Docket No. 10-035-124

Utah Office of Consumer Services Witness:

Daniel J. Lawton

Exhibits OCS 1.1SR through 1.6SR

June 27, 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** **Surrebuttal Rate of Return Testimony of Daniel J. Lawton For the Utah Office of Consumer Services**

June 27, 2011

TABLE OF CONTENTS

SECTION I: INTRODUCTION AND PURPOSE OF TESTIMONY 1
SECTION II: CHARLES PETERSON REBUTTAL 2
SECTION III: BRUCE WILLIAMS REBUTTAL 3
SECTION IV: SAMUEL HADAWAY REBUTTAL 5

Exhibit OCS 1.1SR

Exhibit OCS 1.2SR

Exhibit OCS 1.3SR

Exhibit OCS 1.4SR

Exhibit OCS 1.5SR

Exhibit OCS 1.6SR

DIRECT TESTIMONY OF
DANIEL J. LAWTON

1 **SECTION I: <u>INTRODUCTION AND PURPOSE OF TESTIMONY</u>**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Daniel J. Lawton. My business address is 701 Brazos, Suite 500, Austin,
4 Texas 78701.

5 **Q. ARE YOU THE SAME DANIEL J. LAWTON THAT PREVIOUSLY FILED**
6 **DIRECT TESTIMONY IN THIS DOCKET?**

7 A. Yes.

8 **Q. WHAT IS THE PURPOSE OF THIS SURREBUTTAL TESTIMONY?**

9 A. The purpose of this testimony is to address the rebuttal testimony of Charles E. Peterson
10 of the Utah Division of Public Utilities ("DPU") and the rebuttal testimonies of Bruce N.
11 Williams and Samuel Hadaway of Rocky Mountain Power ("Company" or "RMP").

12 **Q. BEFORE ADDRESSING THE SPECIFIC REBUTTAL TESTIMONY OF EACH**
13 **WITNESS, DO YOU HAVE ANY CHANGES OR UPDATES TO YOUR DIRECT**
14 **TESTIMONY?**

15 A. Yes. First, I have updated the RMP cost of long-term debt which I discuss in reference
16 to Mr. Williams' rebuttal testimony below. I have also updated my DCF analysis
17 through May 31, 2011 and I have adjusted the comparable group comparison to reflect
18 the elimination of four companies. These updated schedules are attached as OCS 1.1SR
19 through OCS 1.6SR.

20 The final return on equity recommendation remains 9.5% and the overall
21 recommendation is 7.68%, a decrease from my original 7.73% due to the Company's
22 updated cost of long-term debt. The following is the updated capital structure and
23 recommended return on capital.

24

RECOMMENDED CAPITAL STRUCTURE AND RETURN			
DESCRIPTION	DEBT	COST	WEIGHTED COST
Long-Term Debt	47.80%	5.71%	2.73%
Preferred	30.00%	5.43%	0.02%
Common	51.90%	9.50%	4.93%
Total	100.00%		7.68%

25 My recommended overall return is now 7.68% which reflects the Company's updated
26 and lower cost of long-term debt. I have maintained my recommended return on equity
27 of 9.5%.

28 **Q. PLEASE SUMMARIZE YOUR UPDATED DCF ANALYSIS.**

29 A. I have included in my attached exhibit six schedules updating the data for the constant
30 growth and two-stage DCF analyses. These updates reflect the most recent stock prices,
31 dividend data, growth rate estimates and other data through May 31, 2011. I have also
32 reflected the changes to the comparable group presented in Dr. Hadaway's rebuttal
33 testimony.

34 The results of the DCF update continue to support a 9.5% equity return for the
35 Company. The change in the comparable group does not impact the 9.5%
36 recommendation. The use of the most recent data updates does not impact the 9.5%
37 recommendation. I would note that employing only analyst earnings forecasts and not
38 using sustainable growth estimates only slightly changes the DCF range estimates to
39 9.5% - 9.7%, still generally supporting the 9.5% equity return recommendation.

