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. 11-035-200** **Exhibit No. DPU 1.0-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

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I. INTRODUCTION AND SUMMARY

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

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

Q. On whose behalf are you testifying?

A. The Division.

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

A. Yes.

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

A. My testimony comments on the pre-filed direct testimony of intervenor witnesses who filed testimony regarding the cost of capital of the Company.[1] Specifically, I provide comments on

[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.

the direct testimony of Wal-Mart Stores, Inc., and Sam's West, Inc. (Wal-Mart) witness Steve W. Chriss, Office of Consumer Services (OCS) witness Daniel J. Lawton, and Federal Executive Agencies (FEA) witness Michael Gorman.

While I make relatively few comments concerning the direct testimony of these witnesses, silence on my part regarding any of the methods, analyses, and conclusions of these witnesses does not imply my agreement, or disagreement, with those methods, analyses, and conclusions.

Q. What is the most salient point in the direct testimony and conclusions of Messrs. Lawton and Gorman, and you?

A. The most significant point that can be drawn from our respective testimonies and conclusions is that while each of us approached the problem of estimating the current market expectation of cost of equity for an electric utility like PacifiCorp from somewhat different directions; and in spite of somewhat different methodologies, data inputs and comparable companies, all of us came to similar conclusions. All three of us agree that the appropriate cost of equity point estimate for PacifiCorp should fall within a narrow range of 15 basis point range (9.25 percent to 9.40 percent. Similarly our conclusions of what the reasonable range should be have significant overlap as highlighted in DPU Exhibit 1.1 R COC, which also includes the relative position of PacifiCorp witness, Dr. Hadaway's, "reasonable range."

II. COMMENTS ON INTERVENOR COST OF CAPITAL WITNESSES

<u>Steve W. Chriss</u>

Q. What did Wal-Mart witness Mr. Chriss recommend to the Commission?

A. Mr. Chriss does not make any numerical recommendations regarding PacifiCorp's cost of equity. Instead, his testimony focuses on the reduction in risk faced by the Company's stockholder due to the implementation of the energy balancing account (EBA). He asks the Commission to consider reducing the Company's ROE, by some unspecified amount, as a result of the risk reduction to the Company due to the EBA. [2]

Q. Do you agree with Mr. Chriss?

A. Yes, I agree that the EBA will reduce the variability of recovery of net power cost expense and therefore reduce, *ceteris paribus*, the overall risk to the Company and its stockholder. However, Mr. Chriss does not attempt to quantify how much the authorized ROE should be reduced, leaving it up to the Commission to decide an amount.

Q. Has Mr. Chriss made this argument before?

A. Yes, this is essentially the same argument that he made in the previous general rate case, Docket No. 10-035-124.

[2] Mr. Chriss's Exhibit 2 seems to suggest that the adjustment could be as much as 50 basis points, which if adjusted from Dr. Hadaway's 10.2 percent recommendation would result in an ROE of 9.70 percent; if the adjustment were from Mr. Gorman's recommendation, who I believe also made no specific adjustment for the EBA, then the result would be 8.75 percent (9.25 -0.50 percent).

Q. Do you have any further comments regarding Mr. Chriss' testimony?

A. I dealt with the issue of reducing authorized ROE for the apparent reduction in risk to the Company through various mechanisms including the EBA in my rebuttal testimony in Docket No. 10-035-124 which I include here by reference (see especially lines 73-81 and footnotes 7 and 8). The basic problem is that it has been very difficult to extract a reliable estimate from market data of the effect on cost of equity of a reduction in risk through a mechanism such as the EBA. This problem is compounded by the fact that the comparable or proxy companies also employ, to a greater or lesser extent, the same or similar risk reducing mechanisms.

<u>Daniel J. Lawton and Michael Gorman</u>

Q. What are the primary differences between your analysis and Messrs. Gorman and Lawton?

A. First, FEA witness Mr. Gorman and OCS witness Mr. Lawton use somewhat different comparable companies than I do. DPU Exhibit 1.2 R COC sets forth a comparison of the comparable (or proxy) companies used by me, and by the other cost of capital witnesses. Mr. Gorman adopted Dr. Hadaway's list of companies. Mr. Lawton created his own larger list. As can be seen, Mr. Lawton includes seven companies unique to his analysis; and there are eight companies that are common to all of the witnesses.

Q. In your direct testimony, you discussed why you did not include some of the comparable companies on your list that were included on Dr. Hadaway's (and,

consequently, Mr. Gorman's) list. Why didn't you include the companies that are unique to Mr. Lawton?

