–BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH–

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. 20-035-04** **Exhibit No. DPU 2.0 SR**

FOR THE DIVISION OF PUBLIC UTILITIES

DEPARTMENT OF COMMERCE

STATE OF UTAH

Surrebuttal Testimony of

Casey J. Coleman

October 8, 2020

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, EMPLOYER, AND BUSINESS ADDRESS.

A. My name is Casey J. Coleman. I am employed by the Division of Public Utilities (DPU or Division) for the State of Utah. My business address is 160 East 300 South Salt Lake City, UT 84114.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on the Division's behalf.

Q. ARE YOU THE SAME CASEY J. COLEMAN WHO FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I will respond to the rebuttal testimony and calculations provided by Ms. Ann E. Bulkley for Rocky Mountain Power (RMP) regarding cost of equity and the fair rate of return.

Silence on any topic or criticism raised by Ms. Bulkley in her rebuttal testimony should not be construed to mean agreement with her comments or criticisms.

Q. IN HER REBUTTAL TESTIMONY MS. BULKLEY EXPLAINS SEVERAL CRITICISMS OF YOUR ANALYSIS DETAILED IN YOUR DIRECT TESTIMONY. IS THERE ANY MERIT TO ANY OF THESE CRITICISMS?

A. No. Her concerns are without merit.

Q. DO YOU HAVE ANY GENERAL COMMENTS CONCERNING THE ANALYSIS YOU PERFORMED IN THIS PROCEEDING?

A. Yes. I stand by the analysis and recommendations that I made on behalf of the Division in my direct testimony. My analysis is consistent in the application of the discounted cash flow (DCF) model, Capital Asset Pricing Model (CAPM), and risk premium models. Furthermore, a reduction in the authorized rate of return from the current level of 9.8 percent to 9.25 percent is reasonable and provides a fair rate of return for all parties.

II. FAIR RATE OF RETURN

Q. IN YOUR DIRECT TESTIMONY YOU DISCUSSED HOW COST OF EQUITY IS A FLOOR FOR THE ROE AND THE AUTHORIZED RATE OF RETURN BY OTHER COMMISSIONS WOULD BE THE CEILING FOR THE ROE. CAN YOU EXPLAIN THIS IDEA AGAIN?

A. Yes. In my direct testimony I explain why the DPU is recommending the 9.25 percent ROE. [1] The testimony illustrates when setting allowed rates of return, utility commissions have an upper and lower threshold for rates. My direct testimony follows the ideas suggested by Dr. James C. Bonbright that calculated rates should act as a minimum cost when determining the fair rate of return.[2] Dr. Bonbright is even more direct in his conviction when he writes "calculating the cost of equity for any given company the only such cost that can be determined with confidence is a *minimum cost.*"[3]

[1] Direct testimony of Casey J. Coleman pages 66 – 67.
[2] James C. Bonbright, *Principles of Public Utility Rates* (New York: Columbia University Press, 1961), republished on the web (July 2005) Page 255:
http://www.terry.uga.edu/bonbright/publications
[3] James C. Bonbright, *Principles of Public Utility Rates* (New York: Columbia University Press, 1961), republished on the web (July 2005) Page 255:
http://www.terry.uga.edu/bonbright/publications

According to Dr. Bonbright, the minimum cost or floor for a regulated utility would be the cost of equity. Cost of equity is a starting point for regulatory commissions to set rates and then adjustments are made according to other policy considerations. An allowed rate of return by regulators may have some component of the cost of equity in addition to some rate to compensate for other policy considerations. An allowed rate of return should capture all elements necessary for just and reasonable rates for a regulated utility.

In DPU SR-02 Attachment 6, the Division updated the calculated regulated electric utility average ROE for 2020 at 9.50 percent. If Dr. Bonbright's principle is followed that the cost of equity is a minimum figure to which Commissions may add, an average of 9.50 percent allowed ROE suggests the cost of equity for each of the listed companies was below 9.50 percent. When looking at the just and reasonable rate for each utility, presumably the commissions started with some calculated cost of equity. The cost of equity would be adjusted according to the appropriate risks and financial constraints specific to that company that each commission felt best represented the allowed rate of return.

III. ROCKY MOUNTAIN POWER'S REBUTTAL TESTIMONY

Q. WHAT GENERAL OBSERVATIONS DO YOU HAVE REGARDING MS. BULKLEY'S REBUTTAL TESTIMONY?

A. From the criticisms presented in Ms. Bulkley's rebuttal testimony, it is clear that she does not understand the process Duff and Phelps uses to calculate its risk-free rate (RFR) as well as its equity risk premium (ERP). Additionally, it appears Ms. Bulkley did not understand the framework and method the Division employed to determine its recommendation of an allowed rate of return of 9.25 percent.

Ms. Bulkley is critical of the analysis done by the Division because volatility and uncertainty[4] has increased and the Division is silent on this issue. Additionally, she argues the Division has not considered how the market has responded to the unprecedented intervention by the Federal Reserve.[5] Ms. Bulkley is also critical of the Division for failing to mention in its testimony the Coronavirus Aid, Relief, and Economic Security (CARES) Act signed into law.[6]

Each of these criticisms is unfounded and without merit. When one begins an analysis of the inputs involved and considered by Duff and Phelps in calculating its RFR and ERP, it is obvious that careful consideration is given to a number of topics. On April 16, 2020, Duff and Phelps initiated a webinar which explained cost of capital considerations in the current coronavirus environment, which I attended.[7] A general summary of the information considered by Duff and Phelps in this webinar includes:

- COVID-19 Brief Timeline, Real GDP Growth—Sources of Estimates
- U.S. Real GDP (Annualized) Growth Estimates for 2020 Before and After Enactment of the U.S. Fiscal Stimulus Package (CARES) Act
- S & P 500 Earnings Consensus Estimates—Before and After Coronavirus
- S & P 500 Index October 1, 2019—April 15, 2020
- U.S. Market Crashes
- Using S & P 500 Price Index as Benchmark

[4] Rocky Mountain Power, Rebuttal Testimony of Ann E. Bulkley lines 288—292 and line 303.
[5] *Ibid* lines 367—369.
[6] *Ibid* lines 342—344.
[7] For the complete slides in the presentation see DPU SR-02 Attachment 1.

