Witness CCS 4SR

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

	)	**DOCKET NO. 02-057-02**
In the Matter of the Application of	)	**SURREBUTTAL TESTIMONY**
Questar Gas Company for a General	)	**OF DAVID C. PARCELL**
Increase in Rates and Charges	)	**OR THE COMMITTEE OF**
	)	**CONSUMER SERVICES**

11 October, 2002

Q. PLEASE STATE YOUR NAME.

A. My name is David C. Parcell.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes, I filed direct testimony on cost of capital issues on behalf of the Committee of Consumer Services (Committee) on August 30, 2002.

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

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimonies of J. Peter Williamson and David M. Curtis, which were filed on October 4, 2002.

Q. HOW IS YOUR SURREBUTTAL TESTIMONY ORGANIZED?

A. My surrebuttal testimony is organized in such a way as to respond directly to the rebuttal testimony of Dr. Williamson and Mr. Curtis. Accordingly, my surrebuttal testimony is organized as follows:

Capital structure issues

Cost of capital issues
- DCF model
- CAPM model
- CE model

Risk of Questar Gas

Capital Structure Issues

Q. WHAT IS THE CAPITAL STRUCTURE ISSUE IN THIS PROCEEDING?

A. The capital structure issue relates to my proposal to include short-term debt in the capital structure of Questar Gas. Dr. Williamson disagrees with my proposal and, in his rebuttal testimony, claims that the Company does not employ short-term debt in the financing of its rate base.

Q. WHY DOES DR. WILLIAMSON CLAIM THAT SHORT-TERM DEBT IS NOT USED BY QUESTAR GAS TO FINANCE ITS RATE BASE?

A. Dr. Williamson claims that the "rate base equivalent" of Questar Gas is approximately equal to the sum of its common equity and long-term debt. This is not true at the end of the test year. Mr. Robinson's Exhibit QGC 4.3, page 1 shows a system total rate base of about $595 million. Even though neither Mr. Robinson nor Dr. Williamson indicate the dollars of their proposed capital structure, the Company's response to Data Request No. 5.12 of the Division of Public Utilities indicates that the combined dollars of common equity and long-term debt at the end of the test year was about $582 million, or well below the $595 million system rate base.

Q. DO YOU REGARD IT AS NECESSARY FOR THE DOLLARS OF QUESTAR GAS RATE BASE TO EXCEED THE DOLLARS OF COMMON EQUITY AND LONG-TERM DEBT IN ORDER FOR IT TO BE APPROPRIATE FOR SHORT-TERM DEBT TO BE INCLUDED IN CAPITAL STRUCTURE?

A. No, I do not. As I indicated in my direct testimony, Questar Gas owns gas-producing properties. Even though it is my understanding that these properties are in the rate base of Questar Gas, this does not indicate that the proper capital structure ratios are the same as for the more traditional gas rate base.

Questar Gas has also purchased other gas distribution utilities in recent years at prices above the book value of the assets of these utilities. Even though the resulting goodwill may not be in rate base, Questar Gas had to raise capital, either internally or externally, to finance these purchases.

In addition, Standard & Poor's noted in its October 16, 2001 report on Questar Gas (provided in response to Data Request 8.8 of the Committee) that the parent Questar relies on short-term debt "to provide financing support for its subsidiaries."

Q. DO THE RATING AGENCIES CONSIDER SHORT-TERM DEBT IN THEIR BENCHMARK FINANCIAL RATIOS?

A. Yes. Standard & Poor's benchmark ratios of "total debt to total capital", "pretax interest coverage", "funds from operations to total debt", and "funds from operations interest coverage" all incorporate short-term debt and short-term interest.

The above-cited Standard & Poor's October 16, 2001 report on Questar Gas notes the following levels of short-term debt to total capital for Questar Gas:

1997	18.3%
1998	17.6%
1999	14.0%
2000	17.8%
2001	21.7% (12 months ended June 30)

These are all above the 10.28 percent ratio of short-term debt I recommend in my capital structure for Questar Gas.

