacks and Yahoo! Finance as well.[9] I find the assumption that Value Line's actual growth
104 forecast is less reliable than its data for "sustainable growth" that covers the same time period
105 to be questionable, at best. In my view it would be more valid to use Value Line's actual
106 growth forecasts, rather than trying to piece together an alternative forecast from Value Line
107 numbers. I recommend rejecting Mr. Lawton's "sustainable growth" rates. If that were done,
108 then Mr. Lawton would have arrived at a cost of equity estimate similar to my own.
109

110 **Q. Do you have any other comments regarding Mr. Lawton's testimony?**
111 A. I believe Mr. Lawton may have made a calculation error in column "T" of Exhibit OCS 1.5,
112 page 2, Mr. Lawton's "sustainable growth" calculations. The calculation seems to be a five-
113 year annual growth rate (actually 5.5 years since the base year is an average of 2009 and
114 2010), but is actually a two-year annual growth rate. Correcting this apparent error probably
115 won't materially change Mr. Lawton's overall conclusions, or affect my critique of the
116 "sustainable growth" calculations.
117

118 <u>Michael Gorman</u>
119 **Q. As with Mr. Lawton, you briefly discussed Mr. Gorman's growth rate estimates above.**
120 **Would you elaborate further on Mr. Gorman's growth rates?**
121 A. Yes. Mr. Gorman compiles analyst growth rates and arrives at an average of 5.38 percent,
122 which is 10 basis points below mine. Unlike Mr. Lawton, Mr. Gorman uses this growth rate
123 in an independent cost of equity estimation. Like Mr. Lawton, Mr. Gorman uses Value Line
124 data and forecasts to arrive at "sustainable growth" estimates that average 40 basis points
125 below the growth rates I used and he also uses these "sustainable growth" rates in an

[9] Direct Rate of Return Testimony of Daniel J. Lawton, Docket No. 10-035-124, May 11, 2011, lines 506-513.

126 independent DCF model. It appears that Mr. Gorman does not use Value Line's actual
127 growth forecasts; instead he uses forecasts from Zacks, Reuters, and SNL Interactive that
128 cover the same period as the Value Line forecasts used in the "sustainable growth" model. I
129 have the same criticisms of Mr. Gorman's "sustainable growth" rates as I did with Mr.
130 Lawton's. I recommend rejecting Mr. Gorman's "sustainable growth" estimates. Rejecting
131 the model using sustainable growth would move Mr. Gorman's cost of equity point estimate
132 closer to mine.
133
134 **Q. Do you have other comments regarding Mr. Gorman's analyses?**
135 A. Yes. Like Mr. Lawton (and Dr. Hadaway), Mr. Gorman creates a risk premium model based
136 upon authorized utility returns. In my direct testimony I have outlined reasons for
137 questioning the validity of regulatory authorized returns as essentially market observations.[10]
138 However, if Mr. Gorman, Mr. Lawton, and Dr. Hadaway believe that authorized returns are
139 valid estimators of utility cost of equity, then I suggest that it is much more transparent and
140 straightforward to simply use the most recent quarter's averages and not worry about
141 regression slopes and rate spreads to try to reshape the authorized returns estimator.
142

143 **III. CONCLUSIONS AND RECOMMENDATIONS**

144
145 **Q. Do you have any final comments regarding the analyses of Messrs. Lawton, Gorman**
146 **and Chriss?**
147 A. As outlined above, the primary difference between my analysis and the analyses of Mr.
148 Lawton and Mr. Gorman is that each, to a greater or lesser degree, have used lower growth

[10] Peterson, Op. Cit., May 11, 2011, pages 44-45, lines 962-987.

149 rates than I used, which were the main drivers in their respective cost of equity estimates.
150 Further, I showed that this difference in growth rates was due to their inclusion of
151 "sustainable growth" rates. For reasons discussed above, I recommend rejection of these
152 "sustainable growth" rate calculations, which if done, would move the results of Messrs.
153 Lawton and Gorman closer to mine. I note in passing that secondary differences, which are
154 largely incidental, include the use of somewhat different, though overlapping lists of
155 comparable companies and somewhat different time frames for calculating stock prices and
156 otherwise obtaining data. Furthermore, because it seems that no two analysts ever use exactly
157 the same models in exactly the same way, some variation in results are inevitable.
158
159 The primary concern is whether or not the results seem to be in a reasonable range. In this
160 regard, as I mentioned above, Mr. Gorman's overall conclusion is not really significantly
161 different from mine (and likely would be closer if the "sustainable growth" model were
162 excluded). Mr. Lawton's result gives me some concern that it may be too low although it is
163 supportable by some of the analyses that I did.
164
165 **Q. What is your recommendation?**
166 A. I continue to support my original recommendation that for PacifiCorp and its division, Rocky
167 Mountain Power, the Commission adopt as the authorized cost of equity of 10.0 percent and
168 an overall weighted average cost of capital of 7.98 percent.
169
170 **Q. Does this conclude your testimony?**
171 A. Yes.