- 10-year Yields for U.S., Germany, U.K., Japan
- Federal Reserve (Fed) A Selection of Monetary Policy Measures
- Federal Reserve Balance Sheet
- Chicago Board Options Exchange (CBOE) VIX Index
- Other Cost of Capital Inputs.

Even though the above list seems exhaustive, it is not all of the factors Duff and Phelps used to calculate its RFR and ERP. As the list above shows, each of the specific areas discussed by Ms. Bulkley were analyzed and carefully considered in the recommendations provided by Duff and Phelps. To further reflect the impact to markets Duff & Phelps publishes a Cost of Capital in the Current Environment.[8] This infographic shows the Duff and Phelps recommended U. S. ERP, normalized U. S. RFR, Real GDP Growth, VIX Index, and U. S. Corporate Credit Spreads. This shows the current market impacts as a result of COVID-19 and how the volatility in the market is impacting the various metrics used to measure cost of capital.

Clearly, Duff and Phelps has considered the current market situation and how these unprecedented times are changing the investing landscape. Ms. Buckley's criticism is misplaced.

Q. DUFF AND PHELPS CONSIDERED MANY DIFFERENT IMPACTS TO THE MARKET. HOW DOES THAT CORRELATE WITH THE DIVISION AND ITS ANALYSIS?

A. The Division anlyzed Duff and Phelps' RFR and ERP when choosing key metrics to determine if the various financial models were producing accurate results. Using a U. S. ERP of 6.0 percent and a normalized U. S. RFR of 2.5 percent, the Division is able to

[8] For the most recent version of the infographic from Duff and Phelps see DPU SR-02 Attachment 3.

quickly determine if the financial models are producing accurate return on equity calculations. ROE rates close to 8.50 percent or below would produce results that would pass the reasonable test.

The Division reviewed the work done by Duff and Phelps to determine if the calculated results adequately considered the current market conditions. Duff and Phelps meticulously evaluated past and current market criteria. When the Division analysis uses Duff and Phelps' RFR and ERP as a key metric, by association, the Division is just as meticulous in its determination of an appropriate cost of capital. Because the Division used 8.5 percent (which is Duff and Phelps total market return) as its reasonable test for the appropriate financial models, the Division has considered the Federal Reserve's monetary policy, the impact of quantitative easing on the market, the impact of interest rates on the cost of capital, how the U. S. GDP rate will impact the rate of return for investors, how volatility and uncertainty impacts investors, and dozens of other market considerations.

The criticisms in Ms. Bulkley's rebuttal testimony regarding the Division's analysis and silence on the current market conditions are faulty. The Division has carefully consider the current market situation when making its recommendations.

IV. RMP'S UPDATED FINANCIAL ANALYSIS

Q. USING THE UPDATED INFORMATION IN MS. BULKLEY'S REBUTTAL TESTIMONY AND COMPARING THAT TO DUFF AND PHELPS MARKET RETURN, HOW WOULD YOU EVALUATE MS. BULKLEY'S RESULTS?

A. Ms. Bulkley's calculations significantly overstate the return on equity in the CAPM and ECAPM models, the Treasury Yield Plus Risk Premium model, Expected Earnings, and the Mean High for her Constant Growth DCF models. Each of these models are producing results higher than the total market return of 8.5 percent. With her CAPM, ECAPM, and Expected Earnings Analysis, producing results that are higher than the ceiling of 9.5 percent. Only two analyses completed by Ms. Bulkley provide a return on equity the Division would generally be comfortable in using her Mean Low and Mean for the Constant Growth DCF model.

Q. HOW WOULD YOU EXPLAIN SUCH A DISPARITY IN THE MARKET RATE CALCULATED BY DUFF AND PHELPS AND MS. BULKLEY'S FINANCIAL MODELS?

A. From Ms. Bulkley's rebuttal testimony it is clear that RMP and the Division see the financial situation of RMP and the ROE the company should be allowed to earn differently. Even though the processes Ms. Bulkley and I followed were similar, using a variety of financial models to calculate an ROE, the results are incongruous.

There may be some general reasons why Ms. Bulkley and I see RMP's situation so differently. Three possible explanations are: (1) The financial models (i.e. discounted cash flow (DCF), capital asset pricing model (CAPM), and Bond Yield Risk Premium are inherently flawed and unable to provide reasonable calculations for ROE; (2) the data and information being used in the models to calculate the ROE are incorrect and inaccurate; or (3) the perception of the risks faced by RMP. I address and analyze these reasons below.

Given the history and wide use of the financial models used in cost of capital proceedings before this Commission and others, it seems unlikely that those models' shortcomings sufficiently explain the wide difference in recommendations. Thus, we must look to the other two explanations to see the differences between Ms. Bulkley's testimony and mine.

Over the course of my testimony I will show how there has been no evidence provided by RMP and Ms. Bulkley that supports the premise that RMP has a higher risk profile than comparable regulated electric utilities or the whole market, therefore requiring the Commission to order an ROE of 10.2 percent or to leave the ROE of RMP at 9.8 percent. There is no risk justification for Ms. Bulkley's recommendation.

If the financial theories are capable of calculating a relatively accurate ROE and RMP is not riskier than a comparable set of regulated utilities, then the remaining reason for the substantial differences in ROE between parties could be attributed to incorrect data being used in the financial models, differing application of judgement, or something else. Ms. Bulkley uses 129 pages plus attachments in her rebuttal testimony in an attempt to illustrate why in her opinion each analysis done by the DPU and other parties is unacceptable. What follows is my analysis as to why her recommendation is fundamentally flawed.

Q. WILL YOU EXPLAIN WHY A MINIMUM COST IS IMPORTANT TO MS. BULKLEY'S ROE RECOMMENDATION OF 9.8 PERCENT AND WHY THE DIVISION IS UNCOMFORTABLE WITH HER RECOMMENDATION?

