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 Testimony of

Michael Gorman

On behalf of

The Federal Executive Agencies (FEA)

Project 9432
June 27, 2011

BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

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Surrebuttal Testimony of Michael Gorman

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

2 A Michael Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,
3 Chesterfield, MO 63017.

4 **Q ARE YOU THE SAME MICHAEL GORMAN WHO PREVIOUSLY FILED**
5 **TESTIMONY IN THIS PROCEEDING?**

6 A Yes, I filed direct testimony on behalf of the Federal Executive Agencies ("FEA") on
7 May 11, 2011.

8 **Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS**
9 **PROCEEDING?**

10 A I will respond to the rebuttal testimony of Rocky Mountain Power ("RMP" or
11 "Company") witnesses Bruce Williams and Dr. Samuel Hadaway.

12 <u>**Response to Mr. Williams**</u>

13 **Q DID MR. WILLIAMS TAKE ISSUE WITH ANY POSITIONS ADVOCATED IN YOUR**
14 **TESTIMONY?**

15 A Yes. Mr. Williams asserts that my credit metric evaluation test of my proposed return
16 on equity is “seriously flawed.” He states that I did not include over half the
17 off-balance sheet adjustments normally advocated by Standard & Poor’s in producing
18 these credit metrics. Therefore, he believes these credit metrics are severely flawed,
19 and do not accurately reflect the methodology advocated by Standard & Poor’s.

20 **Q IS MR. WILLIAMS’ CONCERN ABOUT YOUR CREDIT METRIC TEST**
21 **ACCURATE?**

22 A No. I did not include all off-balance sheet PacifiCorp debt in this credit metric study,
23 but that was intentional. I intentionally did not include the off-balance sheet debt
24 obligations noted by Standard & Poor’s in its credit review of PacifiCorp because
25 PacifiCorp could not show that the off-balance sheet debt at issue is related to
26 regulated utility operations in the state of Utah.[1]

27 As noted in my direct testimony at page 33, my credit rating review addressed
28 PacifiCorp’s retail cost of service for Utah. PacifiCorp has financial obligations that do
29 not relate to regulated cost of service in Utah. Hence, I did not include off-balance
30 sheet debt obligations not related to Utah, and I only included Utah retail Funds from
31 Operations, and Earnings Before Interest, Taxes, Depreciation and Amortization
32 (“EBITDA”) in my credit metric evaluations to determine whether the proposed Utah
33 rates in this proceeding would be adequate to support PacifiCorp’s bond rating. As
34 such, my credit metric evaluations focused exclusively on cash flows produced from

[1] PacifiCorp response to FEA 1.7(b).

35 retail operations in Utah, and financial obligations supporting those retail operations.
36 This provides an accurate assessment of whether or not the rates proposed to be
37 charged to retail customers in Utah would fully support all financial obligations
38 PacifiCorp incurs in order to provide service to those retail customers.

39 Had I followed Mr. Williams' proposal, I would have reflected only cash flows
40 produced from retail operations in Utah, against financial obligations PacifiCorp has
41 for retail operations inside and outside Utah, and for financial obligations supporting
42 non-regulated businesses of PacifiCorp. Mr. Williams' proposed revision of my credit
43 metric evaluation is inappropriate and does not provide a robust study of whether or
44 not the proposed Utah retail rates provide PacifiCorp fair compensation and will allow
45 it to maintain its financial integrity for the capital supporting operations in Utah.

46 **Q IS MR. WILLIAMS CORRECT THAT YOU DID NOT ATTEMPT TO REPLICATE**
47 **STANDARD & POOR'S CREDIT RATING METRICS EXACTLY?**

48 A Yes. I noted that in my direct testimony at page 33. Rather, my credit metric
49 evaluation was again used as a test to determine whether or not my rate of return,
50 which provides fair compensation, would also provide PacifiCorp an opportunity to
51 maintain its financial integrity and access to capital. It was a very focused analysis
52 simply attempting to answer two important questions: (1) does the rate of return
53 represent fair compensation, and (2) will it maintain the financial integrity of the utility
54 operations? My credit metrics study answers the second question. The answer is
55 yes, my proposed rate of return will support PacifiCorp's Utah operations' financial
56 integrity.

