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 Service Schedules and Electric Service Regulations	**Docket No. 10-035-124** **DPU Exhibit No. 10.0SR-RR**

Surrebuttal Testimony of

Mark E. Garrett

REVENUE REQUIREMENT

For the Division of Public Utilities

Department of Commerce

State of Utah

July 19, 2011

Surrebuttal Testimony of Mark E. Garrett

Q. Please state your name.

A. My name is Mark E. Garrett.

Q. Are you the same Mark Garrett that filed direct testimony in this docket on May 26, 2011?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony addresses several new issues raised by the Company in its rebuttal testimony. Specifically, my testimony address the Company's new positions on incentives and payroll expense set forth in Mr. Wilson's testimony, and the lead-lag treatment of long-term debt in Mr. McDougal's testimony. I also address the Company's rebuttal position on medical cost increases.

Q. Please describe the Company's rebuttal position on incentive expense.

A. In its rebuttal testimony the Company accepts the DPU's recommendation to use a 3-year average to help determine the appropriate level of projected incentive expense to include in rates, but departs from the DPU's recommendation to use a 3-year average of actual incentive payments and instead uses a 3-year average of the percentage of incentive payments compared with total payroll levels (regular time, overtime and premium pay) multiplied by June 2012 test period wages.[1] The DPU's methodology results in an adjustment of $1.414 million and the Company's rebuttal position results in an adjustment of $1.130 million.

[1] See Wilson rebuttal testimony at page 4-6.

Q. Do you agree with the Company's rebuttal adjustment?

A. I agree that it, like the DPU's adjustment, yields a reasonable result even though its methodology differs slightly from the DPU's approach. I believe the Company's position represents sufficient movement in the right direction. Like the DPU's approach, the Company's rebuttal methodology relies on actual historical results to predict future payment levels.

Q. Please describe the Company's rebuttal position on payroll expense.

A. In its rebuttal testimony the Company rejects the DPU's proposed adjustment to reduce payroll expense by 1.5% for productivity gains and accepts instead Ms. Ramas' adjustment, for this filing only, to reduce the proposed payroll expense by 1.27% for lower-than-projected levels of FTEs. The Company's rebuttal position results in an adjustment of $1.947 million to the Utah jurisdiction.

Q. Do you agree with the Company's rebuttal adjustment?

A. Yes. Although I believe it is inappropriate for the Company to reject the DPU's proposed productivity adjustment, in that the Commission decided in the Company's last litigated rate case that a productivity adjustment is appropriate when a forecasted test year is used, the Division believes that the Company's rebuttal adjustment is a reasonable substitute for a productivity adjustment in this case and that no further adjustment is needed.

Q. Please describe the Company's rebuttal position on including long-term debt interest expense in the lead-lag calculations.

A. In its rebuttal testimony the Company makes the following arguments to support its position that interest expense on long-term debt should not be included in a lead-lag study:

1. Interest expense on long-term debt should be excluded from the lead-lag calculations like interest expense on short term debt that is recovered through AFUDC. (McDougal lines 1134-1142).

2. The idea of including interest expense on long-term debt in the lead-lag calculations is a “well worn” notion that is given little credence by Robert L. Hahne who believes that few commissions have accepted this view. (McDougal lines 1149-114).

3. Mr. Garrett makes a simple assumption that all interest is collected from customers and then paid to investors and this assumption is not always the case and any differences should be included in the calculations. (McDougal lines 1167-1177).

Q. Please address the Company’s first argument.

A. The Company is incorrect in comparing interest on long term debt to interest on short term debt included in the AFUDC calculations, believing that both should be excluded from the lead-lag calculations. Interest on short term debt associated with construction projects is excluded from the lead-lag calculations because this interest is capitalized through AFUDC and earns its return during the construction period through the AFUDC calculations. It would double-count the return on short term interest used for construction projects if this interest were also included in the lead-lag calculations. So, there is an important reason why most utilities treat interest expense on short term debt differently in their lead-lag calculations than they treat interest expense on long term debt.