A. Yes. In Ms. Bulkley's rebuttal testimony she argues the ROE should be 10.20 percent but because of market conditions RMP suggests keeping its ROE at 9.80 percent.[9] As discussed before, the average allowed ROE calculated by the DPU is 9.50 percent. The 10.2 percent or 9.8 percent of Ms. Bulkley's cost of equity calculations cannot be reconciled with the allowed ROE for regulated electric utilities of 9.50 percent based on the evidence presented. As discussed previously, cost of equity calculations should be the minimum or floor for commissions when setting the appropriate ROE. RMP's updated recommendation starts 30-basis points higher than the average allowed ROE by commissions in other jurisdictions. Ms. Bulkley provides scant analysis to support a rate for RMP that begins higher than the average allowed ROE for regulated electric utilities in recent cases.

Q. EARLIER YOU DESCRIBED HOW YOU AND MS. BULKLEY SEE THE MARKET DIFFERENTLY. CAN YOU GIVE A PRACTICAL EXAMPLE AND THE IMPLICATIONS OF THE DIFFERENCES?

A. Yes. The theory by Dr. Bonbright as discussed above, demonstrates the stark differences in the market as calculated and observed by Ms. Bulkley and the Division. Ms. Bulkley's recommended range of 9.80 or 10.20 percent appears to flip the regulatory principle elaborated by Dr. Bonbright. The constraining floor for Ms. Bulkley has become the average allowed ROE of regulated electric utilities. Ostensibly, this is related to the principles outlined in *Hope* and *Bluefield* that suggest one factor is whether a utility should be allowed to earn a return equal to other utilities of similar risk. Rather than

[9] Rocky Mountain Power, Rebuttal testimony of Ms. Ann E Bulkley lines 133—135.

finding the minimum cost of equity and deviating upward because of risk and other factors, Ms. Bulkley appears to use other utilities' allowed ROE as a minimum floor.

In Ms. Bulkley's rebuttal testimony she argues that the Division's analysis does not "reflect the well-known principle that the ERP is inversely related to the risk-free rate."[10] Because the market risk premium estimates, in her opinion, do not reflect this principle, Ms. Bulkley has concerns with the analysis done by the Division. However, because Ms. Bulkley's recommendations do not fit within the principle that cost of equity represents a minimum cost, her analysis should cause serious concern to the Commission. Her ROE recommendation is significantly higher than warranted given traditional regulatory and financial principles. Ms. Bulkley does not provide sufficient discussion and analysis to justify why RMP's ROE should be significantly higher than most of the rate cases completed this year in other jurisdictions.

The Division calculated a ROE range of 7.24 percent to 9.17 percent with a recommendation of 9.25 percent. Embedded in this recommendation is the belief that 7.24 percent is the minimum cost.

The *Hope* and *Bluefield* cases establish a few principles to be considered: (1) that the utility be allowed an opportunity to earn a return on its utility property generally equal to returns earned by other companies of similar risk; (2) this return should assure confidence in the financial soundness of the utility; (3) this allowed return should maintain and support the credit of the company and allow it to attract capital; (4) recognition that a

[10] Rocky Mountain Power, Rebuttal Testimony of Ms. Ann E. Bulkley line 1296.

return that is "right" at one time may become high or low by changes in the economy regarding alternative investments; and (5) particularly in *Hope,* what is important is that the "end result" of the rate order be just and reasonable; it is less important how that result is arrived at. While the above list reflects the rights of the utility as outlined in *Hope* and *Bluefield* cases, the public interest requires rates to be "just and reasonable," introducing a measure of fairness toward the Company's captive customers.

The Division's recommendation is consistent with the theory suggested by Dr. Bonbright and the *Hope* and *Bluefield* standards. The ROE of 9.25 percent is above the floor calculated in each of the financial calculations done while providing just and reasonable rates to the company as well as the captive customers of RMP. As will be illustrated later in my testimony, the Division's ROE is lower than the comparable group of companies because RMP has lower risks than the comparable group of companies. This lower recommendation still follows the *Hope* and *Bluefield* cases because utilities are generally given the opportunity to earn equal returns earned by other companies of <u>similar risk</u>.

Because there is no way to reconcile Ms. Bulkley's recommendations with long practice and regulatory principles outlined by experts like Dr. Bonbright, and other relevant principles, Ms. Bulkley's analysis is not credible.

V. RMP'S JUSTIFICATION FOR ITS ROE RECOMMEDATION

Q. MS. BULKLEY OUTLINES IN HER REBUTTAL TESTIMONY SIX FACTORS[11] THAT SUPPORT RMP'S REQUESTED ROE. DO YOU AGREE?

[11] Rocky Mountain Power, Rebuttal Testimony of Ms. Ann E. Bulkley lines 227—241.

A. No. For ease of discussion Ms. Bulkley's six factors are listed below:

1. Supported by the analyses contained in my direct testimony and updated in my rebuttal testimony;
2. Consistent with current and prospective financial market conditions;
3. Supported by the methodologies considered by the Commission as well as other regulatory jurisdictions;
4. Consistent with the range of ROE awards for integrated electric utilities in other state jurisdictions;
5. Considers the unique business and operating risks of RMP in Utah; and
6. Will support RMP's ability to attract capital to finance investments at reasonable rates, which will provide long-term benefits to ratepayers by limiting the long-term cost of capital.

The above listed factors do not support RMP's requested ROE of 9.8 percent. As outlined before, Ms. Bulkley's financial analysis does not produce reasonable results. Although, it is accurate that Ms. Bulkley's ROE recommendation fits within the range of ROE awards for integrated electric utilities in other state jurisdictions, her recommendation is above the average allowed rate of return for integrated electric utilities. Later in the Division's testimony, analysis will be provided to explain the use of ROEs for integrated electric utilities and why those averages are inappropriate to use, creating a situation where investors could be compensated twice for the same risk. Ms. Bulkley has not provided compelling evidence to support why the ROE of RMP warrants a premium to the average allowed ROE for integrated electric utilities. While RMP's recommended ROE may meet capital attraction standards, the Division asserts a return of 9.8 or 10.2 percent does not provide a long-term benefit to ratepayers that is worth the cost to ratepayers. The 9.8 percent provides a benefit to the Company but at too high of a cost—ratepayers, the captive customers of RMP, are paying a higher rate than the regulatory framework requires.

