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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of an Application of
QUESTAR GAS COMPANY for a General
Increase in Rates and Charges

POST-HEARING BRIEF OF THE COMMITTEE OF CONSUMER SERVICES

Docket No. 02-057-02

Pursuant to Utah Admin. Code R746-100-10L and directive of the Public Service Commission of Utah ("Commission"), the Committee of Consumer Services ("Committee") provides its post-hearing brief summary of the evidence and arguments in the recently-concluded hearings in these proceedings.

INTRODUCTION

On May 3, 2002, Questar Gas Company ("Company," "Questar Gas," or "utility") filed an application for a $23.017 million general rate increase. Corrections to its filing and negotiated settlements between the Company, the Division of Public Utilities ("Division"), and

the Committee on the Company's revenue requirement and other contested issues reduced the Company's requested rate increase by $5.132 million to $17.885 million.[1]

If the Commission accepts the settlements reached among the principal parties in these proceedings, there will be two major issues left for it to decide:

(1) setting a reasonable, fair, and sufficient rate of return on equity for the Company for the new rate-effective period; and

(2) whether short-term debt should be recognized as a component of the Company's capital structure, and, if so, at what level.

The revenue requirement stipulation negotiated by the parties effectively disposes of the Company's concerns relating to regulatory lag, declining customer usage, rising utility costs, Section 29 tax credits, and other revenue requirement issues for purposes of this rate case. The remaining issues of return on equity and capital structure must be resolved by the Commission in light of the specific evidence in the record relevant to those issues.

It should not be difficult for the Commission to dispose of the Company's request for a rate of return increase, given the unreasonably selective analysis of its expert witness. The more compelling and complete analyses of Committee and Division witnesses show the Company's return on equity needs to be significantly *lower*, not higher, than the 11% it is presently entitled to earn. Division witness Powell pinpoints the unrepresentative companies in Dr. Williamson's proxy list as a primary cause for his skewed results. Committee witness Parcell calls attention to Dr. Williamson's over-reliance on analysts' forecasts to the exclusion of other earnings indicators – such as projected dividend per share and historical data – as reasons for the

[1]Exhibit 1 to the October 16, 2002 Revenue Requirement Stipulation and Settlement.

Company's and Committee's fundamentally different conclusions. Committee witness Parcell further demonstrates that current and foreseeable general economic conditions, as well as the Company's significantly lower than average risk profile, support a significant reduction in the Company's allowed rate of return for the coming rate- effective period.

Mr. Parcell also examined the Company's capital structure, concluding that the Company utilizes short-term debt to help finance its rate base. While noting the Company has utilized much higher levels in recent years, he recommends its regulatory-assigned capital structure, for purposes of this rate case, incorporate the10.28% level of short-term debt *actually on the Company's books* on December 31, 2001 – the calendar year which formed the basis for the Company's partially-projected test year.

ARGUMENT

I. The Company Failed to Sustain its Burden to Prove it is Entitled to an Increase in its Allowed Rate of Return on Equity.

A. Company Has the Burden of Proof

The Company has the burden to prove it is entitled to its requested return on equity. In analyzing the evidentiary record in this case, the Commission must, first and foremost, determine whether the Company has met that continuing burden of proof.

> In the regulation of public utilities by government authority, a fundamental principle is: the burden rests heavily upon a utility to prove it is entitled to rate relief and not upon the commission, the commission staff, or any interested party or protestant; to prove the contrary. A utility has the burden of proof to demonstrate its proposed increase in rates and charges is just and reasonable . . .

> Rate making is not an adversary proceeding in which the applicant needs only to present a prima facie case to be entitled to relief.[2]

B. The Company's Changing Position

The Commission's responsibility in this instance has been complicated by the Company's changes to its return on equity request. In direct testimony submitted with the Company's rate increase application, Company expert witness, Dr. J. Peter Williamson, asserted his analysis showed the Company was entitled to a 12.6% rate of return on equity during the subsequent rate-effective period.[3] In rebuttal testimony, Dr. Williamson lowered his asserted rate entitlement to12.46%, based on "the most recent reports published by IBES and Value Line".[4] At the October 21, 2002, hearing, Company legal counsel lowered the Company's rate of return request even further to "something in the high elevens."[5] In explanation of that most recent lowering, Company counsel stated:

> [T]here's been discussion, a considerable amount of discussion about the changed circumstances that the Company is looking at with respect to its current and

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[2]*Utah Department of Business Regulation v. Public Service Commission*, 614 P. 2d 1242, 1245-1246 (Utah 1980).