40 **SECTION II: CHARLES PETERSON REBUTTAL**

41 **Q. PLEASE ADDRESS MR. PETERSON'S REBUTTAL TESTIMONY?**

42 A. Mr. Peterson's testimony is a general factual observation that Mr. Gorman and I used
43 somewhat different comparable companies and lower growth rates in our analyses and
44 that my 9.5% return on equity recommendation is within the values of estimates Mr.
45 Peterson considered.[1] While Mr. Peterson's, Mr. Gorman's and my recommendation

[1] See C. Peterson Rebuttal testimony at 2:30-3:45.

46 appear to cover or overlap the same general range of reasonableness, for some reason
47 Mr. Peterson is not comfortable selecting a point estimate below 10.0% for equity
48 return.

49 In my opinion, the data and results presented by Mr. Peterson, Mr. Gorman and my
50 analyses all support an equity return below 10%. Further, recent decisions by regulatory
51 authorities in Idaho and most recently Washington, have concluded equity returns below
52 10% for PacifiCorp operating entities is appropriate at this time.[2]

53 **Q. MR. PETERSON SUGGESTS REJECTION OF SUSTAINABLE GROWTH**
54 **RATE CALCULATIONS WHICH WOULD MOVE YOUR RESULTS CLOSER**
55 **TO HIS – DO YOU AGREE?**

56 A. A review of employing only current analyst growth estimates in earnings would result in
57 a 9.5% to 9.7% constant growth and two-stage DCF estimate. While slightly closer to
58 his 10%, the results continue to be below his 10% recommendation – closer to my 9.5%
59 equity return recommendation.

60 **SECTION III: <u>BRUCE WILLIAMS REBUTTAL</u>**

61 **Q. WHAT ISSUES ARE YOU ADDRESSING WITH REGARD TO MR.**
62 **WILLIAMS' TESTIMONY?**

63 A. The first issue is with regard to the update of the cost of debt. When Mr. Williams
64 originally filed his testimony he estimated that the Company would have a May 2011
65 $400 million debt issue at an interest cost of 5.65%.[3] The Company did in fact complete
66 a $400 million first mortgage bond issue on May 12, 2011 at an interest cost of 3.968%.[4]
67 Given that the cost of debt capital was substantially lower than estimated by Mr.
68 Williams, the overall long-term debt cost included in capital structure decreased from
69 5.81% to 5.71%. I have included this updated 5.71% in capital structure as discussed
70 earlier in my testimony.

71

---

[2] See Hadaway Rebuttal Workpapers (RRA DATA), April 4, 2011 Edition at 4, and January 7, 2011 Edition at 6.
[3] See Bruce Williams Direct Testimony at 20:432-437.
[4] See B. Williams Rebuttal Exhibit RMP__(BNW-1R) Page 2 of 4, line 25, column (i).

72 **Q. IS THE LOWER INTEREST EXPENSE OF 3.968% FOR LONG-TERM DEBT**
73 **CONSISTENT WITH DECLINING CAPITAL COSTS?**

74 A. Yes. I should note part of the lower cost is attributable to the shorter 10 year term of the
75 actual debt issue versus the 30 year term in the original forecast estimate.

76 **Q. AT PAGE 4:79-87 OF MR. WILLIAMS REBUTTAL, HE ADDRESSES YOUR**
77 **CONCERNS RELATED TO RATING AGENCIES AND THE COMPANY'S**
78 **DIVIDEND PAYMENTS – DO YOU HAVE ANY COMMENTS?**

79 A. Yes. The specific concerns are those raised by the Fitch Rating Special Report cited and
80 discussed in my testimony. While Standard & Poor's and Moody's may have not raised
81 concerns to date, Moody's and Standard & Poor's may very well address these issues as
82 dividends continue to be paid. Moreover, the issues may be addressed by the rating
83 agencies in the context of declining cash flows as bonus depreciation declines.

84 **Q. MR. WILLIAMS ASSERTS THAT YOU HAVE NOT CORRECTLY**
85 **EVALUATED THE COMPANY'S CREDIT METRICS – DO YOU HAVE A**
86 **RESPONSE?**

87 A. Yes, at page 6 of his rebuttal testimony, Mr. Williams claims my credit metric analysis
88 is flawed because I failed to make the Standard & Poor's purchased power obligation
89 adjustment or consider the qualitative aspects of ratings analysis outcomes.

