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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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

REPLY BRIEF

Docket No. 02-057-02

The following is the Reply Brief of the Division of Public Utilities (DPU) to Questar's Brief filed November 12, 2002.

INTRODUCTION

A little over two years ago this Commission authorized an 11% return on equity for Questar. The Company claims it has engaged in broad cost cutting[1] and other efficiency moves and that the DPU and CCS would reward its efforts by reducing the rate of return below 11%. Questar argues that a reduction below 11% would be a "devastating signal to Company management, to its employees, to its direct and indirect shareholders, and to the investment

[1]Questar's initial Brief p. 3.

community at large."[2] The implication Questar argues is that they would be viewed as being held in low regard by regulators and is not entitled to earn a return competitive with its peers.[3] This focus of Questar is completely misplaced. Regulators in this state through the stipulation have made significant concessions regarding issues that will affect the Company's financial performance. The Stipulation should have a positive effect on the Company's financial performance and has materially changed the business risk profile of the Company since the 11% return was awarded. If any "devastating" signal is sent, it would be to the public and the DPU and CCS. It would say to those groups that the stipulation that materially alters Questar's business risk profile is not being recognized by the Commission. Instead of lowering the authorized rate of return it awarded two years ago, the Commission would either leave it the same or increase the return.

Independent of the change in the business risk profile of Questar the DPU continues to believe that the DCF calculations do not support an increase in the authorized return above 11% and that a reduction is still justifiable.

Dividend Growth Rate Issues

The main issue separating the DCF results is the DPU/CCS use of dividend growth rates in developing "G" and Questar's continued failure to use dividend growth rates at all. This is not

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[2]Questar's initial Brief p. 3.

[3]As was stated by the DPU in its Initial Brief little relevant evidence can be obtained from what other states are awarding. Too many differences exist between one state and another. Later in this brief the DPU will present the most current information available as to those return being awarded in other states with the 2002 article that appeared in the most recent issue of *Public Utility Fortnightly*. This information shows returns awarded in other jurisdiction for both

a new issue. When Dr. Williamson testified in 1989 he used only earnings growth rates. This failure to use dividend growth rates has continued in each case since 1989. The reason is obvious. Dividend growth rates are lower then earnings growth rates. The Company cites Salt Lake Citizens Congress v. Mountain Bell[4] for the proposition that "there must be substantial justification for making any such material change in the foundation for the utility's's rates"[5] with respect to the proposed use of short-term debt but fails to cite this case for its proposed changes in the use of dividend growth rates in defining "G" for the DCF model. Insufficient evidence has been presented to justify the PSC's deviation from a long standing policy to include dividend growth rates in developing "G" for the model.

Questar seems to ignore what the imputes to the DCF formula are. "G" represents the payment of dividends in the infinite future. The assumption in using earnings growth rates is that earnings and dividends grow at similar rates. The analyst does not know what "G" is and there is no document one can go to for "G." Value Line and IBES forecast earnings and dividends for a short time period not for an infinite time horizon as the DCF model requires. Questar asks that the Commission come up with "G" by only looking at earnings forecast. As the PSC stated in USWC 1995 rate case: "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."

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gas and electric companies. The trend in return awards in both the 2001 article Cross 5 and the 2002 article is that returns are trending downward.

[4]846 P 2d 1245, 1253 (1992).

[5]Questar's initial Brief p. 24. The quote is with reference to the Company's position on capital structure.

The Company claims in its Brief that dividend growth rates are less relevant today, and that is a reason the PSC should not give any weight to the growth rates Value Line projects. The DPU does not agree. In its list of quotes on p. 8 and 9 of its Brief they fail to cite Cross 10. Dividend growth rates are relevant particularly in today's market. Renewed interest in dividend paying stocks is occurring. However it is not surprising with the lowest inflation in recent times and low interest rates that dividend growth rates would be low and decline.[6]

A review of Cross 11 shows that earnings growth rates fluctuate widely from one year to another while dividends grow at a steady and constant rate. Relying only on earnings to develop a dividend growth rate for the DCF model may overstate "G."

The Company argues that Dr. Powell has given less weight to earnings' growth rates in this cases compared to the last rate case. They claim that in the last case he gave 25% weight to dividend growth rates while in this case he increases their emphasis to 33%.[7] The DPU believes that in this case Dr. Powell has given less emphasis to dividends then last case. The Commission should closely review its Order in the last case that describes how Dr. Powell performed his analysis.[8] In the last rate case Dr. Powell did not use IBES or Zacks earnings forecast to calculate "G" but only used the Value Line earnings and dividend growth rates. Therefore, there was no need to weight the Value Line earnings estimate with the number of analysts in the IBES list. Second, and probably more significant, in the last case Dr. Powell used the dividend and earnings growth rates to develop a "G" to be included in the DCF model. The

