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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

**REPLY BRIEF OF THE COMMITTEE OF CONSUMER SERVICES**

Docket No. 02-057-02

The Committee here submits its Reply Brief addressing the major issues of rate of return on equity and capital structure of Questar Gas Company ("Company") raised in these proceedings.

## INTRODUCTION

Unless it believes using several different data sources does *not* contribute to a more robust and reliable ROE analysis, the Commission's ROE decision in these proceedings seems clear: the Company's overly-narrow analysis should be discarded or conformed to the basically harmonious Committee and Division analyses. The Commission has considered this very issue before:

> The upshot is that we remain convinced that we should use as much relevant information as is available, and that means both earnings and dividend information. The record shows that using only the earnings growth forecasts . . . produces the highest DCF estimates for the return requirements of the proxy companies . . . We also find reasonable agreement that several sources of information should be used to estimate the growth variable "G."[1]

The Commission must also recognize the Company expert's disregard of the Company's lower-than-average risk profile in determining his recommended ROE rate. His inclusion of the non-comparable, distinctly higher-risk, companies, Questar Corporation and National Fuel Energy, in his proxy group, and failure to adjust his results to account for the higher return expected from those non-comparable companies gives his results an incorrect upward bias. As Division witness Powell concludes:

> Given the greater risk of these two companies, 10.5% is a relatively high estimate for the cost of capital for Questar Gas. If I had eliminated [them] from the set of comparables, and only used the remaining seven distribution utilities, then my recommendation would have been 10.2% . . .
>
> [I]f we were to use the common set of utilities [common to the prior Questar rate case, ed.] then, based on current information, the average ROE estimate would be 9.81%. The lower average estimate for the common set of utilities reinforces the previous conclusion that 10.5% is a relatively high estimate of the cost of capital for Questar Gas.[2]

While Committee witness Parcell used the Company's proxy list, he corrected the inclusion of non-comparable companies by performing a separate "risk profile" analysis.[3] Had the Company's expert witness been sensitive to the impact of the Company's lower risk profile in attempting to set a competitive ROE, he would have either excluded Questar Corporation and

[1]Division Exhibit 6.0 SR, page 4, quoting the Commission's Order in Docket No. 95-049-05.

[2]August 30, 2002, Pre-filed Direct Testimony of William A. Powell, page 5.

National Fuel Energy from his proxy list altogether, or adjusted his final recommendation to reflect the Company's markedly lower business and financial risks when compared to the other companies in the proxy group.[4]

If the Commission concurs with the Committee's and Division's methodologies, it must also conclude that the Company's return on equity for the new rate-effective period must be significantly lower than the 11% currently allowed. Stated another way, if the Commission concurs that the Company's capital costs and operating risks have significantly declined as a result of a weaker economy, lower interest rates and the pending revenue requirement stipulation, it must also concur that the Company's return on equity needs to be significantly lower than the 11% it was granted before those conditions pertained. A significantly lower rate would be in the range of the Committee's 10.0% to the Division's 10.5%.

## ARGUMENT

### 1. The Company's Rate of Return on Equity Should be Set between 10% and 10.5%.

The Company has the burden to show it is entitled to an increase in its ROE for the new rate-effective period. It has not sustained that burden. It has carefully avoided any reference to the overall substantially weaker national and regional economies which do not support its

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[3]August 30, 2002, Pre-filed Direct Testimony of David C. Parcell, pages 39-40.
[4]Dr. Williamson specifically states:

> I believe that the "risk in Questar Gas, as measured by the bond rating and other risk measures, is very close to the average for the proxy companies.

May 3, 2002, Pre-filed Direct Testimony of J. Peter Williamson, page 22.

position. The Company's expert has attempted to derive a statistical conclusion supporting its position with a very narrow DCF analysis on a proxy group of companies that includes at least two clearly non-comparable companies. The Company then attempted to buttress its expert's analysis with a purported comprehensive list of recent utility ROE awards.

The ROE evidence in the record clearly exposes the inadequacies in the Company's case, and shows that just and reasonable rates for the new rate-effective period require a significant reduction in the Company's rate of return on equity.