[3]May 3, 2002 Prepared Direct Testimony, page 3.

[4]October 3, 2002, Prepared Rebuttal Testimony, page2. One significant result to be noted in Dr. Williamson's DCF analysis update, and not mentioned by him, is the evidence of a marked downward trend.

[5]Reporter's October 21, 2002, Transcript Proceedings, Docket No. 02-057-02, page 529, line 1.

> previous risk profile . . . [T]he Company recognizes that as an incremental matter it is in a somewhat better regulatory risk position today, presuming of course, that the Commission approves the revenue requirement settlement that been presented to them, that (sic) was when it filed its original case and indeed when it filed it's rebuttal case . . . The settlement does incorporate a test year collection of results that are very near the end of the year 2002. And that is . . . a major improvement on the regulatory lag picture . . . [T]he Company's regulatory risk profile is somewhat better than it was prior and previously. And the Company thinks its appropriate to recognize that.[6]

Whatever the reason, the Company's moving position has created a dis-connect between the evidence it originally presented to support its proposed return on equity and the level it finally proposes. It justifies its latest reduction as a reflection of the "improvements in its risk profile." Its correction, however, is something less than half-a-loaf. The rigorous modeling and risk profile analysis undertaken by Committee expert witness Parcell shows that the Company's *pre-revenue requirement settlement* risk profile, when considered along with other relevant factors, takes the appropriate return on equity for the Company down well below 11%.[7] The Company's acknowledged risk profile reduction also further compromises its expert witness' inclusion of clearly non-comparable companies in his proxy company list. The considerably higher risk profiles of Questar Corporation and National Fuel Gas made them questionable proxy

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[6]*Ibid.* at 529, lines 10-15.

[7]The Company justified the approximately 0.8% drop in its return on equity request from 12.6% to "the high elevens" on the significant reduction in its risk profile produced by the just-concluded revenue requirement stipulation. If one takes the Company's 11% return on equity entitlement from the last rate case and assume capital costs overall have not changed, the acknowledged reduction in risk reduces its return on equity entitlement to approximately 10.2%.

candidates even before the revenue requirement settlement in this case. The lower risk profile acknowledged by the Company due to that settlement moves those companies – along with the third company, Peoples Energy, with its uncharacteristically higher rate of return – even further from any appropriate proxy company list.[8]

Perhaps the most important thing to note about the Company's changing return on equity request is the downward trend, which parallels the downward earnings trend evident in the larger economy and in ratepayers' pocketbooks. The Company's changes attempt to more closely align its return on equity with current economic realities and the evidentiary record in this case. However, rather than strengthening its position, those repeated changes have compromised the proof the Company presented to support its return on equity request. In short, its "if you won't take that – will you take this" approach is indicative of the general lack of persuasive proof supporting its position.

C. The Company's Analysis for Determining an appropriate Return on Equity Is seriously Flawed

One critical problem with the Company's proposed return on equity is the methodological flaws in its expert's analysis. Specifically, Dr. Williamson selectively included and excluded data in a way which would produce the *highest* calculated rate of return for the

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[8]As will be further explored in this brief, according to Division witness Dr. William A. Powell, if those three non-comparable companies are excluded from the Company's proxy list, the average return on equity estimate for the Company for the coming rate-effective period drops to 9.81%.

Company during the rate-effective period. He excluded reported dividend growth ratios because they "are not reliable for determination of the rate of return for Questar Gas" and "lead to rates of return that are absurd as a basis for setting rates."[9] He placed inordinate reliance on *brokerage firm analysts'* future forecasts, despite the scholarly research and observations of market experts such as Federal Reserve Chairman Alan Greenspan which indicate such forecasts have been "persistently overly optimistic"[10] and clouded with evident conflicts of interest.[11] He excluded historical retention growth rates which Committee expert witness Parcell included in his DCF methodology because "[t]he DCF is a forward-looking market based method, and expectation

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[9]October 3, 2002, Prepared Rebuttal Testimony of J. Peter Williamson, page 30. Dr. Williamson considers it absurd that an investor would purchase an equity investment with a projected dividend return at or below what he or she at the present moment could obtain by purchasing a safer debt instrument. But, he never responds to Mr. Parcell's view that investors look at projected dividend returns *along with other data* in deciding where to make their equity investments. This Commission has included DPS growth projections in setting the Company's rate of return in previous general rate cases. [See August 30, 2002 Prefiled Direct Testimony of David C. Parcell, page 28, his October 11, 2002 Surrebuttal Testimony, pages 8-9, and his summary testimony in Reporter's October 18, 2002 Transcript of Hearing, pages 383-384. See the Commission's reasoning in its orders in Docket No. 99-057-20 at page 11, Docket No. 93-057-01, pages 20-21, and Docket No. 89-057-15, pages27-29.]