[6]See Cross 10.
[7]Questar's initial Brief p. 14 & 15.
[8]99-057-20 p. 7 & 8.

growth rate developed in the last case was 6.95%, while in this case the mean combined dividend and earnings growth rate is 6.08% and the median is 6.5%.[9] In this case Dr. Powell independently calculated a DCF result using both dividend and earnings growth rates. The end result of both approaches is to come up with a "G" to be included in the DCF model. One cannot reach a conclusion that Dr. Powell gave less weight to earnings in this case; and in fact, Dr. Powell concluded just the opposite.[10]

It is undeniable that Dr. Powell changed methodologies from last case, but to argue that he attempted to give less emphasis to earnings growth rates is not justifiable. Instead, Dr. Powell used different ways to develop "G," both of which end of with a result less than 11%. The recalculation using last case methods to this case produces a result of 10.98%.

<u>How Should One Combine Results</u>

The Company manipulates Dr. Powell's results to calculate a higher end result.[11] This manipulation by the Company that develops the 11.83% takes the dividend growth rate results and essentially treats it as one more of the numerous earnings growth rate estimates. Such a manipulation is clearly an attempt to de-emphasis the lower dividend growth rates by "hiding" it amongst the earnings growth rates. The ultimate question for the Commission is what level of importance does the PSC want to place on the dividend growth rates provided by Value Line? The Company has neatly manipulated the various results to de-emphasis the dividend growth rate. The DPU belies that the results should be combined as Dr. Powell has done in this case or

[9]See DPU Ex. 6.4, 6.5 and 6.6 for dividend and earnings growth rates. See Ex. DPU 2.3 99-057-20. These are non-weighted results.

[10]TR 511-512

as he did in the last case, but that dividend growth rates should not be so diluted to become meaningless. Either using Dr. Powell's method in this case to calculate separate DCF results or Dr. Powell's method of developing "G" from the last case result in returns of less than 11%. The important point is that either method treats dividend growth rates as a separate and distinct way of calculating "G" and not just one of many earnings estimates.

The Mean Versus Median Issue

In the last rate case one or more of the ROE estimates were an outlier. The choice was to either remove that estimate or use the median to develop the central tendency of the ROE. In this case there is no outlier in the earnings estimates of the sample companies. Therefore, there was no need to use the median to calculate the central tendency of the sample for earnings. The Company argues that when you combine all of the results of Dr. Powell's DCF model runs as they attempted on Cross 13 and14, they claim it is obvious that the results that are from the dividend growth models are outliers. The Company even argues that to argue that the results using dividend growth rates is not an outlier is "preposterous." Such strong rhetoric from the Company is uncalled for and should be ignored. No one is recommending a rate of return award of 7%.[12] It is only one input into an attempt to arrive at the unknown "G." It seems clear that the DPU/CCS way of defining the end recommendation is more reasonable than Dr. Williamson. Dr. Williamson ignores dividend growth rates both in this case and the last time he appeared in Utah. Dr. Powell and Mr. Parsell use dividend growth rates and then are faced with how to

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[11]See p. 15-16 Questar inital Brief.

combine both dividend and earnings growth rates into a reasonable recommendation a problem Dr. Williamson avoids.

Rate of Return Awards in Other States

The Company has attached to its Brief its Exhibit that shows the authorized returns from other states. Early in the proceeding the DPU submitted Cross 5, which is the 2001 *Public Utilities Fortnightly* article that is produced each December to show what states are doing on rate of return awards. The new *PUF* article has been released and the DPU submits that article for the PSC consideration. The DPU has also prepared a schedule that summarizes both gas and electric returns authorized by various states that are reported in this *PUF* article. Interestingly some gas returns are included in the recent *PUF* article that are not on the Company's exhibit. Again the DPU does not believe that returns in other states should be a focal point for the PSC's decision in this case. There are too many differences between one state and another. However, both this year's article and last year's *PUF* article both show that states authorized returns are not going up as Questar suggests but instead are declining. A return of under 11% would not be as Questar suggest an abnormal result but would be in line with the trend to reduce returns over what was previously authorized.

CONCLUSION

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[12]The DCF results are made up of a combination of stock price, dividend yield and growth rates. The end result of the DCF model using dividend growth rates is an input into development of the "G" factor which is an unknown.

The DPU continues to urge the PSC to reduce the 11% return authorized two years ago. Interest rates are down. Inflation is down. Questar's business risk profile has vastly improved over last case and finally the DCF results justify a decrease under the 11% return.

Dated this ______ day of November, 2002.

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CERTIFICATE OF SERVICE

I hereby certify that copies of the **REPLY BRIEF** in Docket Number 02-057-02 were mailed or hand delivered on the **______** day of November, 2002 to the following:

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ATTACHMENT 2