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 SR** **Cost of Capital** **Surrebuttal Testimony and Exhibits** **Charles E. Peterson**

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

Surrebuttal Testimony of

Charles E. Peterson

July 18, 2012

Surrebuttal Testimony of Charles E. Peterson

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. I have filed direct and rebuttal testimony in the cost of capital phase of this docket.

Q. What is the purpose of your surrebuttal testimony?

A. My purpose is to comment on the rebuttal testimonies of PacifiCorp witnesses Mr. Bruce N. Williams and Dr. Samuel C. Hadaway.

I have tried to be brief in my surrebuttal comments. Therefore, I do not comment on all of the points that I could have commented on. Silence on a given subject should not be interpreted as agreement.

Q. In his rebuttal testimony, Mr. Williams proposes to modify the Company's cost of debt to 5.37 percent. Do you agree with this modification?

A. Yes. In my direct testimony I had stated that the cost of debt needed to be modified based upon the Company's issuance of $100 million in new debt coupled to the early retirement of certain pollution control revenue bonds. I had estimated the cost of debt to be 5.36 percent.

Q. Do you understand why there is a 1 basis point difference?

A. Yes. The primary difference is the addition of $4.9 million in redemption expenses that I was not privy to at the time I prepared my direct testimony. These additional expenses result in a slight increase in the overall cost of debt, which rounds up to 5.37 percent.

Q. Dr. Hadaway now states that "…my DCF models continue to support *a reasonable range* of 9.6 percent to 10.2 percent, the same as in my direct testimony. My updated risk premium analysis indicates a range of 9.55 percent to 9.88 percent, which is slightly above the range of 9.55 percent to 9.70 percent from my direct testimony."[1] [Emphasis added]. Is his claim of a "reasonable range" of 9.60 percent to 10.20 percent for return on common equity consistent with his direct testimony?

A. No. While he computes values in that range in his direct testimony, nowhere does Dr. Hadaway suggest that anything below 10.2 percent is reasonable. In fact, in his direct testimony he clearly stated that "As I will discuss later in this testimony, these risk premium estimates continue to be depressed by the federal government's stated intentions to keep interest rates artificially low. For these reasons, the risk premium results are *not reasonable* estimates of the Company's market required COE."[2] [Emphasis added].

[1] Rebuttal Testimony of Samuel C. Hadaway, page 2, lines 26 to 31.
[2] Direct Testimony of Samuel C. Hadaway, page 3, lines 56 to 59.

Dr. Hadaway's "reasonable range" now overlaps Mr. Lawton's and my reasonable ranges at the lower end.

Q. Does it appear to you that in rebuttal testimony Dr. Hadaway is softening and retreating from his direct position?

A. Yes. However, the fact that his point estimate for return on equity remains at the highest value he calculates, renders Dr. Hadaway's idea of a "reasonable range" nearly meaningless.

Q. What is Dr. Hadaway's primary argument for dismissing your cost of equity estimate (and the estimates of Messrs. Gorman and Lawton)?

A. Essentially, Dr. Hadaway claims that the low interest rate environment created by the Federal Reserve and market "turbulence" makes the standard DCF and risk premium models close to useless; therefore, the only recourse is to use the highest value calculated from those models. As support for this position he cites that Regulatory Research Associates reports that show the average authorized returns on equity in the first quarter of 2012 as 10.30 percent—down from 10.39 percent in the fourth quarter 2011.[3]

Of course, Dr. Hadaway ignores the fact that in Wyoming, where in direct testimony he supported a 10.20 percent cost of equity rate, his client, PacifiCorp, recently settled for a 9.80 percent cost of equity rate.

Q. Do you agree with Dr. Hadaway's contentions about the investment environment and the applicability of the standard cost of equity estimation models?

[3] Rebuttal Testimony of Samuel C. Hadaway, pages 2-5.

