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**

Surrebuttal Testimony and Exhibit of

Michael P. Gorman

on Cost of Capital Issues

On behalf of

The Federal Executive Agencies (FEA)

July 18, 2012

BRUBAKER & ASSOCIATES, INC.

Project 9584

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**

Table of Contents to the
Surrebuttal Testimony of Michael P. Gorman

Page

Response to Mr. Williams 3

Response to Dr. Hadaway 6

Exhibit FEA-1SR (MPG-1SR)

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**

<u>Surrebuttal Testimony of Michael P. Gorman</u>

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A Yes.

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

A I will respond to arguments made by Rocky Mountain Power ("RMP" or "Company") witnesses Bruce Williams and Dr. Samuel Hadaway.

Response to Mr. Williams

Q WHAT ISSUES DOES MR. WILLIAMS TAKE THAT CONCERN YOU IN HIS REBUTTAL TESTIMONY?

A Mr. Williams takes issue with my proposed adjustments to the common equity balance supporting utility operations. Mr. Williams outlines at pages 5 and 6 of his testimony, non-utility investments and subsidiary investments, which he claims actually are included in the utility rate base. Specifically, Mr. Williams claims that the Bridger mine investment is included in rate base, therefore the capital supporting this investment should not be excluded from the regulatory capital structure.

Q PLEASE RESPOND TO MR. WILLIAMS.

A To the extent the investments categorized as non-utility or subsidiary investments are included in rate base, then I agree with Mr. Williams that it is not appropriate to remove the capital supporting the investments from the regulatory capital structure. I confirmed that the Bridger mine and the Trapper mine investments are included in the Company's rate base. These two investments represent the bulk of my proposed capital structure adjustment. Including the remaining common equity balances in my capital structure does not have a significant impact on the Company's proposed capital structure.

As a result, I am no longer recommending adjustments to the Company's proposed capital structure.

Q DOES MR. WILLIAMS TAKE ISSUE WITH YOUR CREDIT METRIC ANALYSIS?

A Yes. Mr. Williams states that my credit metric analysis is inappropriate because it does not reflect all the liabilities considered by credit rating agencies, excludes a significant amount of interest expense the Company reports on its financial statements, and ignores credit rating agencies' published expectations for PacifiCorp. For example, Mr. Williams asserts that it would be appropriate to include funds from operation ("FFO") to interest coverages in my analysis. Based on those assertions, Mr. Williams believes that my credit metric evaluation should not be given any consideration.

Q IS MR. WILLIAMS' ASSESSMENT OF YOUR CREDIT METRIC EVALUATIONS VALID?

A No. It is very clear in my direct testimony that I was not attempting to calculate credit metrics in the same way credit rating agencies would calculate them for RMP. Rather, I was calculating the credit metrics based on the Utah jurisdictional cost of service to determine whether or not the earnings and cash flow opportunities reflected in the Utah cost of service will contribute to RMP's overall financial strength and financial integrity. In significant contrast, Standard & Poor's ("S&P") would be considering all cash flows and all financial obligations of PacifiCorp in assessing its credit rating. S&P does not focus in on Utah jurisdictional operations, which is the focus of my rate of return and financial integrity assessment. Therefore, there is a difference between S&P's considerations for total Company and my considerations limited to an evaluation of Utah retail operations.

The objective of my analysis is to determine whether or not the jurisdictional revenue requirements, earnings and cash flow strength represent fair compensation to RMP for its investments in equipment serving Utah retail customers. In significant contrast, Mr. Williams' assessment would not distinguish between PacifiCorp's cost to serve to Utah customers, but would instead include all financial obligations whether they relate to Utah customers or other businesses outside of the Utah retail operations. Mr. Williams' preferred method would allow for a rate adjustment in Utah that subsidizes PacifiCorp financial obligations related to other jurisdictions or other business units.

Mr. Williams' arguments are inappropriate because he is not recognizing the need to set just and reasonable rates for Utah customers.

Q PLEASE RESPOND TO MR. WILLIAMS' ARGUMENTS THAT YOU DID NOT INCLUDE ALL INTEREST EXPENSE, AND DID NOT INCLUDE THE FFO TO INTEREST RATIO IN YOUR FINANCIAL INTEGRITY ANALYSIS.

A I included in my analysis interest expense that is reflected in the cost of service for retail operations in Utah. Other interest expense that has not been shown to apply to this jurisdiction is not properly included in my analysis.

With respect to the FFO to interest ratio, I agree that that is a financial metric that generally is identified by S&P in credit metrics reports. However, S&P removed the FFO to interest ratio from its general benchmark credit metric standard practices in 2009. Therefore, there is no longer an S&P benchmark to compare RMP's FFO to interest ratio against. As such, I no longer include this metric in my financial integrity analysis simply because it is no longer included in S&P's corporate credit metric benchmark matrix.

Response to Dr. Hadaway

Q DID DR. HADAWAY ASSERT THAT THE TRADITIONAL MODELS USED TO ESTIMATE A FAIR RETURN ON EQUITY ARE OUT OF SYNC WITH THE CURRENT COST OF EQUITY?

A Yes. He attributes this to the government's efforts to hold interest rates at low levels in order to stimulate the economy, which have reduced borrowing costs, and he believes have equally mitigated the effects on equity markets. He believes these government effects on interest rates create a challenge to accurately estimate a utility's current market cost of equity.