Q. DR. WILLIAMSON ALSO CLAIMS SHORT-TERM DEBT SUPPORTS CONSTRUCTION WORK IN PROGRESS (CWIP) AND THE COST OF THAT SHORT-TERM DEBT IS INCORPORATED IN THE CWIP CAPITALIZED EXPENSE. IS THIS A VALID REASON NOT TO INCLUDE SHORT-TERM DEBT IN CAPITAL STRUCTURE?

A. No, it is not. Mr. Curtis's Exhibit QGC 7.3R indicates that throughout most of 2001, the most recent complete year of actual experience, the level of short-term debt exceeded the level of CWIP & Gas Balance. This clearly indicates that short-term debt is used for other purposes.

Q. DR. WILLIAMSON ALSO CLAIMS THAT YOUR RESPONSE TO QUESTAR DATA REQUEST NO. CCS 1.11 IS NOT CONSISTENT WITH YOUR DIRECT TESTIMONY ON PAGE 21. IS HE CORRECT?

A. No, he is not. My response to this data request, which is attached as CCS-4.1SR, reflects a position that I have seen utilities claim for the entire 30 plus years of my professional experience – that dollars of capital are not traceable in terms of what is being financed by what type of capital (with certain minor exceptions such as pollution control equipment, etc.). Questar Gas makes no distinction between the capital supporting rate base in Utah versus the dollars supporting rate base in Wyoming and Idaho. In addition, as my response notes, Questar Gas has consistently utilized short-term debt in its capital structure over at least the past five years.

Q. ARE YOU AWARE OF ANY OTHER JURISDICTIONS THAT INCLUDE SHORT-TERM DEBT IN THE CAPITAL STRUCTURE?

A. Yes, I am. For example, the state regulatory commissions in Hawaii, Nevada and Virginia include short-term debt in the capital structures. This is by no means an exhaustive list but reflects jurisdictions that I have testified before during the past year that include short-term debt in the capital structure.

Q. THE REBUTTAL TESTIMONY OF MR. CURTIS CLAIMS THAT QUESTAR GAS HAD A ZERO BALANCE OF SHORT-TERM DEBT SINCE APRIL OF THIS YEAR. DOES THIS IMPACT YOUR RECOMMENDATION?

A. No, it does not. I note that Mr. Curtis' Exhibit QGC 7.3R indicates that Questar Gas maintained a positive balance of short-term debt from at least December 31, 1999 through the end of 2001. This exhibit also indicates that Questar Gas maintained a short-term debt balance that substantially exceed the "CWIP & Gas Balance" amount throughout most of 2001, which was used by the Company as the "basis for the future 2002 test year." During parts of 2001 short-term debt exceeded CWIP & Gas Balance by over $80 million. This refutes the position advocated by Dr. Williamson that short-term debt was only used to finance CWIP.

It is clear from Mr. Curtis' Exhibit QGC 7.3R that Questar Gas routinely employs short-term debt in its capital structure. Short-term debt lowers the cost of capital to Questar Gas and the ratepayers should only be asked to pay the actual cost of capital to the Company, rather than the cost of the higher-cost capital that the Company proposes.

Q. PLEASE SUMMARIZE YOUR RESPONSE TO DR. WILLIAMSON'S REBUTTAL ON THE SHORT-TERM DEBT ISSUE.

A. Dr. Williamson's rebuttal testimony does not in any way negate the appropriateness of including short-term debt in the capital structure for Questar Gas. The Company has consistently utilized short-term debt throughout the past several years, as have virtually all of the proxy companies that both he and I utilize in our respective cost of equity models. Rating agencies such as Standard & Poor's consider short-term debt in their ratings determinations. Finally, Questar Corporation uses short-term debt in its provision of financing support for Questar Gas.