Q. Please address the Company’s second argument.

A. The Company's second argument, that the inclusion of long term debt in the lead-lag calculations is a "well worn notion" that is not accepted by most commissions, is simply wrong. In fact, the opposite is true. It is interesting to note that the Company does not provide even one example of a commission that follows its recommended approach. It is also interesting to note that the authority they cite, Mr. Robert Hahne, does not provide any examples either. This is most likely because such examples would be hard to find in comparison to commissions that go the other way. By way of contrast, in my direct testimony, I provide several examples of states that follow the approach I recommend, including Oklahoma, Nevada, Kansas and Arizona. All of these states include interest expense on long term debt in the lead-lag calculations. Many other states also follow this approach including Illinois, Iowa, Missouri, New Hampshire, North Carolina and Pennsylvania. And many other states such as Alabama, Kentucky, Idaho, New York, Washington and Wisconsin to name a few generally do not use lead-lag studies to determine cash working capital requirements.[2] So no treatment is prescribed in these states. In my research, I came across no state other than Texas that follows the Company's recommended approach.

Below I provide examples of additional states – other than those discussed in my direct testimony, Oklahoma, Nevada, Kansas and Arizona – that follow the approach I recommend. These states include Illinois, Iowa, Missouri, New Hampshire, North Carolina and Pennsylvania.

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[2] See the research of Denise Kay Parrish for the State of Wyoming at *www.naruc.org/.../Section%2022-Wyoming-**Lead-Lag**%20**Studies**.doc*.

For **Illinois**, consider the testimony of John Hengtgen filed on behalf of North Shores Gas Company in the utility’s 2011 rate case.[3] The following excerpt from his filed testimony shows that interest expense is included in the lead-lag calculations while depreciation and common equity are not.

> **Q. What expense-related leads were considered in the lead-lag analysis?**
> A. Lead times associated with the following expense categories were considered in the study: (1) Cost of Gas; (2) Payroll; (3) Inter-Company Billings; (4) Taxes Other Than Income Taxes; (5) Other Operations and Maintenance Expenses; (6) Income Taxes; and (7) Interest on Long-term Debt.

For **Iowa**, see the Iowa Board’s recent decision in the 2009 Interstate Power and Light rate case, Docket No. RPU-2009-0002, that includes interest expense on long term debt and preferred dividends in the lead-lag calculations but not depreciation or common equity. The lead-lag study is included as an attachment to the order at Schedule E.

For **Missouri**, see the direct testimony of Michael J. Adams filed on behalf of Union Electric Company in the utility’s 2008 rate case.[4] The following excerpts from his filed testimony show that interest expense is included in the lead-lag calculations while depreciation and common equity are not.

> **Q. What expense-related leads were considered in the lead-lag analysis?**
> A. Lead times associated with the following expense categories were considered in the study: a) employee pensions and benefits; b) base payroll; c) FICA (social security) and other withholdings; d) fuels

[3] Mr. Hengtgen received his accounting degree and passed the CPA exam in 1978. He received his MBA in 1985. Mr. Hengtgen has 30 years of experience working in the accounting, tax and rates departments for a regulated utility. In total, he has more than 33 years of experience working with regulatory accounting issues.

[4] Mr. Adams has an MBA in Finance from the University of Illinois at Springfield and a BS in Accounting from Illinois College. He is a member of the American Institute of Certified Public Accountants and the Illinois Society of Certified Public Accountants. Mr. Adams has over twenty-five years of direct experience in the public utility industry. He has worked for an investor-owned utility, a regulatory agency, and most recently as a consultant to the energy industry. He has managed and/or participated in a wide variety of consulting engagements and has testified in other regulatory proceedings and jurisdictions.

– nuclear, coal, oil, and gas; e) other operations and maintenance expenses; f) general taxes including taxes other than income taxes; g) federal income taxes; h) state income taxes; i) interest on long-term debt; and j) purchased power.

Q. Provide a description of how lead times associated with the Company's interest expenses were addressed by the study.

A. The Company's interest payments on its long-term bonds were made from current revenues. Thus, there was a lead (or lag) between the date the interest payments were collected from customers and the date when such amounts were paid to financial institutions. The Company generally made interest payments on its long-term debt twice a year at varying times. Using actual due dates on interest payments, a dollar-weighted lead of 91.25 days for interest payments were determined.

For **New Hampshire**, see the testimony of Paul Normand filed on behalf of the utility National Grid in the Company's 2010 rate case, Docket DG 10-017.[5] The following excerpts from his filed testimony show that interest expense is included in the lead-lag calculations while depreciation and common equity are not.