VI. GRADUALISM

Q. MS. BULKLEY WAS UNCOMFORTABLE WITH THE DIVISION'S 9.25 PERCENT ROE RECOMMENDATION AND HOW THE DIVISION APPLIED THE PRINCIPLE OF GRADUALISM. CAN YOU EXPLAIN HOW THE 9.25 PERCENT IS CONSISTENT WITH THE CONCEPT OF GRADUALISM?

A. Yes. Part of her reasoning for suggesting why she views the Division's ROE is incorrect is because the 55-basis point drop is 20-basis points greater than the 35-basis points the Commission allowed in Docket No. 13-057-05, a general rate case involving Utah's largest regulated gas utility. She misunderstands gradualism, which is a post-hoc pragmatic tool, not an underlying principle for determining a correct figure. Additionally, as explained below, Ms. Bulkley does not understand how gradualism factored into the Division's recommendation of 9.25 percent, and how the Commission has viewed gradualism in other rate cases.

It appears part of Ms. Bulkley's confusion is due to her misinterpreting the Division's purposed adoption for gradualism and how that theory factored into the recommendation of 9.25 percent. When recommending 9.25 percent, the question is not the relationship between a past ROE and a new one, as much as it is the relationship between a new ROE relative to other options for capital investment.

Gradualism can be a practical option, when the financial data and average authorized ROE for electric utilities are different such as in the current market situation. However, the Commission is not charged with setting an ROE for the benefit of investors alone but must set just and reasonable rates in support of the public interest. Shareholders have enjoyed an authorized return set in a rate case concluded approximately seven years ago, and rates have remained historically low. Far from a reasonable application of gradualism, Ms. Bulkley appears to simply suggest further delays in setting appropriate rates by keeping RMP's ROE at 9.8 percent.

The Division's recommended ROE of 9.25 percent balances the competing forces of customers and investors while recognizing the need for gradualism in the current market and the Utah specific regulatory climate. It allows just and reasonable rates.

In today's financial market, applying gradualism is probably the area that requires the most seasoned judgment and analysis to arrive at the correct ROE. In recommending the 9.25 percent ROE, the Division looked at a past Commission order that lowered the ROE in that proceeding by 50 basis points.[12] This provided a general framework for an amount that the Commission was comfortable with and seemed reasonable. Applying the financial models and theories the Division calculated the cost of equity for RMP roughly around 7.24 to 9.17 percent. From a ratepayer's perspective, a rate higher than this represents a premium on the actual cost of equity. From an investor's perspective, an ROE below the average authorized ROE for electric utilities, which was calculated at 9.50 percent by the Division, represents something of a discount against other options. Something between the ratepayer- and shareholder-centric numbers represents the number the public interest requires for just and reasonable rates.

[12] See Commission Report and Order in Docket 13-057-05 Questar Gas Company 2013 General Rate Case

Total market returns are also relevant. Duff and Phelps' published market cost of equity is 8.5 percent.[13] Because RMP is a regulated electric company with increased stability and certainty over most market participants, its ROE should be below that of the total market. Following this well understood financial theory, the ROE for RMP should be below 8.5 percent or the total market return if there were no competing principles.

Dr. Bonbright discussed investor expectations as well as consumer expectations when he stated:

> "[U]nder systems of private or public ownership that depend entirely on revenues rather than on taxes for financial support, there is an important degree of harmony between the interests of consumers and of investors. This partial harmony justifies a public service commission in going far toward the acceptance of the long-run interests of consumers as its sole responsibility. With an important qualification, the ***legitimate*** interests of investors may be regarded as amply protected by the allowance of rates sufficiently high to maintain corporate credit and hence to assure that maintenance of adequate service."[14]

An ROE for RMP of 8.5 percent or lower – a 130 basis point decrease – would likely not be just and reasonable when weighing investor expectations. Therefore, a rate reflecting a gradual reduction to ROE is necessary. Based on its analysis and experience, the Division chose a 9.25 percent ROE as the just and reasonable point. The conclusion is firmly supported for the following reasons.

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[13] DPU SR-02 Attachment 4.

[14] James C. Bonbright, *Principles of Public Utility Rates* (New York: Columbia University Press, 1961), republished on the web (July 2005) Page 39 emphasis added: http://www.terry.uga.edu/bonbright/publications

When analyzing the total market return as calculated by Duff and Phelps, a 9.25 percent ROE is higher than the total market return with a 75-basis point difference. This is the impact to rate payers as a result of gradualism. From an investor's standpoint, the ROE would be decreasing 25-basis points from the calculated average authorized ROE for electric utilities. A 25-basis point drop for investors is within the range of 50 basis points the Commission has used in previous rate cases. The 75-basis point increase for ratepayers does fall outside the range the Commission has felt comfortable with before. As stated before, gradualism is a tool that helps to smooth out the rates for all parties involved. There are no specific ranges that the Commission must follow. Instead judgment and reasoning must be employed to ensure just and reasonable rates are being set. This is an appropriate use of gradualism that also provides for just and reasonable rates.

Another important element to consider is the proposed capital structure in this case. The Company has asked to increase the percent of total equity to 53.67 percent. A 9.25 percent ROE with the higher equity percentage calculates to a weighted average cost of 7.18 percent. It should be noted that the Company recently signed a settlement stipulation in the State of Washington and agreed with an overall weighted cost of capital of 7.17 percent.[15] The agreed rate is nearly identical to the Division's calculated overall rate of 7.18 percent.

[15] Dockets UE-191024, UE-190750, UE-190929, UE-190981, UE-180778, Testimony in support of settlement stipulation, July 17, 2020, Exh. JT-1T, page 34.