A. No. At least not in the way he conflates them. Without question the Federal Reserve continues to work to keep interest rates at historically low levels in its on-going attempt to jump-start the U.S. economy. Indeed, I discussed this in my direct testimony. However, I disagree that the markets are "turbulent" much beyond fairly normal fluctuations—markets are always fluctuating—in response to the daily news. Markets are "turbulent" such that the prices of proxy electric utility stocks are, on average, over 6.5 percent higher than they were on May 14, 2012, when I filed my direct testimony, through July 16, 2012. The Standard & Poor's 500 Index is also slightly higher over same period.

But more than market "turbulence" Dr. Hadaway argues that the low interest rate environment is something that the standard models were not designed to deal with. This appears to be solely Dr. Hadaway's personal opinion, since he provides no supporting documentation of this opinion.

Common equity investors have to take the investment environment as they find it. If it is not to their liking, they can withdraw from participating in the market. Those investors who continue to participate are faced with the trade-offs the markets present them with. If an investor has a choice of receiving a 2.0 percent (or less) return from 10-year U.S. Treasury note, a 3.0 percent return from 10-year first mortgage bond from a regulated utility, and a 5.0 percent common dividend yield with the chance to receive a 3.0 percent addition return from the growth in the common stock of the same utility for an 8.0 percent total return,[4] what would a rational investor choose? Dr. Hadaway apparently believes that the presence of

[4] The 8.0 percent return is, in effect, the return on equity calculated from a DCF single-step model.

actual investors in common stock with an expected return of 8.0 percent should be ignored[5] and that his GDP model showing a 10.2 percent return must necessarily be accepted without any empirical support.

PacifiCorp has easily found investors for its 10-year first mortgage bonds at an interest rate of less than 3.0 percent. I agree, of course, that PacifiCorp's common equity is riskier than its 10-year first mortgage bonds, and therefore should command an expected return higher than 3.0 percent. By Dr. Hadaway's own calculations, a difference of 505 basis points between average utility bond rates and authorized returns on equity is a historic high.[6] As I showed in my direct testimony, the 9.30 cost of equity figure I am proposing is 520 basis points above the Company's recent 30-year debt offering and 635 basis points above its 10-year debt offerings.[7] This clearly supports the proposal that if PacifiCorp common stock were publicly traded investors, in the current environment, would accept expected returns noticeably less than 10 percent.

Q. Dr. Hadaway complains that you use some comparable companies he believes you should have excluded; and if you had excluded them your cost of equity estimate would have been higher. Do you have comments on this issue?

A. Yes. Dr. Hadaway notes that some of the proxy companies are not doing as well as other companies for one reason or another. The three he questions are Entergy, Edison International and P G & E. In fact Dr. Hadaway himself used Edison International in his direct testimony, but now he belatedly removes it from his list.

[5] Perhaps Dr. Hadaway believes investors are currently irrational?
[6] Hadaway Op. Cit. Exhibit RMP__(SCH-8R).
[7] Direct Testimony of Charles E. Peterson, DPU Exhibit 1.3 Dir. COC.

These three companies passed my selection criteria and I leave them in the proxy list. In my direct testimony I was aware of the characteristics that Dr. Hadaway complains about and I made some adjustments to mitigate the effects. For example, on DPU Exhibit 1.5 Dir. COC, I eliminated the negative growth rate forecasts from the calculation of the growth rates for the single-step DCF models. Additionally, on DPU Exhibit 1.7 Dir. COC I adjusted the cost of equity by eliminating estimates that appeared to be too low, including estimates for Edison International, Entergy and PG &G, *and* estimates that appeared to be too high. Dr. Hadaway appears to be only interested in adjustments that are "too low" in his mind and does not consider that estimates for some companies, such as Wisconsin Energy, may be "too high" when compared with PacifiCorp's expectations. In the end, if one makes symmetric adjustments, not just removal of the lower estimates, then these adjustments make little difference in the central tendency of the estimates to a figure around 9.30 percent (and a reasonable range of about 9.00 to 9.60 percent).