***Dr. Williamson's Over-Dependence upon Analysts' Forecasts***

Dr. Williamson limited his data sources to analysts' forecasts for purposes of determining a DCF growth rate; thus necessarily excluding data which would have substantially moderated his results. The extreme narrowness of Dr. Williamson's data sources undermines the credibility of his results. Opposing parties have both cited Alan Greenspan to weaken the value of the other's data sources.[5] Were that data excluded, it would narrow Mr. Parcell's growth rate analysis, but would completely destroy Dr Williamson's because it would eliminate *all* his input data – limited as it was to analysts' forecasts.

***Mr. Parcell's Broader, More Robust Analysis***

Mr. Parcell utilized several data sources (forecasts, historical data, dividend earnings ratios, other proxy groups, etc.) so his analysis would not be critically dependent upon any single

[5]Mr. Parcell cites Mr. Greenspan's view that analysts forecasts have been "persistently overly optimistic" and affected by conflicts of interest (page 44 of Pre-filed Direct Testimony). The Company's post-hearing brief cites Mr. Greenspan's comment that low dividend payout ratios have caused investors to pay more attention to earnings (page 8 of Company's brief).

type of data or data source. He did so to provide a more reliable final recommendation, and also because of his belief that a broader consideration of sources better reflects investor behavior:

> 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 (sic). 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 five. We're not proposing seven.[6]

***Dr. Williamson Disregarded the Company 's Lower Risk Profile***

Dr. Williamson very uncritically concluded that "the risk in Questar Gas, as measured by the bond rating and other risk measures, is very close to the average for the proxy companies."[7] Mr. Parcell reaches a different, but well-documented, conclusion. He shows that rating agencies such as Standard & Poor's (S&P) assign the Company a significantly lower risk profile,[8] He also cited several Company-specific conditions that contribute to that lower risk profile; including:

1. A gas-balancing account;
2. A significant amount of Company-owned production;
3. Regulatory support for risk management tools;
4. Minimized bad debt exposure;
5. A customer equal payment plan;
6. A weather normalization adjustment clause; and
7. Lack of any gas utility competition.[9]

The Division's post-hearing brief further support this point by noting:

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[6]Reporter's October 18, 2002, Transcript of Hearing. Docket No. 02-057-02, page 384.
[7]See footnote no. 4, above.
[8]August 30, 2002, Pre-filed Direct Testimony of David C. Parcell, pages 14-19.
[9]*Ibid*, at 19.

> [A]t least since 1989, the actual capital structure has been used to set rates. However, in the past, the commission has recognized that when Questar's equity ratio is higher than the sample of companies, the lower financial risk associated with this capital structure should be taken into account in establishing rate of return. [Citation omitted, ed.] Questar's equity ratio is, once again, higher than the sample companies in this case and, thus, should be taken into account.[10]

To be further added to this list of risk-reducing considerations is the minimization of regulatory lag embodied in the pending revenue requirement stipulation.

Mr. Parcell's analysis established a *range* of appropriate ROE rates for the natural gas distribution industry which he then narrowed to a final recommendation of 10% for the Company, given its specific risk profile. Dr. Williamson's analysis discloses no thorough consideration of risk.[11]

***<u>Recent ROE Awards Are Trending Down</u>***

To try and further support its expert's conclusions, the Company offered into evidence a list of recent ROE awards. As already noted, the list has no probative value for purposes of determining a proper rate for the Company in these proceedings. And, as Mr. Parcell's affidavit shows, it is not even a complete list.[12] A better list can be found in the cross-examination exhibit proffered by the Division: a December 2001 article from *Public Utilities Fortnightly;*[13] and the relevant fact to note from that article is its conclusion that the trend in ROE awards around the

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[10]Division's Post-Hearing Memorandum, page 3.
[11]See footnote 4, above.
[12]See Exhibit 1 to Committee's Post-hearing Brief.

country is down. A just-released November 2002 issue of *Public Utilites Fortnightly*, contains an article which further reinforces that same conclusion. That article is attached as Exhibit 1 for the Commission's further study.