[10]August 30, 2002 Prefiled Direct Testimony of David C. Parcell, pages 44-45.

[11]*Ibid,* at 45-46.

data are much to be preferred to historic data."[12] He excluded the lower future retention growth rates for the years 2003 and 2004, relying instead on the higher rates for years 2005-2007, because "the DCF model is a very long-run model" and "we should be using, for each source of

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[12]October 3, 2002, Prepared Rebuttal Testimony of J. Peter Williamson, page 29. In his Prepared Direct Testimony [at page 15] Dr. Williamson argues somewhat differently that his analysis reflects historical growth data because:

> [t]he growth forecasts I have used in applying the DCF method, those collected by IBES and those published by Value Line, are the work of professional analysts who can be expected to have made use of all relevant sources of information including both earnings and dividend history for the nine companies. So, in using analysts' forecasts, I have incorporated historical growth in my analysis."

The reality is the Company's expert witness has unduly relied on the recognized "overly-optimistic" product of "professionals" oft-times beset by conflicts of interest rather than tempering his analysis with actual historical data, as Mr. Parcell has done. Dr. Williamson's favoring of future forecasts over actual results gets no support from Justice Cardozo's view that: "prophecy, however honest, is generally a poor substitute for experience." *West Ohio Gas Co. v. Public Util. Comm'n,* 294 U.S. 79, 82, 55 S. Ct. 324, 325, 79 L.Ed. 773 (1935). It also conflicts with this Commission's long-standing policy that future utility rates are more accurately set based on historical test year data rather than a future projected test period.

growth, the longest forecast available."[13] Finally, as Division witness Powell persuasively demonstrates, Dr. Williamson skewed his results to the high end by inappropriately averaging the *median* rather than the *mean* estimates of his calculations.[14]

Dr. Williamson applied similarly selective data and analysis as the Company's expert rate of return witness in a 1989 rate case before this Commission, and the Commission rejected such analysis then just as it should in these proceedings:

> We can only accept Dr. Williamson's DCF results in part. The critique offered by the Division and the Committee witnesses is persuasive in three important respects. First, the adjustment to bring the dividend to the next period is excessive. Second, the sample of firms contains at least one company that, arguably, is not comparable, producing an upward bias in the dividend growth rate estimate. And, third, reliance upon earnings growth rate forecasts to estimate the dividend growth rate also imparts an upward bias. A cost of equity estimate near those of the other two witnesses is obtained when corresponding adjustments are made.[15]

Company witness Alan K. Allred stated in testimony filed with the Company's original application:

> The main purpose of rate making is to ensure that rates are set in a way that provides the utility with sufficient revenues during the time when rates will be in

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[13]*Ibid.* at 28.

[14]October 11, 2002, Prefiled Surrebuttal Testimony of William A. Powell, pages 7-11.

[15]November 21, 1990 Report and Order of the Commission. Docket No. 89-057-15, page 29.

> effect – the rate-effective period – and allows it a reasonable opportunity to recover its costs, including an appropriate return on investors' equity.[16]

Mr. Allred's statement is incomplete, because "the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests."[17] Under that more complete standard, Company expert witness Williamson's calculations are overly-generous for shareholders, onerous for utility customers, and well wide of the mark which a more balanced analysis would have produced.

D. Recent Authorized Returns on Equity from other Jurisdictions

Company witness Allred introduced QGC Exhibit Rev. 1.13R to support the Company's argument for a higher return on equity. The exhibit lists various local gas distribution companies and shows their return on equity awards. Although presented as a comprehensive list, the Exhibit is, in fact, incomplete. For example, Committee witness Parcell testified in 2001 and 2002 in gas rate cases in Nevada and Delaware (utility awards from neither state are included on the Company's list) and in both cases the returns on equity agreed upon in settlement among the parties was under 11%.[18] Perhaps other recent awards are missing as well.

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[16]May 3, 2002, Prepared Direct Testimony of Alan K. Allred, page 5.

[17]*Federal Power Com'n v. Hope Natural Gas Co*. 320 U.S. 591, 603 (1944).

[18]See Exhibit 1, Affidavit of David C. Parcell.

Company Exhibit 1.13R additionally fails to provide any context for the various awards. Companies with a higher indicated rate may also have a substantially higher risk profile, whereas Questar Gas is at the lower end of any such measure.