VII. BUSINESS RISK

Q. THE DIVISION'S ROE OF 9.25 PERCENT IS LOWER THAN THE AVERAGE AUTHORIZED ROE FOR ELECTRIC UTILITIES. CAN YOU EXPLAIN WHY THE ROE FOR RMP SHOULD BE LOWER THAN THE AVERAGE FOR ELECTRIC UTILITIES?

A. Yes. The simple answer is that RMP is less risky than other electric utilities. Dr. Roger A Morin, professor of finance and author of *New Regulatory Finance,* discusses various risks that are determinants of required return. [16] Dr. Morin explains that the Risk Premium is made up of a variety of risks, those risks include; (1) Interest rate risk, (2) Business Risk, (3) Regulatory Risk, (4) Financial Risk, and (5) Liquidity Risk. Required return is the sum of the risk-free rate and the risk premium.

Of the risks listed above, business risk is the area where RMP differs extensively from the market as a whole and is noticeably different from a comparable list of regulated electric utilities. To begin the discussion, let's refer to Dr. Morin's statement that "[b]usiness risk encompasses all the operating factors that collectively increase the probability that expected future income flows accruing to investors may not be realized." [17]

He continues that "[b]usiness risk is due to sales volatility and operating leverage. Sales volatility is the uncertainty in the demand for the company's products due in part to external non-controllable factors, such as the basic cyclicality of the demand for the

[16] Morin, Roger A, *New Regulator Finance* (Public Utilities Reports, 2006) 35-45.
[17] *Ibid* page 38.

company's products, the products' income and price elasticity, the degree of competition, the availability of product substitutes, the risk of technological obsolescence, the degree and quality of regulation, weather variations, and the conditions of the labor and raw materials market.

Sales volatility is also related to internal or controllable factors. The reactions of a company's management to the business environment, such as adoption of a particular cost structure, are important dimensions of business risk."[18]

Dr. Morin outlines how business risk is assessed "by examining the strength of the long-term demand for utility products and services. Many factors have an impact on business risk, including the size and growth rate of the market, the diversity of the customer base and its economic solidity, the availability of substitutes and degree of competition, and the utility's relative competitive standing in its major markets, including residential, industrial, and commercial markets."[19]

Finally, Dr. Morin makes this important observation, "[t]he regional economics of a utility's service territory exert a strong influence on the company's risk."[20]

Ms. Bulkley acknowledges company specific risk differences and their effects on ROE in her direct and rebuttal testimony. She argues that because "RMP does not have a capital cost recovery mechanism unlike many electric utilities in the proxy group"[21] RMP has a

[18] *Ibid* page 38.
[19] *Ibid* page 39.
[20] *Ibid* page 39.
[21] Rocky Mountain Power, Rebuttal Testimony of Ms. Ann E. Bulkley lines 1562—1564.

higher business risk. Additionally, she argues that because "RMP has fewer cost recovery mechanisms than the proxy group, it is reasonable to conclude that RMP has great regulatory risk than the proxy group"[22] As discussed in my direct testimony, the Division does not believe this is a significant business risk to RMP because many of the companies in the proxy group do not have cost recovery mechanisms. If RMP was the only company that did not have cost recovery mechanisms then Ms. Bulkley's assertion would be accurate. The reality is that "52 percent of the operating companies held by the proxy group have some form of capital cost recovery mechanism in place"[23] There is just slightly less, 48 percent, of the operating companies in the proxy group that do not have some form of capital cost recovery similar to RMP. The Division finds it difficult to conclude that RMP is much riskier than the proxy group when almost half of the companies do not have any capital cost recovery mechanism.

In all the pages of testimony and rebuttal testimony filed by Ms. Bulkley there is little compelling evidence to support an ROE higher than the average allowed rate of return for comparable electric utilities of similar risk. When comparing RMP to the entire market, it is difficult to accept that RMP has more competition, has a greater risk of technological obsolescence, and the amount of business risk as a regulated utility is higher than a software developer or myriad other businesses seeking capital in the market. Rather, RMP is lower risk because it is a regulated utility with a strong and vibrant regional economy for its customer base, a growing population in the State of Utah increasing

[22] *Ibid* lines 1573—1574.
[23] Rocky Mountain Power, Direct Testimony of Ms. Ann E. Bulkley lines 1336—1339.

demand for its products, and a majority of the population using electric as the primary source to cool their homes in the summer season.

Ms. Bulkley in her rebuttal testimony discusses the regulatory environment addressing how "the Division did not acknowledge in March 2020 that RRA downgraded regulatory ranking based in part on the Commission's decision for DEU in Docket No. 19-057-02."[24] Again, Ms. Bulkley's argument does not have merit. It is correct that RRA did downgrade its rankings in March of 2020, but the information provided by the Division in its direct testimony was as of May 19, 2020. Because the report shared by the Division is after the downgrade discussed by RMP, the attitudes and information presented by the Division reflecting RRA's opinion of the regulatory environment in Utah are still accurate. RRA has rated the regulatory environment of Utah as balanced. In the Division's direct testimony a second report dealing with credit metrics in Utah was shared. This report was published in June 8, 2020.[25] In this report RRA claimed the regulatory environment in Utah as highly credit supportive. Just as with the previous report discussed, because the opinion by RRA was after the downgrade outlined by RMP, the Division's point is still valid. The regulatory environment in Utah does not support a higher ROE as recommended by RMP.

Ms. Bulkley, attempts to dispute the claim made by the Division that RMP is lower risk than the proxy group of companies because it is affiliated with Berkshire Hathaway Energy (BHE). She states the following: "the stand-alone principle of ratemaking holds

[24] Rocky Mountain Power, Rebuttal Testimony of Ms. Ann E. Bulkley lines 1567—1574.
[25] For the full reports see DPU SR-02 Attachment 7 and Attachment 8.

that regulated rates should be based on the risks and benefits of the regulated utility, not its investors, parent or affiliates."[26] The Division is curious how the legislation recently passed in Oregon, Washington, and Wyoming dealing with coal-fired power plants fits this financial principle? Ms. Bulkley uses the legislative situation in each of those states as justification for increased business risks for RMP. If rates should be based on the risks and benefits of the regulated utility and not its affiliates, then the business risks discussed by Ms. Bulkley are not valid because they deal with affiliates in Wyoming, Washington, and Oregon not the regulated utility in Utah.