***The Company's Misdirected Criticism***

The Company's post-hearing brief expectedly criticizes elements of Dr. Powell's and Mr. Parcell's analyses – twelve and one-half pages of critique to Dr. Powell – considerably less to Mr. Parcell.[14] Interestingly, however, although acknowledging that:

> the single issue that drives the large difference between Professor Williamson on the one hand and Dr. Powell and Mr. Parcell on the other is the proper role of dividend growth rates in the DCF calculations . . .,

most of the Company's critique is devoted to the overblown tempest of "*Mean Versus Median and What's an 'Outlier'?*" While that dispute is not irrelevant, the Company's own brief acknowledges where the real differences lie. They lie in Dr. Williamson's indefensibly narrow selection of data sources and uncritical inclusion of non-comparable companies in his proxy list.

***Dr. Williamson's Approach Has been Criticized by the Commission Before***

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[13]Division Cross-Examination Exhibit CR-5.

[14]The Company's post-hearing brief criticism of Mr. Parcell's analysis was essentially that he included too much data. He looked at three proxy groups of companies instead of just the nine-company list of Dr. Williamson. He considered more than just the analysts' forecasts that Dr. Williamson used, including dividend earnings ratios and historical data. Mr. Parcell's analysis of two further proxy groups was an effort to make his analysis as accurate as possible by considering more and different data sources than Dr. Williamson. In the specific case of proxy groups, the Company's post-hearing brief criticism is misplaced, as Mr. Parcell's conclusion was the cost of capital for each of the three groups was "approximately the same." [The essential difference which Mr. Parcell makes, however, is he further qualifies the Company's place in that cost of capital range to reflect its lower risk profile.] The remaining Company criticisms of Mr. Parcell's analysis have already been discussed above.

The Company's Brief attempts to divine from a prior Commission order some intent to limit data sources in the calculation of a growth rate, and, specifically, to exclude dividend ratios (the Company's own touted policy of steadily increasing quarterly dividends notwithstanding). Rather than seeing the statement: "the witness who chooses to use only earnings growth should carefully rationalize the decision" as a caution against the narrow growth analysis Dr. Williamson conducted in this case, the Company mystically sees the statement as a signal to justify the elimination of dividend ratio data. The Company must apparently resort to hidden meanings because all clear and explicit Commission statements on narrowly-derived analyses are to the contrary. A good example is found in its order from the last Questar rate case where Dr. Williamson testified in Utah:

> We can only accept Dr. Williamson's DCF results in part. . . 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]

The Commission's position makes good analytical sense. Each particular data source may have drawbacks, but, in complement with the other sources, contributes to a more balanced and accurate indication of future conditions. While not perfect, Mr. Parcell's and Dr. Powell's analyses better meet that objective.

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

***Moody's Investors Service Rating***

Company counsel just distributed copies of Moody's Investors Service November 12, 2002 rating action and the Company's public response. He advised he may further address the substance of Moody's report in the Company's Reply brief. It is difficult to see what relevance Moody's report has now for this rate case. A close reading of the paragraph addressing Questar Gas's A2 rating states:

> [The Company] has filed for a general rate increase in Utah with settlement expected to be announced in the near-term. We assume in our rating that the settlement results in a revenue increase that would at a minimum help to prevent a further weakening in its returns and coverages.[16]

The pending revenue requirement settlement in this case quite clearly satisfies the concerns expressed in Moody's report, including the additional concern that in the past the company's returns have been "below its authorized returns and also the industry average." Beyond that, perhaps the best response to this report, for purposes of this case, is the one the Company has made in its responding news release:

> Our credit remains solidly investment grade – and we will maintain strong credit ratings,"said Keith O. Rattie, Questar president and chief executive officer. "In assigning a 'stable' outlook, Moody's has confirmed there are no significant credit issues facing the company.[17]

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[16]Moody's November 12, 2002, Rating Action Report, page 2.
[17]November 12, 2002, News Release of Questar Corporation, page 1.

## 2. Short-term Debt Should be Included in the Company's Capital Structure

The incomplete argument of the Company in response to the proposal that some amount of short-term debt be recognized in its capital structure is: since *x* is used for *y*, it therefore isn't used for *z*. Since short-term debt is utilized to finance CWIP and monthly swings in cash balances, it isn't utilized to finance rate base. The argument is logically incorrect on its face, and prudent reasoning dictates it is also factually incorrect.