Q IS DR. HADAWAY'S CONCERN ABOUT GOVERNMENT INTERVENTION IN INTEREST RATE MARKETS AND THE ABILITY TO ACCURATELY ESTIMATE A UTILITY'S COST OF EQUITY, ACCURATE?

A No. I agree that government is impacting short-term interest rates in a way to stimulate the economy. However, government action does not directly impact the long-term interest rate markets. These long-term interest rate markets are predominantly influenced by investors via demand for the securities and valuations tied to investors' relative risk assessment.

The U.S. economy is currently one of the strongest in the world, which is attracting low-risk investors to the U.S. security markets. This has helped to reduce the long-term interest rates on both Treasuries and low-risk Corporate Bonds including the utility securities market. This world market appetite for low-risk securities is also decreasing the cost of equity for utilities' equity securities.

As shown on Exhibit FEA-1SR (MPG-1SR), the valuation metrics for the proxy groups are relatively robust now compared to the last 11 years. This is evidenced through a relatively high price-to-earnings ratio and price-to-cash-flow ratio. A higher stock price indicates lower required return on common equity, all else equal. For all these reasons, Dr. Hadaway is simply refusing to recognize that stable low-risk investments are in high demand from investors, which is driving up securities prices and driving down cost of capital.

Q DOES DR. HADAWAY MAKE SPECIFIC CRITICISMS OF YOUR RETURN ON EQUITY FINDINGS?

A Yes. At pages 24 and 25 of his rebuttal testimony, Dr. Hadaway states the following:

1. It was a mistake to retain Edison International because the analysts' growth rate data was unreliable.
2. My multi-stage discounted cash flow ("DCF") analysis was understated because my long-term gross domestic product ("GDP") growth rate analysis is understated.
3. My risk premium analysis result was understated because I reject the well documented inverse relationship between equity risk premiums and interest rates.

Q DO YOU AGREE WITH DR. HADAWAY THAT EDISON INTERNATIONAL SHOULD HAVE BEEN EXCLUDED FROM YOUR DCF ANALYSIS?

A No. Edison International did have a result which was out of line with the other companies in the group, however that low outlier result would have been eliminated by relying on the group median, which I did. Further, to the extent you eliminate the low estimates of the group, it would also be balanced and appropriate to eliminate the high-end estimates. Dr. Hadaway is only estimating the low-end and therefore skewing the results. In any event, my group average result of 9.32% is reasonably comparable to my group median result of 9.38%. Therefore, retaining Edison

International in the group average did not skew the group average result, as Dr. Hadaway claims.

Q DO YOU AGREE WITH DR. HADAWAY THAT YOUR LONG-TERM STEADY-STATE GROWTH RATE OR GDP GROWTH RATE UNDERSTATES THE MARKET'S EXPECTATIONS?

A No. Dr. Hadaway develops his own GDP growth forecast, which cannot be found in any published document other than his testimony in rate cases. In contrast, my growth rate is based on consensus analysts' projections, and is reasonably consistent with other sources of GDP published data supporting the outlook of the market participants for future GDP growth. Dr. Hadaway's belief that the GDP growth rate will revert to historical levels is inconsistent with a wealth of published projections made by professional economists whose outlooks are independent and used for general market, investor and economic study purposes. In contrast, Dr. Hadaway's analysis is developed by him, used only for his rate of return studies, and is not reasonably consistent with data which would be considered by an investor in forming investment decisions. Therefore, his GDP growth rate is not a fair reflection of market outlooks, investors' or general market sentiment and outlooks.

Q DO YOU AGREE WITH DR. HADAWAY THAT YOUR EQUITY RISK PREMIUM SHOULD HAVE REFLECTED AN INVERSE RELATIONSHIP?

A No. While an inverse relationship is one factor that helps describe or gauge what an appropriate equity risk premium is currently, it is not the only factor. As such, my disagreement with Dr. Hadaway on this issue is not that there is during certain markets an inverse relationship between equity risk premiums and interest rates, but rather that the interest rate/risk premium is not the only factor that helps properly gauge an equity risk premium.

Academic studies strongly support the notion that an appropriate equity risk premium is tied to the current assessments of the relative risks of investing in debt securities versus equity securities. This risk differential is not described simply by changes in interest rates as Dr. Hadaway erroneously asserts. Rather, the risk premium is impacted by many factors, including but not limited to interest rates. As such, Dr. Hadaway's simplistic assumption that equity risk premiums are impacted only by interest rates is without merit and is simply erroneous.

Q HOW DO YOU RESPOND TO DR. HADAWAY'S CLAIM THAT HIS USE OF LONG-TERM HISTORICAL DATA PRODUCES A BETTER ASSESSMENT OF FUTURE GDP GROWTH THAN THAT REFLECTED IN ANALYSTS' PROJECTIONS?

A Dr. Hadaway's assessment simply does not reflect the general market consensus of investors or investment security professionals. Rather, he is reflecting his own opinion, which he has failed to show in any way that it reflects general market sentiments. Analysts who project GDP growth are in business to provide the market with relevant information to make investment decisions for securities, decisions for capital projects and other business/economic decisions. The need for long-term GDP growth outlooks is relevant to the market, and these analysts are in business to provide the market with that relevant data. In significant contrast, Dr. Hadaway is in business to support a return on equity desirable for the utility. His GDP forecast does not reflect the market outlook, and is not an independent assessment of future GDP growth. Therefore, it should be disregarded.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

\\doc\shares\prolawdocs\sdw\9584\testimony-bai\221739.doc