Q. DID YOU INCLUDE ANY OTHER EXPENSES BESIDES O&M EXPENSES IN THE CALCULATION OF THE EXPENSE LAG?

A. Yes. Since Property Taxes, Other Taxes, Federal and State Income Taxes, and Interest on Long Term and Short Term Debt represent cash outlays, they were included in the fiscal 2009 period in the calculation of CWC. All property tax payments made during 2009 were analyzed, and since they are generally prepaid, they produced a negative lag. Other Taxes consist mostly of Payroll Taxes, Unemployment Taxes, and Other Taxes. Each type of tax was

[5] Mr. Normand graduated from Northeastern University in 1975, with a Bachelor of Science Degree and a Master of Science Degree in Electrical Engineering-Power System Analysis. He has more than 35 years of experience working with regulated utility issues. He has testified or submitted written testimony about such studies before the following regulatory agencies: the Maine Public Utility Commission, the Public Utility Commission of Texas, Illinois Commerce Commission, New Hampshire Public Utilities Commission, New Jersey Board of Public Utilities, New York Public Service Commission, Pennsylvania Public Utility Commission, the Massachusetts Department of Public Utilities, the Kentucky Public Service Commission, the Arkansas Public Service Commission, the Public Service Commission of Louisiana, the Public Utilities Commission of Ohio, the Public Service Commission of Missouri, the Delaware Public Service Commission, the Maryland Public Service Commission, the Indiana Utility Regulatory Commission, the North Carolina Utilities Commission, the Kansas Corporation Commission, and the Federal Energy Regulatory Commission.

> analyzed separately and assigned a lag based on the service periods and payment dates. Federal and State Income Taxes were assigned lags based on the statutory required fiscal tax year equal tax payments. Interest on Long & Short Term Debt was assigned lags based on the actual interest payments for the June 30, 2009 fiscal period.

If you examine Mr. Normand's filed lead-lag study summary attached to his testimony at PMN-LL-2, you will see a good example of how interest expense on long term debt is included in the calculations while depreciation expense and return on common equity are not. This utility does not have preferred dividends.

For **North Carolina**, see the testimony Karyl J. Crean on behalf of the public staff of the North Carolina Utilities Commission in the Duke Power Company rate case in Docket No. E-7, SUB 909.

> This Commission has consistently ruled - in Docket Nos. 18 E-7, Sub 338, E-7, Sub 358, E-7, Sub 373, E-7, Sub 391, E-7, Sub 408, and E-7, 19 Sub 487 - that the Company collects the funds to pay interest on debt prior to the time that it actually pays that interest and that it is, therefore, appropriate to assign a lag to the interest. Interest expense is a component of the cost of service and, as such, is paid by the ratepayers through their payments to the Company for electric service. The Company has the use of these funds provided by the ratepayers until such time as it pays the interest to the debt holders. Therefore, it is appropriate to assign a lag to this item. The lag on Interest on Long-Term Debt, calculated by the Company at the Public Staff's request, is 89.99 days.

For **Pennsylvania**, see the research of Denise Kay Parrish for the State of Wyoming at *www.naruc.org/.../Section%2022-Wyoming-**Lead-Lag**%20**Studies**.doc*. This research shows that interest expense on long term debt is included in the lead-lag calculations in Pennsylvania.

<u>Pennsylvania Cash Working Capital</u>

1. Expenses such as purchased gas costs are excluded from lead-lag studies since they are recovered through automatic cost recovery

mechanisms governed by the 1307(f) Purchased Gas Cost regulations in Pennsylvania.

2. We have generally included all taxes in the lead –lag studies. The lead-lag calculations are based on federal and state tax due dates, including the incorporation of estimated payments and final true-up dates. Additionally, we have advocated the adoption of ratepayer favorable options, such as safe-harbor provisions, where applicable, whether or not these have been proposed by the utility.

3. <u>Since the payment of debt interest is usually no less than semi-annually and dividend payments are no less than quarterly, the Commission has treated these items as a reduction to the utility's CWC requirement.</u> As a final note, lead-lag studies are only required by Commission for those utilities requesting a revenue increase in excess of $1,000,000. As a cost-saving alternative, the FERC formula method or one-eighth method is accepted for those filing cases less than $1,000,000. (Emphasis added).

