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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Questar Gas Company to File a General Rate Case	**Docket No. 07-057-13**

PREFILED SURREBUTTAL TESTIMONY OF KEVIN C. HIGGINS

[RATE OF RETURN]

The UAE Intervention Group hereby submits the Prefiled Surrebuttal Testimony of Kevin C. Higgins on rate of return issues.

DATED this 12th day of May, 2008.

/s/_____________________________
Gary A. Dodge,
Attorneys for UAE

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served by email this 12th day of May, 2008, to the following

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BEFORE

THE PUBLIC SERVICE COMMISSION OF UTAH

Surrebuttal Testimony of Kevin C. Higgins

on behalf of

UAE

Docket No. 07-057-13

[Rate of Return]

May 12, 2008

SURREBUTTAL TESTIMONY OF KEVIN C. HIGGINS

Introduction

Q. Please state your name and business address.

A. Kevin C. Higgins, 215 South State Street, Suite 200, Salt Lake City, Utah, 84111.

Q. By whom are you employed and in what capacity?

A. I am a Principal in the firm of Energy Strategies, LLC. Energy Strategies is a private consulting firm specializing in economic and policy analysis applicable to energy production, transportation, and consumption.

Q. On whose behalf are you testifying in this proceeding?

A. My testimony is being sponsored by the Utah Association of Energy Users Intervention Group (UAE).

Q. Are you the same Kevin C. Higgins who previously filed direct testimony on Rate of Return in this proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony responds to assertions in the rebuttal testimony of Questar Gas Company ("QGC") witness Robert B. Hevert and Division of Public Utilities ("DPU") witness William A. Powell concerning the relevance of the analysis of UAE witness Robert H. McKenna. Mr. McKenna's analysis addresses the risk reduction benefit to QGC from Conservation Enabling Tariff ("CET").

Q. Please summarize your surrebuttal testimony.

A. In their rebuttal testimonies, Mr. Hevert and Dr. Powell maintain that Mr. McKenna's analysis is inconsistent with the guidelines established by the United States

Supreme Court in the *Hope* and *Bluefield* cases because his analysis is specific to QGC and is not based on the returns on investment in other enterprises of corresponding risk.

Beyond the fact that Dr. Powell and Mr. Hevert are both apparently offering legal analyses, their criticisms are misplaced. Neither Mr. McKenna nor I use his analysis to propose a specific return (or range of returns) on equity for QGC. Thus, we make no attempt to recommend a return for QGC "in isolation" from other enterprises of comparable risk. We simply recommend that Mr. McKenna's analysis of the benefit to QGC from the CET be factored into the Commission's decision on where <u>within the range of reasonable returns</u> QGC's return on equity should be set. This approach is entirely appropriate. Indeed, QGC uses a similar approach in arguing for the establishment of its return on equity in the <u>upper</u> end of the reasonable range based on the Company's financial and operating performance.

Moreover, Mr. Hevert himself recently recommended a downward adjustment to an Arkansas gas utility's return on equity based on the reduction in its risk that would result from adoption of a proposed revenue stabilization mechanism. There is absolutely no basis to conclude that Mr. Hevert's recommendation in Arkansas is consistent with *Hope* and *Bluefield*, whereas a similar recommendation in this proceeding by Mr. McKenna and me somehow is not.

Also, while Dr. Powell states that no reduction in QGC's cost of equity capital is warranted at this time, he also states in his direct testimony that based on Mr. Hevert's analysis and recommendation in the Arkansas case, a reduction in the cost of equity for QGC in the range of 10 to 25 basis points may be partially supportable. This acknowledgement is consistent with the recommendation advanced by UAE.