90 Mr. Williams is correct, I did not consider these factors as they are irrelevant to my basic
91 analysis of regulated earnings and cash flows under my recommendation. First, the
92 Standard & Poor's imputed interest obligation is not debt and does not belong in my
93 analysis. As to the qualitative analysis, I did not perform such an analysis. But, I can
94 say recent regulatory actions in other PacifiCorp jurisdictions setting equity returns
95 below 10 percent have not resulted in downgrades or poor qualitative assessments of
96 PacifiCorp's financial prospects. In other words, credit metrics sufficient to maintain
97 current bond ratings and credit quality are maintained by the Company at equity returns
98 below 10% as previously discussed.

99

100 **SECTION IV: SAMUEL HADAWAY REBUTTAL**

101 **Q. DO YOU HAVE ANY GENERAL COMMENTS REGARDING DR.**
102 **HADAWAY'S REBUTTAL TESTIMONY?**

103 A. Yes I do. Most of Dr. Hadaway's rebuttal asserts that all parties are incorrect in
104 recommending low equity return estimates. He goes on to suggest that if all parties had
105 correctly performed their equity return estimates, by employing Dr. Hadaway's
106 assumptions, then all the parties and this Commission would conclude that a 10.5%
107 equity return is appropriate.

108 The Commission has before it all parties' recommendations, assumptions and estimates
109 regarding equity return for RMP. As in most cases, none of the experts will agree on the
110 one best recommendation – so continuing this back and forth may not help this
111 Commission make its decision on equity return. The main issue I will address in this
112 rebuttal surrounds Dr. Hadaway's claim that "Mr. Lawton's basic premise that capital
113 costs are declining is simply not true."[5] In my opinion, the facts support the premise that
114 capital costs have declined and continue to remain low is true. In the following pages I
115 will outline the facts, not assumptions or estimates, but facts, which should assist the
116 Commission in setting a lower equity return in this case.

117 **Q. HOW DO REGULATORY AUTHORITIES GENERALLY RESOLVE THE**
118 **CONTENTIOUS DISPUTES THAT SURROUND SETTING THE EQUITY**
119 **RETURN?**

120 A. Regulatory authorities generally, and this Commission specifically, are all too familiar
121 with the contentious disputes that surround how the allowed equity return is set in a
122 traditional base rate cost-of-service setting. Resolution of these equity return disputes
123 hinge, as always, on the riskiness of the utility operating environment. Like this case,
124 there are often disputes surrounding the appropriate empirical method (discounted cash
125 flow, risk premium, or capital asset pricing model, etc.), the model assumptions (such as
126 earnings growth rates, risk premium, etc.), and capital structure and financial risk, that
127 must be resolved. The financial estimates and ultimate determination of the return on

[5] See Dr. Hadaway Rebuttal at 18:345-346

128 equity is often more art than science. After all the science and discussion of financial
129 theory, the answer regarding where to set the return depends on a number of factors
130 which boil down to the risk the utility faces.

131 The next obvious question becomes – utility risk compared to what? In my direct
132 testimony I noted a U.S. Supreme Court 1923 decision in Bluefield Water Works, which
133 was later affirmed in the court's 1944 Hope Natural Gas decision, the basis for
134 establishing equity return is "corresponding risk." The goal is to establish an equity
135 return equivalent to other firms having corresponding or comparable risk to the utility,
136 keeping in mind that the ultimate goal is a just and reasonable return and just and
137 reasonable rates.

138 In the current case, all the experts have applied various financial models to a general
139 group of comparable risk utilities. A set of results or reasonable range of equity returns
140 is established by each expert's analysis. In the overall scheme of things the experts in
141 this case are not far apart. Now the Commission, in considering and weighing
142 PacifiCorp's specific risk factors, must sift through the evidence presented by the
143 various experts and select a specific equity return to establish just and reasonable rates.
144 This is why the setting of equity return by regulatory authorities is considered more of
145 an art than a science. All the financial models and various applications and assumptions
146 only go so far in the ultimate determination of a reasonable equity return. The
147 Commission's ultimate responsibility of balancing a just and reasonable return for
148 shareholders, with just and reasonable rates for customers, requires specific
149 consideration and weighing of PacifiCorp's current and future circumstances. The facts
150 demonstrate capital costs have declined and continue to decline. The Company's risks
151 continue to decline as the rate mechanisms limiting regulatory lag are employed. The
152 Company's current cash flow and dividend payments provide substantial benefits to
153 RMP. Each of these issues is discussed below.