Later in Ms. Bulkley's rebuttal testimony[27] she tries to persuade the Commission that the business risks described by the Division are not valid because no analysis was done to support the claims by the Division. Her claims are without merit. The Division did analysis whether RMP pays dividends, and found that it does not. The Division did analyze the proxy companies and learn that each of the proxy companies do pay dividends. Dividend paying stocks is one of the criteria used to screen the proxy companies. RMP does not pay dividends regularly to BHE significantly affecting its cash flow and providing flexibility. No other proxy company has the same flexibility RMP does when it comes to dividends. This makes RMP a lower risk than the proxy group.

Her claims concerning the economic environment and how RMP compares to the proxy groups asserting that the Division did no analysis, are unsupportable. On August 12, 2020 the American Legislative Exchange Council published a report *Rich States, Poor*

[26] Rocky Mountain Power, Rebuttal Testimony of Ms. Ann E. Bulkley lines 1607—1609.
[27] *Ibid* lines 1583.

States.[28] This report details states' individual performances over the past ten years based on State Gross Domestic Product, Absolute Domestic Migration, and Non-Farm Payroll Employment. In this report Utah is ranked number one.

As part of the research for the direct testimony filed by the Division, this report was reviewed. With Utah ranking number one and none of the proxy group companies being located in the State of Utah, the economic climate for RMP is better than the proxy group companies. In an effort to minimize the length of the direct testimony this report was not included in my direct testimony but has been included as DPU SR-02 Attachment 5. The Division did complete an analysis to confirm that the economic environment in Utah was superior to the economies of the companies in the proxy group, and thus results in lower risk than the comparable group of companies.

Q. IN HER REBUTTAL TESTIMONY MS. BULKLEY ARGUES THAT THE RECOMMENDATIONS OF THE OTHER ROE WITNESSES INCLUDING THE DIVISION FAIL TO CONSIDER THE OVERALL RISK RELATED TO THE TAX CUTS AND JOBS ACT (TCJA) FOR UTILITIES. WILL YOU COMMENT ON THIS CONCERN AS IT PERTAINS TO THE DIVISION?

A. Yes. The Division did not explicitly discuss the overall risk related to the TCJA because it did not believe this will be a significant risk faced by RMP in 2021. Investors have had time to understand and evaluate the cash flow implications to RMP. Additionally, RMP proposes in this Docket to adjust rates because of the credits accrued to customers as a

[28] The entire report from ALEC is included as DPU SR-02 Attachment 5.

result of the TCJA. By 2021, investors will have a much clearer picture of the impacts and the associated risks. No consideration of TCJA is necessary by the Commission.

VIII. ALLOWED ROE FOR INTEGRATED ELECTRIC UTILITIES

Q. MS. BULKLEY IN HER REBUTTAL TESTIMONY PREPARES FIGURE 2 CONSISTING OF AUTHORIZED ROES 2018-PRESENT. CAN YOU DISCUSS THIS FIGURE AND THE ACCURACY OF THE INFORMATION?

A. Yes. First let me address the average allowed rate of return (AROR) for integrated electric utilities. As stated in the Division's direct testimony, the correct rates to compare and analyze is the AROR for all electric utilities. If a party believes an integrated electric utility is a higher risk, then the appropriate place to adjust for those perceived risks is in the capital structure. If the Commission were to allow a higher equity portion in the capital structure and allow a higher ROE for an integrated electric utility, it would be compensating investors twice for the same risks. Those risks must be accounted in either the capital structure or the ROE but never both.

Ms. Bulkley's use of integrated electric utilities in Figure 2[29] is incorrect and provides inaccurate information for the Commission to base its evaluation. Figure 2 is a graph showing the authorized returns from 2018 to present. Ms. Bulkley uses this data to attempt to undermine the recommendations of the Division and Office of Consumer Services (OCS) expert witness. Ms. Bulkley asserts the DPU's recommendation of 9.25 and OCS's recommendation of 9.0 percent are well below the majority of authorized

[29] Rocky Mountain Power, Rebuttal Testimony Ms. Ann E. Bulkley line 191.

ROEs over this period. The Division is having difficulty based upon its own data and calculation reconciling this point.[30]

The average year to date for all regulated utilities is 9.5 percent and the average for vertically integrated utilities is 9.54 percent. Both rates are very similar. Additionally, there have been other commissions who have ordered rates at or below 9.25 percent. Green Mountain Power Corp. in Vermont had an AROR of 8.2 percent. Empire District Electric Co. in Missouri was awarded an AROR of 9.25 percent. Duke Energy Kentucky Inc. had an AROR 9.25 percent. From this small sampling of integrated electric companies, it is apparent that other commissions are awarding rates close to the rates proposed by the Division and OCS. Ms. Bulkley's assertion that an ROE of 9.25 percent is not consistent with current AROR is misleading.

IX. CAPITAL ASSET PRICING MODEL

Q. WILL YOU DISCUSS THE VALIDITY OF MS. BULKLEY'S OBSERVATIONS REGARDING THE DIVISION'S METHODS FOR DETERMINING ROE USING THE CAPITAL ASSET PRICING MODEL?