In response to Commission Chairman Mecham's request for additional information, Questar has submitted a 2nd Revision to its Exhibit 1.13R. However, the revision still lacks sufficient information to allow one to put the awards into any meaningful context. Company witness Allred was able to find an upward trend in return on equity awards in his exhibit. His conclusion differs from that of the annual survey of energy utility rate proceedings in the December 2001 edition of Public Utilities Fortnightly, which is in the record as Division Exhibit CR-6. That published survey unequivocally states public utility commission awards for return on equity are "trending down."[19]

II. The Evidence Before the Commission Shows the Return on Equity for the Company for the Rate-effective Period Should be well Below the current Rate of 11%.

Not only did the Company fail to establish its case for an increase in its allowed rate of return on equity, it failed to counter Committee and Division evidence that its current rate is too high and should be substantially reduced.

Comparing the utility's earnings position and performance with national or regional economic indicators may be too unrefined, by itself, to produce usable results. National and

[19]See graph at the bottom of page 29 of the article.

regional economic conditions, however, do provide a necessary perspective, as noted in the often-cited U.S. Supreme Court *Bluefield* case:[20]

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. **A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties**; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. **A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.** [Emphasis added, ed.]

Committee witness Parcell made current national and regional economic conditions a proper starting point in his analysis. He testified:

> [T]he economy slowed considerably in late 2000 and was in a recession during the first three quarters of 2001, notwithstanding the Federal Reserve lowering interest rates eleven times in 2001 in an aggressive effort to create a 'soft landing' and avoid a recession. The events of September 11, 2001 further damaged the U.S. economy.[21]

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[20]*Bluefield Water Works and Improvement Company v. Public Service Comm'n*, 262 U.S. 679, 692 (1923).

[21]August 30, 2002 Pre-filed Direct Testimony of David C. Parcell, pages 10-11.

He further testified that "the 1.6% national rate of inflation in 2001 was among the lowest levels over the past 26 years;"[22] and "[o]ver the past several months, both long-term and short-term interest rates have declined."[23] Regarding stock prices and equity investor expectations, he noted:

> [o]ver the past two years,. . . stock prices have been volatile and have declined substantially from their highs reached in 1999 and early 2000. Immediately after September 11, stock prices dropped significantly and then rebounded somewhat. Recent months have seen extremely volatile stock price levels, stemming largely from concerns about the strength of the economy and about the accuracy of reported corporate profits.[24]

In addition to examining general national and regional economic conditions, and in further accord with the prescription of the *Bluefield* decision, Mr. Parcell also examined the risk profile of the Company. He concluded that the utility's high bond ratings were reflective of its lower risk profile in comparison to other Questar companies and most other gas distribution utilities he examined:

> The significance of this is that Questar Gas has higher ratings than the typical gas distribution utility in spite of the fact that its ratings are negatively impacted by the non-regulated activities of Questar. Stated differently, if Questar Gas were rated on a stand-alone basis (i.e., without the negative impact of Questar's non-regulated subsidiaries) its ratings might be even higher.[25]

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[22]*Ibid.* at12.

[23]*Ibid.*

[24]*Ibid.* at 12-13.

[25]*Ibid.* at 17.

Mr. Parcell also observed several Company-specific conditions that further reduced the Company's risk profile and increased its attractiveness to an investor. Those conditions include a gas-balancing account and Company-owned (Wexpro) gas supplies which reduce gas supply and price risk, a lowered bad-debt exposure, regulatory support for the utilization of risk-management tools to hedge against market price volatility, and its position as the only investor-owned gas distribution utility in Utah.[26]

The Company offered little response to this array of evidence. Instead of rebutting Mr. Parcell's much broader analysis of indicators, the Company's expert witness narrowly applied his statistical and comparative earnings analyses in a virtual vacuum. He arbitrarily selected data that skewed his results upward and disregarded historical and other earnings information more reflective of the economic conditions disclosed in Mr. Parcell's analysis.

A. Summary of Mr. Parcell's Analysis

Mr. Parcell's results were achieved utilizing well-recognized methodologies for calculating the cost of common equity – in fact, the same methodologies utilized by the Company and Division witness Dr. Powell. All utilized the Discounted Cash Flow ("DCF"), Capital Asset Price Model ("CAPM"), and Comparable Earnings ("CE") methodologies, with primary emphasis on the DCF methodology, to estimate a proper rate of return on equity for the Company. As will be evident below, the different conclusions reached by the Committee's expert witness and the Company's result not from applying different methodologies but rather

[26] *Ibid.* at 19.

from Dr. Williamson's arbitrary decisions about the relevance and value of different earnings data.