57 **Q** **MR. WILLIAMS ALSO SAYS THERE ARE OTHER ISSUES WITH YOUR CREDIT**
58 **METRIC ANALYSIS. ARE THESE OTHER ARGUMENTS ADVOCATED BY**
59 **MR. WILLIAMS REASONABLE?**
60 A No. While Mr. Williams is correct that if the Commission should disallow certain
61 expense items, that may impact the Company's cash flows, what Mr. Williams does
62 not recognize is that the Company can respond to disallowed costs by reducing
63 actual expenditures. If that regulatory response to unreasonable costs is achieved by
64 management, then PacifiCorp will be provided with an opportunity to produce the
65 earnings and cash flow indicated in its test year filing, which will support the credit
66 metrics findings in my testimony. In other words, if the Commission finds that certain
67 expense or capital investments of PacifiCorp are unreasonable or imprudent, then
68 they should not be included in PacifiCorp's cost of service. If that should occur, then
69 the onus is on PacifiCorp's management to eliminate or reduce unreasonable costs
70 and, thus, realize its opportunity to achieve the Commission authorized rate of return
71 and cash flows produced through the cost of service approved for setting rates.

72 **<u>Response to Dr. Hadaway</u>**

73 **Q** **DID DR. HADAWAY MAKE A GENERAL COMMENT CONCERNING THE**
74 **APPROPRIATENESS OF THE RECOMMENDED RETURN ON EQUITY FOR THE**
75 **NON-COMPANY PARTIES IN THIS PROCEEDING?**
76 A Yes. At pages 1 and 2 of his testimony, he takes issue with the recommended return
77 on equity by the Division, OCA, and my recommended return on equity. He states
78 that the recommended return on equity of the OCA and mine are lower than
79 historically low rates set in the Company's most recent rate cases.

80 **Q IS IT TRUE THAT YOUR RECOMMENDED RETURN ON EQUITY IS LOWER**
81 **THAN WHAT PACIFICORP HAS BEEN AWARDED IN RECENT RATE CASES?**
82 A No. My recommended return on equity of 9.8% is equal to the return on equity
83 PacifiCorp was just awarded in the Washington jurisdiction. Further, it was only one
84 basis point lower than what PacifiCorp was awarded in the Idaho jurisdiction. While
85 that is lower, it is certainly close enough to support the reasonableness of my
86 recommended return on equity in this proceeding.

87 **Q DR. HADAWAY IS ALSO CONCERNED THAT YOUR RECOMMENDED RETURN**
88 **ON EQUITY IS SUBSTANTIALLY LOWER THAN INDUSTRY AVERAGE**
89 **AUTHORIZED RETURNS ON EQUITY FOR REGULATED UTILITY OPERATIONS.**
90 **PLEASE COMMENT.**
91 A The trend in authorized returns on equity for regulated utility companies is clearly
92 downward. This reflects substantial declines in utilities' cost of capital over the last
93 few years. However, my recommended return on equity of 9.8% is reasonably close
94 to the first quarter of 2011, contrary to Dr. Hadaway's representations. The
95 Regulatory Research Associates' first quarter 2011 average authorized return on
96 equity was 10.35%. However, that quarterly return included two 12.30% returns on
97 equity for Virginia Electric Power Company. Those authorized returns on equity were
98 not for integrated electric utility operations, but rather were dedicated to incentive
99 returns on equity produced for generation plant investments. Excluding those two
100 authorized returns on equity for Virginia Electric Power Company, 7 out of 12
101 authorized returns on equity were 10% or lower, and the quarter average for first
102 quarter 2010 was 10.03%. While my recommended return on equity is slightly lower
103 than this, I believe it is fully consistent with the trend of lower authorized returns on

104 equity by regulatory commissions which coincides with lower capital cost today than
105 has existed over the last several years.