A. Yes. Ms. Bulkley states in her rebuttal testimony that "Mr. Coleman does not rely on the results of his CAPM analysis."[31] Her statement is false. The Division used the CAPM analysis in establishing the appropriate floor for RMP and its ROE. Ms. Bulkley again tries to speak for the Division when she states "it appears Mr. Coleman agrees that the

[30] DPU SR-02 Attachment 6.
[31] Rocky Mountain Power Rebuttal Testimony Ms. Ann E. Bulkley lines 1076—1077.

results of his CAPM analysis are unreasonable."[32] She then follows up this statement with the conclusion that she "agrees with Mr. Coleman that his CAPM analysis is not producing reliable results and should not be used to inform the cost of equity estimate for RMP in this proceeding."[33] Finally she concludes, "[t]he results of Mr. Coleman's CAPM analysis are well below the authorized ROE for any U. S. electric utility in the past 40 years. As a result, Mr. Coleman's CAPM analysis does not meet the comparable return requirement of *Hope* and *Bluefield*."[34]

The only statement that has any sliver of truth is when Ms. Bulkley asserts the CAPM analysis does not meet the comparable requirement of *Hope* and *Bluefield*. What she fails to add to her statement that would make it completely correct is, if the CAPM analysis was solely used as the basis for the ROE recommendation, then it would not meet the comparable return requirement of *Hope* and *Bluefield*. The simple fact is that the Division never recommended the Commission set rates at the ranges of the CAPM analysis, instead the range suggested to the Commission was 7.24 percent to 9.17 percent. To suggest that the Division did not use, accept, or believe the CAPM results is incorrect and misleading. As has been discussed previously, setting an accurate floor to begin the cost of capital analysis is vital for building the necessary framework to arrive at the appropriate cost of capital calculation. With current market conditions, the CAPM is a valuable model in establishing that floor and was used by the Division.

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[32] *Ibid* lines 1086.
[33] *Ibid* lines 1088.
[34] *Ibid* lines 1090—1091.

Ms. Bulkley tries to use the RFR used by the Division as justification for projected interest rates.[35] This argument again shows Ms. Bulkley's ignorance concerning Duff and Phelps and the data provided by that company. Duff and Phelps has stated the following about using its RFRs and ERPs:

> Exhibit 3.29 at the end of this chapter provides a summary of both the Duff & Phelps recommended equity risk premium and the accompanying risk-free rate (which can be "spot" or "normalized", depending on conditions at the time) over the time period of December 2007 through December 2018. Please note that the Duff & Phelps recommended ERP is developed in relation to (and should be used in conjunction with) the risk-free rate it was developed in relation to (either "spot" or "normalized", as indicated in Exhibit 3.29).[36]

The Division's use of Duff and Phelps RFR says nothing about the direction of interest rates or where the Division believes interest rates will be in 2021. The truth is that the Division is uncertain where rates will be in 2021. As stated in my direct testimony, we do know that low rates are being used as a way to provide some stimulus to the economy and members of the Federal Reserve have indicated rates will remain low for some time. The Division is not trying to determine the direction of future rates.

Duff and Phelps continued to describe the important relationship of its RFR and ERP as stated below:

> The risk-free rate and the ERP are interrelated concepts. All ERP estimates are, by definition, developed *in relation* to the risk-free rate. Specifically, the ERP is the extra return investors expect as compensation for assuming the additional risk associated with an investment in a diversified portfolio of common stocks, compared to the return they would

[35] *Ibid* lines 1099—1105.
[36] Duff and Phelps 2019 Cost of Capital: Annual U.S. Guidance and Examples, Chapter 3: Basic Building Blocks of the Cost of Equity Capital—Risk-free Rate & Equity Premium page 36.

> expect from an investment in risk-free securities. The risk-free rate is intended to adjust the cost of equity (at least in part) for expected future inflation.[37]

Duff and Phelps further explained:

> This brings us to an important concept. When developing cost of capital estimates, the valuation analyst should match the term of the risk-free rate used in the CAPM or build-up formulas with the duration of the expected net cash flows of the business, asset, or project being evaluated. Further, the term of the risk-free rate should *also* match the term of the risk-free rate used to develop the ERP.[38]

To keep the analysis as congruent as possible, the Division used the RFR and ERP as recommended by Duff and Phelps. This helped to ensure the analysis was accurate and, as clearly as possible, reflected the appropriate market conditions. Because the RFR by Duff and Phelps is at 2.50 does not support the premise by Ms. Bulkley that interest rates will increase. My original position opposing the use of projected interest rates is still valid, and the Commission should not include projected interest rates

When critiquing the Division's CAPM results and suggesting the calculation should be rejected by the Commission, Ms. Bulkley raises questions about the Beta coefficients applied in the Division's analysis. [39]

Ms. Bulkley believes that only levered Betas should be used instead of raw or unadjusted Betas because Beta coefficients tend to regress to 1.00 over time, and the use of "raw" Beta coefficients will understate the Beta coefficient for companies with Beta coefficients

[37] *Ibid* page 1.
[38] *Ibid* page 2.
[39] Rocky Mountain Power, Rebuttal Testimony Ms. Ann E. Bulkley pages 58—59.

less than 1.00. In Ms. Bulkley's opinion the use of raw Beta coefficients biases the Division's CAPM results downward. [40]

Ms. Bulkley is correct that the Division's analysis included raw and adjusted Betas. This choice was made in an effort to provide the most complete data for the Commission. No adjustment is needed to the CAPM to correct for the perceived "bias" for companies who have a Beta below 1.0. The Division's CAPM analysis shows the results of using both raw Betas as well as adjusted Betas. This allows the Commission and other parties the opportunity to decide for themselves which is the correct approach and then see the result of that analysis.

Ms. Bulkley is concerned that the Division's analysis and its choice of Betas will skew the results downward. Yet, she is not concerned about the use of only adjusted Betas and how using only adjusted Betas will skew the results upward. When doing the CAPM analysis the Division included calculations using raw Betas, adjusted Betas, and an analysis that blended both raw Betas and adjusted Betas. This provides the Commission with the most complete information to base its final analysis. Because Ms. Bulkley does not provide any CAPM calculations using raw Betas, her ROE results will have an upwards bias. This is one of the reasons Ms. Bulkley's financial models return rates above the 8.5 percent reasonable threshold and the Division is uncomfortable with her results.

[40] *Ibid* line 1216.