Mr. Parcell examined three comparison groups of natural gas distribution companies to determine the utility's proper cost of common equity in this case: (1) the Value Line Gas Distribution Group; (2) the Moody's Gas Distribution Group; and (3) the proxy group of companies utilized by Company witness Dr. Williamson. He then applied the DCF model, combining the current dividend yield for each such group of company stocks with several indicators of expected growth, with the objective in mind "to reflect the growth expected by investors that is embodied in the price (and yield) of a company's stock."[27] His observations regarding the use of several different growth indicators are critical:

> . . . it is important to recognize that individual investors have different expectations and consider alternative indicators in deriving their expectations. A wide array of techniques exists for estimating the growth expectations of investors. As a result, it is evident that no single indicator of growth is always used by all investors. It therefore is necessary to consider alternative indicators of growth in deriving the growth component of the DCF model.
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> I have considered five indicators of growth in my DCF analysis. These are:
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> 1. 1997-2001 (five year average) earnings retention, or fundamental growth;
> 2. Five-year average of historical growth in earnings per share (EPS); dividends per share (DPS), and book value per share (BVPS);
> 3. 2002-2007 projections of earnings retention growth;
> 4. 2000-2006 projections of EPS, DPS, and BVPS; and
> 5. Five-year projections of EPS growth as reported in First Call (formerly I/B/E/S).

[27] *Ibid.*

> I believe this combination of growth indicators is a representative and appropriate set from which to estimate investor expectations of growth for the groups of natural gas companies.[28]

In addition to a DCF analysis, Mr. Parcell also performed a CAPM analysis and a CE analysis. His CAPM analysis was performed using the same three groups of natural gas utilities he evaluated in his DCF analysis, and resulted in a cost of equity of between 10.25% and 10.50%.[29] For his CE analysis, Mr. Parcell considered not only the earnings of the three groups of gas distribution companies used in his DCF and CAPM analyses, but also the higher-risk Standard and Poor's 500 Composite group.[30]

The final result of Mr. Parcell's modeling and evaluation was a determination that the Company's return on equity should be 10% in the coming rate-effective period. He reached that result by first determining that an appropriate *general* return on equity range for natural gas distribution utilities was 9.5% to 11%. However, he also determined that *at least three* relevant conditions put the Company properly at the lower end of that *general* range; namely:

(i) the Company is viewed as a below-average risk gas distribution utility;

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[28]*Ibid.* at 28.

[29]Dr. Williamson labeled Mr. Parcell's CAPM analysis as "meaningless"[October 3, 2002, Prepared Rebuttal Testimony of J. Peter Williamson, pages 34-35], and apparently disregarded his own CAPM analysis in his final recommendation. [October 11, 2002, Surrebuttal Testimony of David C. Parcell, pages 9-10.]

[30]August 30, 2002, Prefiled Direct Testimony of David C. Parcell, page 37.

(ii) the Company benefits from several risk-reducing mechanisms such as a gas balancing account, lower bad debt exposure, and substantial Company gas reserves; and

(iii) the Company has an above-average common equity ratio, and, hence, a below-average financial risk.

The midpoint in a lower range of 9.5% to 10.5% *is 10%, his final recommendation.*[31]

[31]*Ibid.* at 39-40.

A. The Committee's Position Was never Rebutted in these Proceedings

In contrast with Mr. Parcell's approach to determine an appropriate rate of return on equity for the Company in these proceedings, Company witness Dr. Williamson substantially narrowed both the sources of earnings growth indicators he considered and his statistical methodology to determine a much higher proposed rate of return on equity for the Company. He excluded future retention growth rates for the years 2003 and 2004, relying instead entirely on years 2005-2007. He excluded any direct historical information in his DCF analysis, relying exclusively on analysts projections. He also excluded dividend per share growth estimates. While Dr. Williamson found fault with particular indicators in Mr. Parcell's differing array of growth indicators (such as dividend growth producing unreasonably low results), he failed to even respond to Mr. Parcell's carefully expressed reason for utilizing such a broad selection of earnings growth data. While any particular growth indicator may be an unreasonable or insufficient measure – which is the basic criticism to be levied against Dr. Williamson's reliance upon analysts' forecasts – the basket, or mix, when considered together, should give a more balanced and reasonable prediction of what investor expectations of the future growth rate might actually turn out to be. Once again, the key is the measures of future growth investors actually consider in their investment decisions. Mr. Parcell convincingly argues that investors "rely on a variety of information in making investment decisions"[32] and "are increasingly aware of the problems and conflicts of analysts' projections."[33] Questar Corporation's own persistent and

[32]October 11, 2002, Surrebuttal Testimony of David C. Parcell, page 8.