106 **Q DR. HADAWAY WAS ALSO CRITICAL THAT THE RETURN ON EQUITY DID NOT**
107 **FULLY REFLECT THE FUEL RECOVERY RISK PACIFICORP HAS. IS THAT A**
108 **REASONABLE ASSERTION?**

109 A No. PacifiCorp's cost recovery risk is certainly a factor considered by credit rating
110 agencies, and reflected in PacifiCorp's bond rating. The proxy group used to
111 estimate PacifiCorp's return on equity is based on proxy companies that have
112 reasonably comparable investment risk to PacifiCorp including their fuel cost recovery
113 risk. As such, Dr. Hadaway's contention that PacifiCorp's fuel cost recovery risk
114 suggests that the other parties' return on equity recommendations are too low is
115 inaccurate and without merit.

116 **Q DR. HADAWAY ALSO COMMENTS ON ECONOMIC AND MARKET CONDITIONS,**
117 **AND STATES THAT THE DATA HE OFFERS AT PAGES 3 AND 4 INDICATES**
118 **THAT THE RECOMMENDED RETURN ON EQUITY LEVEL OF YOU AND OTHER**
119 **PARTIES IS TOO LOW. PLEASE COMMENT.**

120 A The bond yield and utility bond spreads shown in Table 1 on page 4 of Dr. Hadaway's
121 rebuttal testimony fully illustrate how capital costs have declined over the last few
122 years. Indeed, this is quite clear from a decline in utility bond yields of over 6% and
123 7% in 2008 and 2009, to the mid 5% area most recently.

124 Further, a substantial decline in the spread of "A" rated utility bond yields
125 relative to Treasury yields shows that the market has again embraced utility
126 investments as low-risk investment opportunities. As shown in Dr. Hadaway's

127 Table 1, utility bond yield spreads over Treasury bond yields peaked in 2008 at well
128 over 300 basis points, and stayed in the high 100 basis points for most of the two-
129 year period shown on his Table 1. However, more recently, utility bond yield spreads
130 over Treasury bond yields have declined to just over 1 percentage point. This is
131 among the lowest utility bond yield spreads over Treasury bond yields in the last 10
132 years.

133 A decline in the spread of "A" rated utility bond yields to Treasury bond yields,
134 indicates the market is requiring a lower premium to invest in utility bonds relative to
135 Treasury bonds. This is clear evidence that utility bond risk is perceived to be
136 relatively low and that the market has a strong demand for utility investments. With
137 this strong demand for utility investments, utility security prices are being bid up and
138 the utility's cost of capital is declining.

139 **Q AT PAGE 24 AND AT PAGES 33 AND 34 OF HIS TESTIMONY, DR. HADAWAY**
140 **ASSERTS THAT YOUR RETURN ON EQUITY MODELS ARE NEGATIVELY**
141 **BIASED, AND QUOTED AN ILLINOIS COMMERCE COMMISSION ORDER**
142 **SUPPORTING HIS CONTENTION. PLEASE COMMENT.**

143 A The Illinois Commerce Commission's finding on negative bias in my analysis was
144 largely attributable to assertions made by Dr. Hadaway in that rate case. Fortunately,
145 Dr. Hadaway's claim of negative bias was not clearly identified in that case, nor is it in
146 this case. Rather, it is an unsupported assertion he made of my testimony and data
147 inputs, that unfortunately was not carefully reviewed by the Illinois Commerce
148 Commission.