A. Mr. Lawton included American Electric Power, which, like Southern Company, I judged to be too large to be genuinely comparable to PacifiCorp. Ameren and Pinnacle West had BBB- bond rating from Standard & Poor's according to the information source I was using. I did not include companies with bond ratings below BBB, or the equivalent Moody's rating of Baa2. I excluded Hawaiian Electric because, among other things, it also had a BBB- rating and was a bit low on the amount of plant it owned. Unisource did not make the cut because of its relatively small size. I excluded Consolidated Edison because it is a distribution-only company, and consequently differs significantly from PacifiCorp in that it essentially has none of its own generation capacity. TECO Energy was a close call, but it failed my initial screen because it includes a relatively high percentage of non-regulated activities.

Q. You said that there were eight comparable companies common to all witnesses. What would be the effect of using just those eight companies?

A. I have not performed a complete analysis. However, if one were to start with Mr. Lawton's Exhibit 1.6D, for example, and reduced the companies he used down to the eight common companies, then the result on that Exhibit would be reduced by about 15 to 20 basis points to give a range of about 8.85 percent to 9.60 percent instead of 9.00 percent to approximately 9.80 percent in the original. DPU Exhibit 1.3 R sets forth these calculations.

Q. Are you recommending a 15 to 20 point additional reduction in PacifiCorp's authorized ROE based upon this analysis?

A. No. What this shows, however, is that using the common comparable companies alone would continue to suggest approximately a reasonable range within the bounds suggested by Mr. Lawton, Mr. Gorman, and me.

Q. Do you have any other comments about Messrs. Gorman and Lawton's direct testimony?

A. Yes, I have three comments. First, both Mr. Gorman and Mr. Lawton develop a "sustainable growth" method based upon Value Line 3 to 5 year forecast factors. Like any calculation, the results are only as good as the inputs. The "sustainable growth" formula used by Messrs. Gorman and Lawton does have a theoretical basis. But the assumption they make is that the Value Line data and forecasts used to construct the "sustainable growth" rates are the correct long-term inputs for these growth rates; in fact they implicitly assume that the Value Line forecasts that went into these "sustainable growth" calculations are better than Value Line's actual growth forecasts, and better than the analyst forecasts he obtains from Zacks and Yahoo! Finance as well. I find the assumption that Value Line's actual growth forecast is less reliable than its data for "sustainable growth" that covers the same time period to be questionable, at best. In my view it would be more valid to use Value Line's actual growth forecasts, rather than trying to piece together an alternative forecast from Value Line numbers.

My second issue relates to Mr. Lawton's risk premium method; a method that is similar to Dr. Hadaway's risk premium method that uses average authorized utility returns and single-A rated bond yields. As I have suggested in my critiques of Dr. Hadaway's analyses, this "risk premium" analysis describes regulatory gradualism rather than an estimate of cost of equity.

Third, on a more positive note, I think Mr. Gorman's CAPM analysis using forecast interest rates has merit. In theory the CAPM should be based on forward-looking inputs. Nevertheless, I do question the accuracy of the Blue Chip interest rate forecast. Mr. Gorman's own data indicates that for just one quarter ahead the Blue Chip forecast deviations are overstated (i.e. high) by an average of 0.76 percent with a standard deviation of about 0.50 percent. Alternatively, the actual rates have averaged 4.85 percent and the quarter-ahead forecast has been 5.35 percent, or 10.3 percent higher than actual, on average. This suggests that the Gorman CAPM may be too high based upon the inputs he applies. DPU Exhibit 1.4 R COC sets forth my analysis of Mr. Gorman's Excel file.

III. CONCLUSIONS AND RECOMMENDATIONS

Q. Do you have any final comments regarding the analyses of Messrs. Lawton, Gorman and Chriss?

A. Yes. As outlined above, I believe that the primary difference between my analysis and the analyses of Mr. Lawton and Mr. Gorman is the difference in the list of comparable companies used, and consequently the somewhat different data sets that went into our models. Secondarily, Messrs. Gorman and Lawton develop “sustainable growth” models based on Value Line data that I would give little or no weight to over Value Line’s actual earnings growth forecasts.

In the end though, the primary concern is whether or not the results seem to be in a reasonable range. In this regard while Messrs. Gorman, Lawton and I approached the problem of cost of equity estimation from somewhat different perspectives, we arrived at essentially the same conclusions.

Q. What is your recommendation?

A. I continue to support my original recommendation that for PacifiCorp and its division, Rocky Mountain Power, the Commission adopt as the authorized cost of equity of 9.30 percent and an overall weighted average cost of capital of 7.36 percent.

Q. Does this conclude your testimony?

A. Yes.