[33]*Ibid.* In defending his mix of indicators approach, Mr. Parcell further stated:

> "Investors don't do a DCF on dividends and a DCF of earnings and a DCF of book value. Investors look at all of these things and factor into a single DCF. That's really what Dr. Powell's done, and that's what I have done. We have not done mini DCF's. We've looked at alternative indicators of growth and combined those to get a DCF growth rate. My DCF is ten. Dr. Powell's is ten

touted record of consistent quarterly dividend declarations certainly supports the idea that investors consider dividend earnings:

> Questar Corporation, for example, according to the latest Value Line, has increased its dividends each and every year since 1992. And good for them. That's good for them; its good for their stockholders. But it must be important to them; it must be important to their investors. Otherwise, they wouldn't do it. They could retain the income for further investment, so dividends are important to investors, and it should be included.[34]

Company expert witness Dr. Williamson's selection of proxy companies to evaluate is also unduly skewed towards a higher rate of return. Division witness Powell, while using Dr. Williamson's list of proxy companies to perform his analysis, nevertheless criticizes the selection. While six of the nine proxy companies Dr. Williamson selected were also proxy companies in the previous Questar rate case (Docket No. 99-057-20), three were different; and Division witness Powell criticized the inclusion of those incomparable companies. The first, Questar Corporation, is a diversified and non-regulated company with a markedly greater risk profile, and, hence, "greater cost of capital."[35] The second, National Fuel Gas, has the same

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five. We're not proposing seven." [Reporter's October 18, 2002, Transcript of Hearing. Docket No. 02-057-02, page384.]

[34]Summary Testimony of David C. Parcell, in Reporter's October 18, 2002, Transcript of Hearing. Docket No. 02-057-02, page 384.

[35]August 30, 2002, Prefiled Direct Testimony of William A. Powell, page 4.

uncharacteristically high risk profile; and the third, Peoples Energy, has an uncharacteristically high ROE estimate.[36] In the words of Dr. Powell:

> If the companies had been chosen at random, you would expect that some ROE estimates would be above the average and others would be below. However, all three of these companies have ROE estimates that are greater than the average estimate, thus, in some sense, inflating the final Recommendation."[37]

The effect of Dr. Williamson's inclusion of Questar Corporation, National Fuel Gas, and Peoples Energy in his proxy list of companies is important to consider. *It essentially produces the difference between the rate of return on equity ("ROE") requested by the Company and the Committee in this case.* Dr. Powell notes:

> [I]f we were to use the common set of utilities [the six companies which were also utilized in the last Questar rate case, ed.] then, based on current information, the average ROE estimate would be 9.81%.[38]

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[36]*Ibid.* at 5.

[37]*Ibid.*

[38]*Ibid.* Dr. Williamson does do a quite meaningless DCF 'model run' excluding Questar Corporation and one just for Questar Corporation. Both produced expected results well above the average results of the six proxy companies used in the last Questar rate case. Clearly, the model run he should have done was the one Division witness Powell made on the six gas distribution companies used in the last Questar rate case, which would have revealed what Dr. Williamson probably already suspected, and explains why he limited his alternative runs to Questar Corporation.

Dr. Powell further states that because his analysis utilized Dr. Williamson's proxy list, which included the three suspect companies, the Division's final recommendation of a 10.5% return on equity "is a relatively high estimate of the cost of capital for Questar Gas."[39] Dr. Powell also takes issue with Dr. Williamson's unjustified resort to *median* average numbers instead of *mean* numbers, in his DCF analyses which, once again, produces a higher than statistically appropriate final ROE result.[40]

Finally, one should add a measure of common sense to this battle of expert witnesses and their derived figures. By any practical and reasonable standard of measure, the national and regional economy today is considerably weaker than it was at the time of the last Questar rate case in 2000. As Committee witness Parcell reflected in his testimony, the cost of money is considerably lower today than it was in 1999. The rate of inflation is also significantly lower. The 1.6% rate in 2001 was "among the lowest levels over the past 26 years." In addition, average stock prices have declined substantially. These practical realities all indicate that, rather than an increase, the Company should receive a substantial decrease in its allowed rate of return on equity. They further confirm the appropriateness of Committee expert witness Parcell's and Division witness Powell's conclusions, and further marginalize the conclusions of the Company's expert witness. From the viewpoint of ratepayers, the utility is well and healthy and has just received a major revenue requirement settlement that favorably addresses its concerns

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[39] *Ibid.*

[40] October 11, 2002, Prefiled Surrebuttal Testimony of William A. Powell, pages 7-12.

relating to regulatory lag, rising costs and declining customer usage. There is therefore no reason why the Company's shareholders should remain immune from the earnings constraints presently affecting ratepayers and much of the rest of the country. To conclude otherwise is to unfairly and unnecessarily burden ratepayers in these proceedings.