Given the substantially lower cost of short-term debt, a prudently-operated company would utilize as much short-term debt as reasonably possible – not only for CWIP, and cash swings, but also for capital costs. That basic assumption is reflected in the rating agency ratios cited in Mr. Parcell's Rebuttal Testimony (page 4). The Company's assertion that it only uses short-term debt to finance CWIP and monthly swings in cash balances is belied by the very evidence the Company has submitted to support its position. That evidence shows that for much of the 2001 basis test year, the level of short-term debt substantially exceeded CWIP and gas balance account sums – at times by over $80 million.[18]

The Committee isn't attempting here to unjustly squeeze $5.7 million out of the Company. It is simply asking that the reality of the Company's use of short-term debt for capital costs be recognized. The real consideration is not that the Company will lose money, but rather

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[18] Company Exhibit QGC 7.3R. See Mr. Parcell's observation in his 11 October, 2002, Surrebuttal Testimony, page6.

that ratepayers should only be asked to pay for the Company's actual cost of capital. As the UAE points out in its post-hearing brief:

> Moreover, given that the issue has now been raised, there is also a risk if the Commission does not address it in this docket. Utilities may be inclined to avoid short-term debt, even when it might otherwise be attractive, for fear of it influencing the capital structure assumed by the Commission in a future rate case. By determining in this case that some reasonable percentage of short-term debt will typically be considered by the Commission to be a prudent and routine part of a utility's capital structure, utilities will be free to utilize short-term debt, as in the past, but with the knowledge that the precise level of short-term debt to be utilized for ratemaking purposes will be subject to analysis and determination based on the relevant circumstances in each case. [19]

## SUMMARY

It is clear from the evidence in the record that the only way to justify an increase in the Company's ROE in this case is to (a) exclude all historical data and dividend earning ratios in determining a growth rate for the DCF analysis, and (b) then apply one's formula to a proxy list of companies which includes non-utility energy holding companies with non-comparable risk profiles and earnings requirements. In doing so, one must also ignore the contradiction between his statistical result and current trends in the national and regional economy.

On the other hand, if one seeks to base the Company's ROE for the new rate effective period on a robust and thorough analysis of a broad range of statistical data – each at least partially off-setting the limitations of the others – and determine a rate for the Company that reflects what a gas distribution company with a significantly lower risk profile than its proxy

[19] Post-Hearing Brief of the UAE Intervention Group, page 5.

peers [and one lowered even further by the pending revenue requirement stipulation] should earn, then one must turn to the Committee and Division experts' analyses and results.

Mr. Parcell's ROE analysis has never been rebutted in these proceedings. For the most part, the Company studiously avoided Mr. Parcell's analysis because its strengths are readily apparent and incontestable if a fair and reasonable ROE is the objective. The Committee recommends Mr. Parcell's methodology and conclusions to the Commission as a proper basis for determining an ROE for the Company in this case in the range of 10.0% to 10.5%.

The Company also failed to logically and factually respond to Mr. Parcell's argument that short-term debt should be recognized as an element in the Company's capital structure. Simply asserting that it uses short-term debt to finance CWIP and cash swings does not, in any logical way, prove short-term debt is not used to finance its capital structure. One would actually expect a prudent CFO today to take advantage of the low interest rates associated with short-term debt in capital asset acquisition, refinancing, bridge financing, etc. It would seem that the Company's witness, Mr. Curtis, perhaps argues too forcefully and conclusively. In any case, the rating agencies include short-term debt in their financial analyses of the Company, and this Commission should also for purposes of determining its capital structure.

The Committee isn't asking the Commission in this case to set a level of short-term debt commensurate with the 17% plus average ratio of short-term debt to total capital recognized by Standard and Poor's in recent years. It is asking for the much more modest amount of 10.28%; an amount clearly supported by the evidence in these proceedings. To not recognize the reality of short-term debt in the Company's capital structure is to unjustly impose upon ratepayers an undue cost burden. The Committee urges the Commission to decide this issue in accordance with the weight of evidence.

Dated this 25th day of November, 2002

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## CERTIFICATE OF SERVICE

I hereby certify that copies of the **REPLY 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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