154 **Q. COMPARED TO THE COMPANY'S LAST RATE CASE DOCKET NO 09-035-**
155 **23, HAS THE COMPANY RECOGNIZED LOWER OR DECLINING EQUITY**
156 **COST?**

157 A. Yes. In the Company's last rate case the Company requested an 11.0% equity return

158 while in this case the Company requests a 10.5% equity return. This fact is outlined in
159 the rebuttal testimony of Mr. Peterson at page 3 and is summarized below:

Table 1[6] EQUITY RETURN RECOMMENDATION COMPARISON		
Witness	Docket 09-035-23	Docket 10-035-124
Dr. Hadaway	11.00%	10.50%
Mr. Peterson	10.50%	10.00%
Mr. Lawton	10.00%	9.50%

160

161 After outlining the factual recommendations of the parties in each case, Mr. Peterson
162 concludes "[t]his suggests general agreement as to the direction and the magnitude of the
163 change in the cost of equity since Docket No. 09-035-23."[7] The facts show all parties' equity
164 recommendations have declined since the last case. Capital costs have declined.

165 Q. IS THE COMPANY'S, AND ALL THE PARTIES', PROPOSED COST OF
166 EQUITY LOWER THAN THE EQUITY RETURN AUTHORIZED BY THIS
167 COMMISSION IN DOCKET NO. 09-035-23?

168 A. Yes. In Docket No. 09-035-23, the Final Order issued on or about February 18, 2010
169 authorized a 10.60% equity return. The parties and the Company all recommend that the
170 current authorized return be lowered. Again, the facts demonstrate that the cost of
171 capital has declined.

172 Q. HAVE U.S. TREASURY RATES AND CORPORATE BOND RATES
173 CONTINUED TO DECLINE?

174 A. Yes. Dr. Hadaway's own rebuttal testimony at page 4, Table 1 demonstrates that since
175 Dr. Hadaway filed his direct testimony in January 2011, interest rates have declined on
176 Long-Term U.S. Treasury Bonds and Single A utility debt.

177 It should also be noted that when Dr. Hadaway analyzed interest rates in his direct
178 testimony he concluded: "[t]he data in Table 2 show that S&P expects, during 2011, that

[6] Rebuttal Testimony Mr. Peterson at 3:47-54
[7] *Id*

179 long-term Treasury interest rates remain at current (December 2010) levels.[8] Now, in his
180 rebuttal testimony based on another new forecast, Dr. Hadaway suggests interest rates to
181 increase by "50 basis points" above the May 2011 levels.[9] While it is a fact that Dr.
182 Hadaway's forecast is now projecting higher interest rates, Dr. Hadaway's own DCF
183 update actually decreases albeit slightly from his original estimates.[10] Thus, his claim of
184 higher or increasing capital costs is not supported by his own DCF updates.

185 **Q. HAVE RECENT RULINGS BY REGULATORY AUTHORITIES ON EQUITY**
186 **RETURN SUPPORTED A LOWER OR DECLINING COST OF CAPITAL?**

187 A. Yes. As I discussed earlier in this testimony, recent rulings in Idaho and Washington
188 have concluded PacifiCorp operating entities cost of equity is below 10%.

189 **Q. WHAT ABOUT RECENT UTILITY RULINGS IN GENERAL – ARE**
190 **REGULATORY AUTHORITIES GRANTING LOWER EQUITY RETURNS?**

191 A. Yes they are. While Dr. Hadaway at pages 9-10 of his rebuttal testimony suggests that
192 the 2010 and first quarter of 2011 are in the 10.35% range – one needs to look a bit
193 closer at the numbers so as to not be mislead. The facts in Dr. Hadaway's own rebuttal
194 Exhibit RMP__(SCH 2R) page 3 of 3 show a different pictures. It is the vertically
195 integrated utilities like PacifiCorp that one should be comparing and the awarded
196 average equity returns are:

2009	10.63%[11]
2010	10.38%
2011	10.18%

197 As can be seen from the above, the 10.63% average equity return is consistent with this
198 Commission's final 10.6% decision in the Company's 2009 filing. Since 2009
199 regulatory authorities have recognized declining equity costs around the country for
200 vertically-integrated utilities like PacifiCorp. Again, these facts are supported by Dr.
201 Hadaway's own evidence.