Cost of Capital Issues

Q. WHAT ARE THE COST OF CAPITAL ISSUES IN THIS PROCEEDING?

A. My review of Dr. Williamson's rebuttal testimony identifies the following issues he makes concerning my testimony:

Proxy group
DCF model
CAPM model
CE model

Q. WHAT IS DR. WILLIAMSON'S POSITION ON THE PROXY GROUPS AND WHAT IS YOUR REACTION TO HIS POSITION?

A. Dr. Williamson appears to object to the first two sets of proxy companies I utilize, even though he acknowledges I also perform analyses on his set of proxy companies. I find his rebuttal testimony somewhat irrelevant on this point since, as I note in my direct testimony, the costs of capital for the three groups is approximately the same. I clearly indicate on page 25 "the actual groups of companies selected for comparison purposes should not be construed as a primary source of disagreement between my recommendations and those of Questar Gas witness Williamson." Dr. Williamson's rebuttal testimony does not challenge this statement.

Q. WHAT IS THE PRIMARY ISSUE ON THE DCF MODEL?

A. The primary issue on the DCF model is the growth rate. Dr. Williamson makes several contentions in his rebuttal testimony on this issue to which I respond below.

First, he claims that it is not appropriate to use future retention growth rates for 2003 and 2004, but instead rely entirely on 2005-2007 in order to use the "longest forecast available." I disagree with this. Investors invest not just for 2005-2007 but for the intervening as well as subsequent years. Dr. Williamson has offered no evidence that investors rely exclusively on the 2005-2007 time periods in making their investment decisions. I believe it is evident that investors rely on a variety of information in making investment decisions. My analyses reflect this and Dr. Williamson's do not. As such, my analyses are more reflective of actual investor expectations.

Second, he claims that it is not appropriate to use historical information in a DCF analysis. I disagree for some of the same reasons identified on the prior point. It is evident that investors are supplied with a significant amount of historical information by sources such as Value Line, Standard & Poor's, and IBES, as well as the financial statements of companies. Dr. Williamson's position appears to be that investors ignore this information and simply rely on projections. This position ignores the fact that historical information is actual information whereas projections are simply the "best guess" of analysts. As I indicated in my direct testimony, investors are increasingly aware of the problems and conflicts of analysts' projections. To maintain, as Dr. Williamson does, that investors continue (if they ever did) to rely exclusively on projections ignores the reality of the investment process.

Third, Dr. Williamson maintains that DPS growth should not be used in the DCF model. In so doing, he clearly ignores the fact that DCF stands for "discounted cash flow", where the cash flows to investors are DPS. In doing this, Dr. Williamson is abandoning the fundamental basis on which the DCF model is based. The issue is not, as Dr. Williamson maintains (per his Exhibits QGC 3.11R, 3.12R, and 3.13R) whether DPS used alone produces results that he does not agree with, but rather whether investors use DPS in conjunction with other indicators of growth, as I maintain.

Fourth, Dr. Williamson's rebuttal testimony, like his direct testimony, implies that only IBES and Value Line forecasts are useful indicators of investor expectations. In my direct testimony, I demonstrated clearly why analysts' forecasts are not proper to be used exclusively as indicators of investor expectations. Questar Gas, and presumably Dr. Williamson, asked a data request (CCS 1.25) on this point, but Dr. Williamson chose to not reference it in his rebuttal testimony. I have attached this response as Exhibit CCS-4.2SR. Clearly, investors are currently aware of, and presumably wary of, the exclusive reliance on analysts' forecasts in making investment decisions. This was also cited on pages 43-46 of my direct testimony.

Q. WHAT ARE THE PRIMARY ISSUES ON THE CAPM MODEL?

A. Dr. Williamson essentially states that the CAPM should not receive any weight in establishing the cost of equity for Questar Gas. Even though he acknowledges that he, Dr. Powell and I all use the "standard formula of the CAPM analysis" he states that my CAPM analysis is "meaningless". He does not describe his own CAPM as meaningless, although he does not appear to give it any weight in his recommendation. Apparently, his concern with the CAPM is his assertion that beta values have no statistical significance.