III. Short Term Debt Should be Included as a Component in the Company's Capital Structure

Until these proceedings, the Company's recognized capital structure has consisted of an assigned composition of long-term debt and common equity. Continuing that tradition, the Company in this case has proposed a capital structure of 47.4% long-term debt and 52.6% common equity. The Committee has determined such a capital structure no longer reflects the realities of the Company's financing of its rate base. According to Committee expert witness Parcell:

> As my CCS Exhibit 4.5 indicates, Questar Gas has consistently utilized short-term debt during recent years. Questar provides this short-term debt. I believe it is appropriate to include short-term debt in the capital structure when a utility consistently employs this type of capital. I would note that rating agencies such as Standard & Poor's include short-term debt in their benchmark ratios.[41]

In response to Mr. Parcell's proposal, the Company asserts there is little or no connection between the Company's rate base and its use of short-term debt to fund swings in cash

[41] August 30, 2002, Prefiled Direct Testimony of David C. Parcell, pages 23-24.

requirements, construction work in progress, and the balance in the 191 gas balancing account.[42] It produced an exhibit which purportedly shows that the levels of short-term debt incurred over time closely tracks the Company's 191 Account and CWIP funding requirements since 1997.[43] The Company also argues that the close match between total funds in rate base and total long-term debt and common equity amounts is a further indication that short-term debt is not utilized to fund rate base.[44]

In reply to the Company, Mr. Parcell points out that even the exhibit the Company tendered to demonstrate the convergence between short-term debt levels and CWIP and 191 Account funding requirements shows that throughout most of 2001, the most recent complete year of actual experience, the level of

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[42]October 4, 2002 Rebuttal Testimony of David M. Curtis, page 8. Note, the careful words "little or no" rather than an unequivocal denial that any short-term debt is utilized to finance rate base.

[43]*Ibid.* at 10. This exhibit will be further examined below.

[44]*Ibid.* at 11-12.

short-term debt exceeded the level of CWIP and gas balance.[45] More importantly, he points out that merely showing the amount of dollars in rate base equals or exceeds the sum of dollars in long-term debt and common equity does not dispose of the issue whether the Company utilizes short-term debt to fund rate base. Common equity and long-term debt can be used to fund assets not included in rate base. For example, Questar Gas in recent years has purchased other gas distribution utilities at prices above the book

[45]October 11, 2002, Surrebuttal Testimony of David C. Parcell, page 5.

value of the assets of those utilities.[46] Capital or debt was used to purchase that value which is beyond the value included in rate base. Mr. Parcell further notes that the Company's argument, that it has had a zero balance of short-term debt since April of this year, also falls short of the mark, since the Company's own exhibit shows it maintained a short-term debt balance from at least December 31, 1999, through the end of 2001 at an amount which "substantially" exceeded the CWIP and Gas Balance account throughout

[46] *Ibid.* at 4.

most of 2001. The year 2001 is especially relevant because it served as the "basis for the future 2002 test year."[47] "During parts of 2001 short-term debt exceeded CWIP and Gas Balance by over $80 million."[48]

Mr. Parcell summarizes this issue as follows:

> The Company has consistently utilized short-term debt throughout the past several years, as have virtually all of the proxy companies that both [Dr. Williamson] 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.[49]

Recognition of short-term debt in Questar Gas's capital structure is an issue whose time has arrived. It has a very material dollar impact. Company witness David M. Curtis values Mr. Parcell's proposal to include a ratio of 10.28% of short-term debt funding in the Company's

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[47] *Ibid.* at 6.

[48] *Ibid.*

[49] *Ibid* at 7.

capital structure at $5.7 million.[50] From the Company's perspective that means a $5.7 million reduction in allowable earnings. From ratepayers' perspective, it means that unless the Commission recognizes that level of short-term debt in the capital structure, the Company may over-earn by that amount.[51]

Short-term debt in recent years, during the test year period, and foreseeably during the new rate-effective period has lowered, and will lower, the Company's cost of capital.