202

[8] Direct Testimony S. Hadaway at 10:202-203
[9] Rebuttal Testimony S. Hadaway at 6:100-101
[10] Dr. Hadaway Rebuttal at Exhibit RMP__(SCH-7R)
[11] The overall (all electric utilities) values, especially when viewed on a quarterly basis, are substantially skewed by power plant only results.

203 **Q. DOES THE COMPANY'S RECENT DEBT FINANCING SUPPORT YOUR**
204 **OPINION THAT DECLINING CAPITAL COSTS ARE AVAILABLE IN THE**
205 **MARKET?**

206 A. Yes. As I discussed earlier, the Company recently had a $400 million debt issue and the
207 cost rate of debt is 3.968% - much lower than originally estimated. This lower capital
208 cost is a factual reality taken from the Company's own evidence. It should also be noted
209 that Mr. Williams' rebuttal at Exhibit RMP__(BNW-1R), pages 2 and 3, at column (l)
210 shows that the recent first mortgage bond issue at 3.968% is the lowest first mortgage
211 bond issue dating back to 1992.

212 **Q. DO THE FACTS SUPPORT A DECLINING COST OF CAPITAL?**

213 A. Yes. As outlined above, capital costs have declined since the last case, and continue to
214 decline as regulatory authorities award lower equity returns. This conclusion is
215 supported by past and current regulatory decisions, Company financings, as well as
216 reported yields on securities. No matter how you look at the facts – capital costs are
217 declining.

218 **Q. DID MOODY'S RECENTLY AFFIRM THE PACIFICORP DEBT RATING?**

219 A. Yes. Another fact that this Commission should consider is the Moody's May 9, 2011
220 assessment of PacifiCorp and the recent $400 million first mortgage bond offering.
221 Moody's affirmed the Company's A2 senior secured rating.[12] Moody's concluded the
222 Company's ratings outlook remained stable.[13]

223 In terms of the underlying analysis and ratings rationale, Moody's Investor Services
224 noted the following in its May 9, 2011 report:

225 "PacifiCorp ratings are supported by the stability of the utility's regulated cash
226 flows, the geographically diverse and relatively constructive regulatory
227 environments in which it operates, the diversification of its generation portfolio,
228 and its solid credit metrics."[14]

---

[12] Moody's Investor Services, Ratings Action, Global Credit Research, May 9, 2011 at 1 of 3.
[13] *Id*
[14] *Id*

229 It should be noted that the constructive regulatory environment in which PacifiCorp
230 operates includes two regulatory authorities (Idaho and Washington) that recently
231 determined equity returns below 10% are appropriate. In terms of credit metrics,
232 Moody's pointed out the obvious impacts of bonus depreciation and stated: "…recent
233 credit metrics have been unusually strong, due much in part to the temporary impact of
234 bonus depreciation." I discussed the bonus depreciation impacts in my direct testimony.
235 Moody's anticipates that after bonus depreciation ends in 2012, the Company's credit
236 metrics will return to the pre-2009 levels – which will strongly support its current bond
237 rating.[15] The Company is not at risk of losing its bond rating.