In my rebuttal testimony I provided an exhibit, based upon Office of Consumer Services witness Daniel Lawton's testimony that showed the effects of reducing the list of proxy to the eight companies common to all witnesses.[8] I replicate that exhibit here as DPU Exhibit 1.1 SR COC with the data for Edison International removed per Dr. Hadaway's rebuttal testimony. The results from these now seven companies indicate a range of between about 8.90 to 9.60 percent, with a midpoint of 9.25 percent. This analysis removes any controversy related to the proxy group membership. The result of this analysis also continues to be very compatible with all of the cost of capital witnesses, other than Dr. Hadaway.

[8] See DPU Exhibit 1.3R COC.

Q. Dr. Hadaway criticizes you for "excessive" mechanical adherence to models, in fact he states that "Mr. Peterson and the other ROE witnesses would have the Commission rely entirely on model results"[9] as if that were a bad procedure. Do you have a comment on this issue?

A. I agree with Dr. Hadaway that the models should be used in conjunction with "expert judgment."[10] I also believe that that is why several models need to be considered and, where necessary, prudent adjustments should be made as I have done. As stated above a reasonable range is developed and a point estimate developed within that range. What I find "excessive" is for an analyst to rest his entire case on a single calculation.

Q. Dr. Hadaway denies that he puts little or no weight on DCF results based on analyst growth rates.[11] How do you respond to this denial?

A. In his rebuttal Dr. Hadaway makes no distinction between running some calculations and giving some actual weight and consideration to those calculations. In fact, Dr. Hadaway does not even give "little weight" to these other calculations—he gives exactly no weight to them. His entire case is based upon his DCF calculation that is based upon his much-criticized GDP weighted historical growth rate.

Q. So, it comes down to the GDP grow rate Dr. Hadaway uses, doesn't it?

A. Largely yes. Dr. Hadaway puts 100 percent weight on his DCF model using his GDP growth rate. In the past he could argue at least that he gave some credence to the other indicators he

[9] Hadaway, lines 365-366.
[10] Hadaway, line 361.
[11] Hadaway, lines 326-331.

constructed. His justification for this procedure this year is that the Federal Reserve has intervened and will continue to intervene in the markets and therefore he claims that the only thing to do is to give PacifiCorp the highest equity return he can calculate.

Furthermore, as in the past, Dr. Hadaway has once again failed to provide any evidence that investors today are relying on something similar to his 5.7 percent GDP growth rate (down from 5.8 percent in his direct case).

Q. Dr. Hadaway also denies that he is increasingly ignoring data.[12] How do you respond?

A. Dr. Hadaway admits he no longer bothers to even calculate a CAPM estimate.[13] However, as shown in my direct testimony, he intentionally excludes data that contradicts his GDP growth estimate and as shown above, he gives zero weight to all of his calculations, except that he puts 100 percent weight on the calculation that happens to give the highest value. Dr. Hadaway's testimony speaks for itself as to whether or not he eliminates data and models because they produce outcomes that, in his opinion, are too low results.

Q. Do you have any concluding comments?

A. Yes. First, in summary, I accept Mr. Williams' calculation of the revised embedded cost of debt value of 5.37 percent. This in turn revises my estimated weighted average calculation from 7.41 percent to 7.42 percent. DPU Exhibit 1.2 SR COC sets forth my revised conclusion regarding the weighted average cost of capital.

[12] Hadaway, lines 367-375.
[13] Id., lines 370-372.

Second, I have not dealt with every issue raised by Dr. Hadaway in his rebuttal testimony. However, his rebuttal testimony is unpersuasive. Therefore, I continue to support and advocate my position in my direct testimony that the appropriate cost of equity for PacifiCorp is 9.30 percent, within a reasonable range of 9.00 to 9.60 percent.

Q. Does this conclude your surrebuttal testimony?

A. Yes.