X. EQUITY RISK PREMIUM AND TOTAL MARKET RETURNS

Q. CAN YOU DISCUSS THE IMPLICATIONS OF THE DUFF AND PHELPS RISK PREMIUM AND MS. BULKLEY'S RECOMMENDED ROE OF 9.8 PERCENT?

A. Yes. First I note that Duff and Phelps is highly respected and recognized sources for a market risk premium to be used when calculating ROE for companies. The Division is comfortable that the results calculated by this source present a reasonably accurate picture of the overall market. A total market return of 8.50 percent is acceptable and reasonable. What this means is a company with risk comparable to <u>the entire market</u> should have a total return of 8.50 percent.

If respected sources calculate an overall market return of 8.50 percent, a conclusion that RMP is anything other than uniquely risky, suggests a 9.80 percent ROE for RMP is far too high. According to basic financial theory, allowing a 9.80 percent return on equity as just and reasonable for RMP, would require concluding that either the Duff and Phelps numbers are totally wrong, that RMP is far riskier than the average non-regulated company, or some other fact that does not appear in the record in this case. Another way to illustrate the point is to calculate the "appropriate" Beta coefficient for RMP that would be required to derive an ROE of 9.8 percent. The formula for the CAPM is as follows:

$$k_e = RFR_0 + \beta * (MR-RFR)$$

Where: k_e is the cost of common equity
RFR_0 is the current risk free rate
β is beta, the risk adjustment factor

(MR-RFR) is the market risk premium which can be separated into two factors: The overall market return, MR, and the RFR that is compatible with the way the MR was estimated.

The calculation would be as follows:

9.8 percent = 2.5 percent + 1.217(6.0 percent)

The risk profile of RMP would have to be significantly higher than a comparable set of regulated electric utilities in order to justify an ROE of 9.8 percent. Any Beta number above 1.0 means a stock is riskier than the total stock market. If a total market return of 8.5 percent exists, as calculated by Duff and Phelps, the Beta coefficient for RMP would need to be 1.217 to justify a 9.8 percent ROE. There is no evidence that RMP should have a Beta coefficient higher than 1.0, therefore Ms. Bulkley's recommendation of 9.8 percent is incorrect and should be rejected.

XI. DISCOUNTED CASH FLOW MODELS

Q. IN MS. BULKLEY'S REBUTTAL TESTIMONY SHE TAKES ISSUE WITH THE DIVISION'S USES OF DIVIDEND GROWTH RATES AND EARNINGS GROWTH RATES. CAN YOU COMMENT WHY THE DIVISION BELIEVES USE OF BOTH GROWTH RATES IS ACCURATE?

A. Yes. Ms. Bulkley is making the same arguments regarding earnings and dividends that has been made before the Commission for years. The Commission was explicit in its desire to have a weighting between dividend growth and earnings growth. In its analysis for this Docket, the Division has followed the same DCF method that it has applied in numerous other rate cases.

Until the Commission determines otherwise, the Division believes the appropriate method for calculating the ROE using a DCF model must include a weighting between dividend growth and earnings growth. Ms. Bulkley does not do this calculation and the Commission should consider this point when evaluating the analysis done by RMP in setting its ROE recommendation.

XII. FINANCIAL MODELS AND ALLOWED ROE

Q. IN MS. BULKLEY'S REBUTTAL TESTIMONY SHE ATTEMPTS TO UPDATE THE DIVISION'S ANALYSIS, ADJUSTING FOR PERCEIVED FLAWS? DO YOU BELIEVE THE UPDATES SUGGESTED BY MS. BULKLEY ARE NECESSARY?

A. No. Because the financial markets are always changing, it is possible to continually adjust any completed analysis. When an outside party begins to adjust the analysis done by another, there is a real risk that the conclusions supplied are incorrect and inaccurate. In Figure 9 of Ms. Bulkley's rebuttal testimony she provides a list of "corrected analytical results" for the Division's ROE calculations.[41] She uses this table as a basis to confirm her recommended ROE for RMP at 9.8 percent. As explained below these adjustments are just as flawed and incorrect as the calculations Ms. Bulkley proposes in her rebuttal testimony.

As stated previously, Ms. Bulkley sees the financial marketplace differently than I do. Each of her "corrected analytical results" would be above the base total market return of 8.5 percent calculated by Duff and Phelps. While Ms. Bulkley is comfortable with those

[41] Rocky Mountain Power, Rebuttal Testimony Ms. Ann E. Bulkley line 915.

"calculated" results, I would be leery of those calculations and how they seem to contradict the well know financial principle that regulated utilities are less risky than the entire market. The ROE for utility companies should generally be lower than the entire market. Because the "corrected" analytical results by Ms. Bulkley cannot be reconciled with this basic financial principle, they should be rejected and the Commission should put no weight on the analysis.

The Division's direct testimony included calculations of ROE using a variety of financial models. Those different calculations were provided to illustrate the appropriate range or "ballpark" for RMP's ROE. Ms. Bulkley showed some discrepancies in the analysis done by the Division, which could lead to some adjustments in the calculated ROE for RMP. None of the discrepancies shown by Ms. Bulkley are of a material nature that would substantially adjust the calculated ROE. Even if some minor adjustments to the calculated ROE were accepted, the Division's original recommendation does not change. The calculated ROE would remain below 8.5 percent, a likely uncomfortable drop for regulatory commissions and investors. Because of gradualism and other policy considerations, the Division's recommended ROE for RMP is 9.25 percent, which softens the drop in the calculated ROE from existing rates.

Additionally, because the original ROE calculation by the Division provided information to the Commission that was "in the ballpark" for an acceptable ROE, no updating or adjusting of the Division's original analysis is necessary at this time.

XIII. CONCLUSION

Q. WHAT IS YOUR CONCLUSION REGARDING THE COMPANY'S COST OF EQUITY?

A. Based on the reasons presented in my direct and surrebuttal testimony the reasonable range of ROE estimates is 7.24 percent to 9.17 percent. The Division's recommended ROE of 9.25 percent is a just and reasonable outcome for investors, customers, and other interested parties. The Commission should adopt the 9.25 recommended ROE for RMP.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.