149 I would note, that in my direct testimony I carefully reviewed and critiqued all
150 the inputs to my proxy group, DCF, risk premium and CAPM studies. To the extent

151 any of it is negatively biased, all information considered was provided in that
152 testimony for a full review of all capital market costs that can credibly be used to
153 estimate PacifiCorp's cost of equity. The only bias I included in my analysis was to
154 provide full disclosure of the data used in my studies, whether I find it useful in
155 estimating PacifiCorp's cost of equity or not.

156 **Q CAN YOU IDENTIFY THE ILLINOIS COMMERCE COMMISSION ("ICC") AND**
157 **OTHER REGULATORY DECISIONS WHICH FOUND YOUR DCF MODELS TO BE**
158 **THE MOST REASONABLE IN REGULATORY PROCEEDINGS?**

159 A Yes. In the 2008 Commonwealth Edison Company ("ComEd") rate case, the case
160 prior to the one referenced by Dr. Hadaway, the ICC found that "IIEC's DCF analysis
161 is logical and well reasoned, consistent with our ruling in Docket 07-0241/0242."[2] I
162 was the witness for IIEC in that ComEd case.

163 Further, in other Illinois proceedings, the ICC has found my DCF models to be
164 reasonable. In those cases, I was the witness for IIEC. For example, in the previous
165 Ameren proceeding, the ICC relied on an average of my DCF studies and Staff's DCF
166 studies:

> 167 The Commission finds IIEC's non-constant growth DCF analysis, along
> 168 with Staff's non-constant growth DCF and CAPM analyses, to be
> 169 without material flaws, and should be considered in establishing AIU's
> 170 cost of common equity.[3]

171 Also, in the April 13, 2010 order for Illinois-American Water the ICC described
172 my recommendations, including my DCF results, as:

> 173 Having reviewed the positions of the parties, and putting aside the
> 174 question of adjustments for business and financial risk, discussed
> 175 below, the Commission observes that the Staff and IIWC

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[2]Commonwealth Edison Company, ICC Docket No. 07-0566, Order, September 10, 2008 at 98.

[3]AmerenCILCO, AmerenCIPS, AmerenIP, ICC Docket Nos. 09-0306, et al., Order, April 29, 2010 at 219.

176 recommendations are somewhat similar and both appear to be
177 generally sound.[4]

178 The ICC has frequently found my return on equity analyses to be reasonable.

179 **Q HAVE OTHER REGULATORY COMMISSIONS FOUND YOUR**
180 **RECOMMENDATIONS TO BE REASONABLE?**

181 A Yes. For example, the Missouri Public Service Commission in 2011 found:

182 The Commission finds Mr. Gorman's testimony to be more credible
183 than the testimony of Mr. Murray and Dr. Hadaway.[5]

184 Further, in a recent PacifiCorp Washington decision, the Washington State
185 Transportation and Utilities Commission concluded that my return on equity analyses
186 were the most reasonable:

187 DCF Analyses: We first address the several variants of the DCF
188 formulas used in this case and compare their strengths and infirmities.
189 PacifiCorp uses three versions of the DCF formula resulting in a cost
190 of equity range between 10.40 and 10.90 percent. ICNU also uses
191 three variants of the DCF formula and produces a cost of equity range
192 from 9.14 to 10.50 percent…

193 We conclude that ICNU's analysis is the better one for two primary
194 reasons. First, ICNU more accurately describes the impact of the
195 recent turmoil in the financial markets....

196 Second, ICNU's criticism of the Company's use of long-term growth
197 rates is valid. [6]

198 I appeared on behalf of the ICNU in this Washington case.

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[4]Illinois-American Water Company, ICC Docket No. 09-0319, Order, April 13, 2010 at 112.

[5]Kansas City Power & Light Company, Missouri Public Service Commission File No. ER-2010-0355, Report and Order, April 12, 2011 at 117.

[6]PacifiCorp D/B/A Pacific Power & Light Company, Washington State Utilities and Transportation Commission Docket No. UE-100749, Order 06, March 25, 2011 at 34-35.