One state, **Colorado**, is still trying to resolve this issue. In Decision No. C10-0365 in Docket No. 09AL -299E the Colorado commission excluded long term debt from the lead-lag calculations as part of a settlement agreement but made it clear that this treatment was not to be construed as precedent on this issue.

> After further consideration of the Settlement Agreement filed in this matter, we will remove the interest payments on long-term debt from the calculation of CWC. We believe the Settlement Agreement represented a balance of compromises between numerous parties and we decline to disturb that balance by changing our treatment of long term interest payments in CWC.
>
> However, we emphasize our decision in this docket does not set precedent going forward. We expect future dialogue concerning computation of CWC, including whether there is a distinction between bond and equity holders. We also expect to revisit this issue in future rate cases.

Q. Please address the Company's third argument.

A. The Company's third argument – that Mr. Garrett makes a simple assumption that all interest is collected from customers and then paid to investors and this assumption is not always the case – is both incorrect and irrelevant. While it is almost always the case that interest expense is collected from customers before it is remitted to creditors there is no assumption that this is always the case, and it would make no difference to the analysis if it were. The purpose of the lead-lag study is to quantify the timing differences in collection and remittance no matter which direction these differences may go. So, the fact that some interest expense is remitted to creditors before it is collected from customers is completely irrelevant to a discussion of whether long term interest expense should be included in the led lag calculations.

The Company also attempts to claim that the analysis provide in my direct testimony was not the "comprehensive analysis" requested by the Commission because it did not provide a quantification of the impact of the long term debt lag. Again, this part of the Company's testimony is merely a distraction. My direct testimony provides the comprehensive <u>conceptual analysis</u> requested by the Commission concerning the appropriate treatment of long term debt, depreciation, common equity and preferred dividends in a lead-lag study. The <u>quantification</u> of the impacts of the recommended treatment is included in Ms. Salter's testimony.

Q. What is your recommendation with respect to the treatment of long term interest expense, preferred dividends, depreciation and common equity in the lead-lag calculations?

A. I recommend that the Commission continue its practice of excluding depreciation expense and common equity from the cash working capital calculations. These items represent the return of and the return on invested capital to the owners of the company. With respect to both of these items, the capital markets are aware of the regulatory lag involved with their recoveries and have adjusted the cost of capital accordingly. Further, with respect to common equity, decisions about how and when profits are distributed to the owners of the company are wholly within the purview of the owners themselves and ratepayers cannot be held accountable for any acceleration or delay in the distribution of profits that result from those decisions.

With respect to interest expense on long-term debt, I recommend the Commission re-examine its treatment of this item. Clearly, interest is a cash expense. The ratemaking formula provides for the recovery of interest costs from the ratepayers through rates and to the extent the utility has the use of these funds for an extended period of time before payments are made to the debt holders, this timing difference should be included in the lead-lag calculations. Debt holders are <u>not</u> owners of the utility and debt payments are not discretionary payments. Instead, debt payments are binding contractual obligations of the company. As such, funds collected to pay interest expense generally provide a significant source of cash for use in the day to day operations of the utility that should be reflected in the lead–lag analysis.

Though generally much less material to the calculations, preferred dividends have the same characteristics as debt and should be treated in the same manner as interest expense on long term debt.

Q. Please describe the Company's rebuttal position on medical costs.

A. The Company rejects the DPU's recommendation to average the AONHewitt and Towers Watson medical cost increase projections. The Company believes that the projections provided by the Company's consultant AONHewitt are more specifically tailored to the

Company and that the projections of an independent source, such as Towers Watson, are not needed.[6]

However, the Company fails to explain or justify why it chose to ignore the Commission's decision in Docket No. 07-035-93 where the Commission found that it was a reasonable approach to take the average of two projections, one from the Company's consultant and the other from an independent source. I believe that this approach gives the Company an increased incentive to aggressively pursue medical cost containment and should be followed again. The difference in this case is nearly immaterial, but conceptually, the Commission's decision in the prior case was the correct one and should be followed again.

Q. Does this complete your surrebuttal testimony?

A. Yes, it does.

[6] See Mr. Wilson's rebuttal testimony at lines 298-309.