I note that he makes no effort to assign any statistical significance to other factors in his testimony, such as analysts' forecasts of DPS. Dr. Williamson's concerns are unfounded. What is important is whether investors rely on the CAPM, not whether he or any other analysts feel that betas are significant or not. I note that the developers of the CAPM received Nobel prizes in economics for their work, indicating that the CAPM has been recognized as making a significant contribution to financial economics.

Q. WHAT ARE THE PRIMARY ISSUES IN THE CE MODEL?

A. It is apparent that Dr. Williamson and I completely disagree on the Supreme Court's quotes in the Bluefield and Hope cases. I note that the DCF, CAPM, and risk premium models were not even developed at the time of these decisions. Clearly, the CE model was the primary cost of equity model until the 1960s, at the latest. In addition, the fact that utilities have their rates set based upon the book values of both their assets (rate base) and liabilities/owners' equity (capital structure) indicates that it is the return on book equity that is incorporated in the corresponding risk standard of the Bluefield and Hope cases.

Dr. Williamson also disagrees with the meaning of market-to-book ratios in a CE context. The rate base – rate of return concept of utility regulation mandates that the assets of a utility and its investors are viewed in a book value context. The only reason an investor would value the assets of a utility above its book value would be an expectation that realized returns will exceed the cost of capital. I agree with Dr. Williamson's statement that market-to-book ratios reflect investor expectations. In fact, this is the basis of my CE analysis.

Risk Issues

Q. WHAT ARE THE RISK ISSUES IN THIS PROCEEDING?

A. It is evident from Dr. Williamson's rebuttal and direct testimonies that, notwithstanding the fact that compared to the proxy companies Questar Gas has higher security ratings and Questar has superior financial ratings, he refuses to acknowledge the lower risk that these indicators are designed to reflect.

Dr. Williamson claims that he made risk an important criterion in the selection of his proxy companies, but he ignores the results of this in his recommendations. As an example of this, his Exhibits QGC 3.2 and QGC 3.2R show the bond ratings of Questar and his proxy group of companies. This indicates that Questar has the highest bond rating, indicating the lowest level of risk, of each company in his proxy group. This higher bond rating is in spite of the negative influence of Questar's unregulated operations on the bond ratings. My Exhibit CCS-4.4 showed the same results. Questar also has a Value Line Safety rating of 2, which is higher than all but one of the proxy companies and a Financial Strength rating of B++, also higher than all but one proxy company. Again, the unregulated operations of Questar add to its consolidated risk. His Exhibit QGC 3.2R also indicates that Questar has the lowest percentage of revenues from gas sales, indicating that Questar is the most diversified into non-regulated operations of all of the proxy companies. This confirms the point I made in my direct testimony concerning the diversification of Questar into more risky operations.

Dr. Williamson also disputes the risk-reducing attributes of Questar Gas that I described in my direct testimony. Had he reviewed the reports on Questar Gas by rating agencies such as Standard & Poor's, he would have realized that my contention is shared by the rating agencies. For example, Standard & Poor's noted the following in their October 16, 2001 report on Questar Gas:

> "Earnings stability is enhanced through the operation of weather-normalization clauses in Utah and Wyoming."
>
> "Questar Gas' market position helps bolster credit quality."
>
> "The likelihood of lost sales is lessened by a stable economy, a secure customer base, low rates, and regulatory practices."
>
> "The company's favorable gas position is largely a function of its proximity to and ownership of supply sources and its 365-day firm transportation provided by Questar Pipeline."

Q. DOES THE REBUTTAL TESTIMONY OF DR. WILLIAMSON CHANGE YOUR VIEW OF THE RELATIVE RISK OF QUESTAR GAS?

A. No, it does not. Questar Gas has lower business risk and lower financial risk than other gas distribution utilities, including the members of the proxy groups. This is not just my view, but is reflected in the higher bond ratings that Questar Gas maintains in relation to the proxy group companies. The statements of Standard & Poor's in its ratings description for Questar Gas confirms my own risk assessments. In addition, the non-regulated operations of Questar exert a negative influence on the ratings of Questar Gas. In spite of this, Questar Gas maintains higher ratings and is a lower risk company than the proxy group companies.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.