199 **Q** **ARE YOUR DCF RETURN ESTIMATES IN THIS CASE REASONABLY**
200 **COMPARABLE TO THE METHODOLOGIES USED IN THE CASES YOU CITED**
201 **ABOVE?**
202 A Yes.

203 **Q** **WHAT DISAGREEMENTS DID DR. HADAWAY MAKE WITH THE GROWTH**
204 **RATES USED IN YOUR DCF STUDIES?**
205 A The primary difference between DCF return estimates lies in the estimate of
206 long-term sustainable growth. For use in my multi-stage growth DCF model, as well
207 as in Dr. Hadaway's, we both relied on GDP growth forecasts to estimate a long-term
208 sustainable growth rate for utility companies. However, Dr. Hadaway derived his
209 long-term sustainable growth rate by review of historical data. In contrast, I relied on
210 long-term projections of published consensus of economists. Dr. Hadaway
211 characterized my long-term consensus analysts' published growth rate projections as
212 "short-term" because these growth rate projections only reflected 10 years.

213 **Q** **IS IT ACCURATE FOR DR. HADAWAY TO CHARACTERIZE THESE 10-YEAR**
214 **ANALYSTS' PROJECTED GROWTH RATES AS SHORT-TERM?**
215 A No. These growth rate projections reflect the consensus economists' projection of
216 future GDP growth, and are the longest growth rate projections reflecting consensus
217 analysts' outlook for which I am aware. More importantly, these GDP growth rate
218 projections by analysts reflect a relatively high GDP growth rate over the next five
219 years, as the economy recovers from the current recession, to a decline of growth
220 rates thereafter, reflecting a more stable long-term sustainable growth rate outlook.

221 **Q AT PAGE 32 OF DR. HADAWAY'S TESTIMONY, HE CHARACTERIZED HIS GDP**
222 **GROWTH RATES AS A FORWARD-LOOKING ASSESSMENT. PLEASE**
223 **COMMENT.**

224 A Dr. Hadaway's analysis to estimate a future GDP growth rate is based entirely on
225 historical GDP growth. While that data may have been taken by the Federal Reserve
226 Bank, it does not reflect the market's outlook for future GDP growth, nor has
227 Dr. Hadaway shown that it represents a consensus investors', analysts' or any market
228 participant's outlook for GDP growth in the future.

229 Indeed, as the U.S. is competing in a more competitive global market going
230 forward than it has in the past, it is reasonable to project, as the consensus
231 economists do, that future real GDP growth will be lower than it has been in the past.
232 Further, future inflation outlooks are lower than they have been historically. As such,
233 Dr. Hadaway's real GDP growth forecast is simply inconsistent with market
234 participants' outlooks, and reflects far too optimistic future growth of the U.S.
235 economy and pessimistic outlook on future inflation.

236 **Q AT PAGE 26 OF DR. HADAWAY'S REBUTTAL TESTIMONY, HE IS ALSO**
237 **CRITICAL OF YOU NOT INCLUDING EMPIRE DISTRICT ELECTRIC COMPANY IN**
238 **YOUR CONSTANT GROWTH DCF STUDY. PLEASE RESPOND.**

239 A It is interesting that Dr. Hadaway states that I should have included Empire District
240 Electric Company in that study, because he believes he has identified growth rate
241 estimates available for this company. Those growth rates include a *Value Line*
242 growth rate of 7%, and Thomson Financial growth rate of 6%. While there may have
243 been analysts' growth rate projections available, clearly other analysts were
244 concerned about the sustainability of Empire's current dividend payment. This may

245 be the reason why consensus analysts' data was not available from the sources I
246 relied on for Empire.

247 Recently, Empire District suspended its dividend payment, and is expected to
248 reinstate the dividend at a lower level. This happened after Empire's service territory
249 was hit by a devastating tornado which produced significant damage to its service
250 territory.