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[50]October 4, 2002 Rebuttal Testimony of David M. Curtis, page 8.

[51]To further indicate the fairness of the Committee's recommendation to include 10.28% of short-term debt in the Company's capital structure, Mr. Parcell notes this amount is far less than the actual amounts which Standard and Poor's has recognized in the Company's capital structure in recent years. That rating agency shows the following levels of short-term debt in the Company's capital structure:

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

[October 11, 2002, Surrebuttal Testimony of David C. Parcell, page 4.]

Ratepayers should only be asked to pay for the Company's actual cost of capital. That means the Commission needs to recognize the well-established practice of the Company to utilize short-term debt in the Company's capital structure, and include it also for rate making purposes.

SUMMARY

If accepted by the Commission, the revenue requirement settlement between the Company, the Division, and the Committee has substantially narrowed the remaining issues to be considered and resolved by the Commission. The Company's original application raised several key concerns with regards to regulatory lag, declining customer usage, increasing operating costs, and, finally, the need to return more to the Company's investors.

The Company has willingly entered into a settlement that, for purposes of this case, disposes of all but one of the several concerns raised in its original application. The remaining concern yet to be resolved by this Commission centers upon the Company's argument that more needs to be returned to its investors. Several considerations must enter into the Commission's evaluation and resolution of that concern. First, and foremost, the settlements in this case have effectively addressed the Company's revenue requirement issues of regulatory lag, increasing costs and declining customer usage. That means the Company stands an even better chance to earn its allowed rate of return than it has in the recent past. Second, while the Company has argued for an increase in its rate of return on equity, it has failed to credibly support that argument. The statistical modeling its expert witness utilized was, according to Division and Committee expert witnesses, skewed to produce unrealistically high rate of return results. Even

the exhibit list the Company presented to show what was happening in other state jurisdictions, if anything, proves the opposite of what the Company claims it shows; namely that rates of return around the country for gas distribution utilities have peaked and are on a pronounced downward trend. Finally, Division and Committee expert testimony and analyses convincingly demonstrate that the Company's rate of return needs to be lowered in fairness to ratepayers. Committee expert witness, Mr. David Parcell, recommends that the Company's current 11.0% return on equity be lowered to 10.0%. The Division's witness, Dr. Powell, recommends 10.5%, but notes that result is on the high side because his analysis is based on the Company expert's proxy list of companies, which includes three uncomparable companies.

In closing remarks, Company counsel proposed a further lowering in the Company's requested rate of return on the grounds the revenue requirement settlement further improved the Company's risk profile. That is certainly true. It improves an already lower-than-average risk profile when the Company is compared to other companies in the Company expert's proxy group. It, therefore, makes even more inappropriate the Company expert's inclusion of Questar Corporation, National Fuel Gas, and Peoples Energy in his proxy group for purposes of establishing an appropriate return on equity for the Company in this case. As Division witness Powell pointedly argues, if those three companies are excluded from the proxy list and the remaining six considered (the same six considered as proxy companies in the last Questar rate case), the resulting appropriate DCF model rate of return for the Company is under 10% instead of the 12.6, 12.46, or "high elevens" the Company asserts. In short, the compelling and

substantial evidence in this case demonstrates the Company's rate of return on equity should be decreased from the present 11.0% to 10.0%.

This case has further established compelling reasons for including short-term debt in the Company's capital structure. The evidence shows the Company has utilized short-term debt in its capital structure for several years, and Standard and Poor's has so included it in their financial rating ratios. During 2001, the year utilized by the Company as the "basis" for its partially-projected 2002 test year, the level of short-term debt at times exceeded the Company's CWIP and Gas Balance account totals by as much as $80 million. The actual levels of short-term debt to capital recognized by Standard and Poor's in recent years has averaged well over 17% (it was over 21% in 2001). The Committee has proposed in these proceedings a level of 10.28% of short-term debt be recognized in the Company's capital structure. For the Commission to determine any lesser level than that would mean it is asking ratepayers to pay an excessive amount in rates and allowing the Company to effectively overearn.

Dated this 12th day of November, 2002

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Reed T. Warnick
Assistant Attorney General
Committee of Consumer Services

EXHIBIT 1

CERTIFICATE OF SERVICE

I hereby certify that copies of the **POST-HEARING BRIEF OF THE COMMITTEE OF CONSUMER SERVICES** in Docket Number 02-057-02 were mailed or hand delivered on the ______ day of November, 2002 to the following:

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