238 **Q. WHILE DR. HADAWAY MAY NOT HAVE CONSIDERED THE RISK**
239 **MITIGATION IMPACTS OF TARIFF MECHANISMS DESIGNED TO**
240 **REDUCE REGULATROY LAG, INCLUDING FUEL ADJUSTMENT CLAUSES,**
241 **FORECASTED TEST YEARS, AND SINGLE ISSUE RATE CASES, ISN'T IT A**
242 **FACT THAT RATING AGENCIES CONSIDER SUCH FACTORS AS**
243 **REDUCING RISK?**

244 A. Yes. For example, Fitch Ratings, January 6, 2011 evaluation of PacifiCorp specifically
245 mentions these items as mechanisms that have meaningfully reduced the Company's
246 operating or regulatory risks.[16] Fitch specifically states: "…efforts to reduce regulatory
247 lag and commodity exposure have significantly improved the utility's business risk
248 profile,…"[17] Fitch goes on to state that these risk reduction measures include forward
249 looking test year and single issue rate case proceedings in Utah, as well as net power
250 supply cost adjustment mechanisms.[18] On the issue of fuel adjustment mechanisms –
251 Fitch states: "…adoption and implementation of fuel adjustors that facilitate full and
252 timely recovery of prudently incurred power supply costs reduce commodity risk and are
253 constructive from a fixed income investor point-of-view."[19]

254 The facts, the Company's own discovery responses,[20] rating agency reports, most
255 experts and basic financial theory recognize that these risk reduction mechanisms reduce

[15] *Id*
[16] Fitch Ratings, PacifiCorp, January 6, 2011 at 1.
[17] *Id* at 3
[18] *Id*
[19] *Id*
[20] See Company response to FEA I, II, Attachment FEA 1.11d

256 risk to the Company. In this, and associated risk reduction cases, only Dr. Hadaway
257 fails to recognize these obvious facts in his analysis.

258 **Q. AT PAGE 23:443 THROUGH PAGE 24:475, DR. HADAWAY STATES THAT**
259 **YOUR CLAIM THAT THE SIX IDENTIFIED RISK MITIGATION FACTORS**
260 **REDUCES THE COMPANY'S OPERATING RISK IS INCORRECT, DO YOU**
261 **HAVE ANY COMMENTS?**

262 A. Yes, I have a number of comments. As discussed above, ratings agencies consider these
263 factors when evaluating risk. Dr. Hadaway suggests that RMP's equity ratio needs to be
264 higher than the comparable group because RMP has imputed debt associated with its
265 purchase power contracts. Dr. Hadaway does not mention that the comparable group
266 companies also have purchase power and imputed debt by rating agencies such as
267 Standard & Poor's. RMP has a higher equity ratio and less financial risk than the
268 comparable group. Thus, the DCF results, based on a comparable group analysis,
269 overstate RMP's equity cost.

270 In terms of other risk mitigation factors such as (i) forward looking test year, (ii) major
271 addition rate adjustments, (iii) energy balancing accounts, (iv) rate design and (v) bonus
272 depreciation cash flow, Dr. Hadaway concludes that other utility companies have such
273 risk mitigation factors and because the Company has not earned its authorized return, the
274 actual risk mitigation is suspect. Unfortunately, Dr. Hadaway fails to identify any
275 comparable utility with all these risk mitigation factors.

276 My first response is that if these factors, such as forecasted test year, are suspect in terms
277 of mitigating risk– then in the next case use a historical test year and deny the use of
278 forecasted data for setting rates. I suspect the Company would voice its complaint loud
279 and clear about increased risk (regulatory lag) if forecasted test year estimates were not
280 allowed. The same is true for major plant addition rate changes. Of course these types
281 of rate mechanisms mitigate risk which should be recognized in setting return in this
282 case.

283

284 **Q. DR. HADAWAY SUGGESTS THAT THE COMPANY HAS NOT EARNED ITS**
285 **AUTHORIZED RETURN, HOW DO YOU RESPOND?**

286 A. First, a regulatory authority, by setting an authorized rate, provides an opportunity (not a
287 guarantee) of earning an authorized return or profit. It is up to the Company to manage
288 its affairs and costs – regulatory authorities do not micromanage the operations of a
289 utility to assure efficiencies are being achieved. Second, as I stated in my direct
290 testimony at 35:883-886, the Company will generate $1.103 billion in cash flow from
291 2010 – 2012. The Company will pay itself $850 million in dividends during this
292 period.[21] The Company shareholders are certainly recovering substantial dollars.

293 The bottom line is that there are a number of risk mitigation factors that benefit the
294 Company. The Commission should consider these factors when weighing the decision
295 of what return on equity should be granted.

296 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

297 A. Yes.

[21] Lawton Direct Testimony 35