251 The significance of this goes to the affordability and sustainability of Empire's
252 dividend, and to whether or not Dr. Hadaway's belief that analysts are projecting its
253 dividend to grow at a very high rate is legitimate. Clearly, Dr. Hadaway's outlook of
254 robust growth to Empire's dividend is wrong.

255 For example, the *Value Line* sheet cited by Dr. Hadaway shows that Empire
256 has not earned its dividend over the last several years. That is, in order to support its
257 current dividend payment, Empire was paying 100% of its earnings and liquidating
258 part of its equity base. Clearly, that is not a sustainable dividend pattern for Empire.
259 *Value Line*'s growth projection cited by Dr. Hadaway reflected its earnings growth
260 rate, not *Value Line* dividend growth. *Value Line* projected that Empire dividends
261 would not grow over the next five years.

262 I note this only because Dr. Hadaway's arguments that I should have included
263 the high growth rate for Empire are unreasonable.

264 **Q DR. HADAWAY IS ALSO CRITICAL OF YOUR CONCERN ABOUT THE**
265 **CONSTANT GROWTH DCF STUDY. DID YOU INCLUDE THE CONSTANT**
266 **GROWTH DCF STUDY IN YOUR RECOMMENDED RETURN ON EQUITY?**

267 A Yes. Despite my concerns about the overstated constant growth DCF return
268 estimate, because analysts' three- to five-year growth rates are too high to be

269 reasonable estimates of long-term sustainable growth, I nevertheless included the
270 constant growth DCF results in forming my recommended return on equity in this
271 case. As such, I provided full disclosure of this result, and described why I believe it
272 was unreasonable.

273 **Q DR. HADAWAY ALSO BELIEVES THAT YOUR SUSTAINABLE GROWTH RATE**
274 **DCF ANALYSIS IS CIRCULAR AND UNRELIABLE. PLEASE RESPOND.**

275 A Dr. Hadaway's arguments are without merit. While I would agree that a sustainable
276 growth DCF model should not be used by itself, in combination with other DCF
277 models, I believe it provides meaningful information to produce a reasonable estimate
278 of a DCF return for PacifiCorp. Indeed, the sustainable growth rate model is based
279 on *Value Line* projections, largely because consensus analysts' projections are not
280 available for the factors underlying the sustainable growth rate inputs. It is curious
281 that Dr. Hadaway would recommend the use of *Value Line*'s analysts' growth
282 projections, concerning Empire, but declines to use *Value Line*'s projections for
283 developing a sustainable growth rate estimate for the proxy group. Dr. Hadaway's
284 arguments are simply inconsistent and should be disregarded.

285 Dr. Hadaway's arguments with my multi-stage growth DCF model relate to the
286 appropriateness of my GDP growth rate outlook. That issue has already been
287 described above. Simply stated, Dr. Hadaway produces an historical derived GDP
288 growth rate outlook that is inconsistent with consensus market participants, it is not a
289 reasonable estimate of the growth rate outlooks investors in aggregate have, and are
290 reflected in their stock price valuations. Therefore, by overstating consensus investor
291 and analysts' growth rate outlooks, Dr. Hadaway is overstating a reasonable DCF
292 return estimate.

293 **Q DO YOU BELIEVE DR. HADAWAY'S RECOMMENDATION TO ADJUST THE**
294 **EQUITY RISK PREMIUM FOR AN INVERSE RELATIONSHIP BETWEEN**
295 **INTEREST RATES AND EQUITY RISK PREMIUMS IS APPROPRIATE?**
296 A No. Indeed, I address this issue in my direct testimony in response to Dr. Hadaway's
297 original position. While inverse relationships have existed in the past, there are many
298 elements that go into describing the relationship between equity risk premiums and
299 interest rates. This relationship is not explained solely by changes in interest rates.
300 Therefore, Dr. Hadaway's analysis is unreliable and inflates a return on equity in this
301 proceeding.

302 **Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**
303 A Yes, it does.

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