Finally, neither Dr. Powell nor Mr. Hevert was able to identify an impact in the cost of equity related to rate stabilization mechanisms for Mr. Hevert's proxy group. This underscores the importance of Mr. McKenna's QGC-specific analysis in providing useful information to the Commission. This Commission has already found that the CET reduces QGC's risk. It is important for the Commission to have an understanding of the value of this risk reduction. Mr. McKenna's analysis provides the most useful evidence in this record as to the value of that risk reduction to QGC.

Surrebuttal to Mr. Hevert and Dr. Powell

Q. Please respond to the criticism by Mr. Hevert and Dr. Powell that Mr. McKenna's analysis is inconsistent with the guidelines established by the United States Supreme Court in the *Hope* and *Bluefield* cases.

A. The gist of this criticism is that Mr. McKenna erred by evaluating the specific benefit to QGC of the CET, whereas *Hope* and *Bluefield* allegedly require that the determination of return on equity be commensurate with returns on investments in <u>other enterprises</u> of corresponding risk.

Without attempting to respond to the legal opinions offered by Dr. Powell and Mr. Hevert on the *Hope* and *Bluefield* cases, their criticism is misplaced, as it fails to consider UAE's actual recommendation on rate of return in this case. Neither Mr. McKenna nor I use his analysis to propose a specific return (or range of returns) on equity for QGC. Thus, we make no attempt to recommend a return for QGC "in isolation" from other enterprises of comparable risk. Rather, we recommend that Mr. McKenna's analysis of the benefit to QGC from the CET be factored into the Commission's decision on where <u>within the range of reasonable returns</u> QGC's return on equity should be set.

Q. Dr. Powell's direct testimony points out that Mr. Hevert recently recommended a similar downward adjustment to a gas utility's return on equity based on the reduction in its risk that would result from adoption of a proposed revenue stabilization mechanism. Do you wish to comment on this?

A. Yes. As discussed in the direct testimony of Dr. Powell, in testimony last year before the Arkansas Public Service Commission, Mr. Hevert recommended a 35 basis point reduction in the return on equity for his client, Centerpoint Energy Arkansas Gas ("Centerpoint"), if a proposed revenue stabilization mechanism was adopted. In light of Mr. Hevert's recommendation in Arkansas, his criticism of Mr. McKenna and me for recommending a similar adjustment for QGC is particularly misplaced. (Neither Mr.

McKenna nor I was aware of Mr. Hevert's Arkansas testimony at the time we filed our direct testimony in this proceeding.)

In the Arkansas case, Mr. Hevert acknowledged that the rate stabilization mechanism proposed by Centerpoint could have a "quantifiable effect on certain volatility and risk measures, thereby affecting the Company's cost of equity." Mr. Hevert estimated the impact on Centerpoint's required return by examining the credit spread associated with one ratings notch difference among the Moody's Utility bond indexes for Aa, A, and Baa rated utilities from January 1, 2001 through November 27, 2006. Mr. Hevert concluded that a downward adjustment of 35 basis points was a "conservative and reasonable estimate" of the potential effect of the proposed rate stabilization mechanism on Centerpoint's return on equity. This adjustment is strikingly similar to Mr. McKenna's estimation of the benefit to QGC of the CET (also 35 basis points[1]), determined independently.

In his final recommendation in the Arkansas case, Mr. Hevert concluded that a range of returns on equity of 10.50 to 11.50 percent was reasonable for Centerpoint, and specifically recommended a return of 11.25 percent <u>absent Centerpoint's proposed rate stabilization mechanism</u>. Significantly, however, Mr. Hevert also recommended that if

[1] In his direct testimony, Mr. McKenna provides an estimate of 37 basis points, but has since modified this to 35 basis points.

Centerpoint's proposed rate stabilization mechanism was adopted, then the Company's return should be adjusted downward by 35 basis points to 10.90 percent. [2]

Q. Does Mr. Hevert draw distinctions between Centerpoint's proposal and QGC's CET to explain the difference in his recommendations with respect to recognizing the reductions in each Company's risk in its allowed return?

A. Yes. In responding to Dr. Powell's direct testimony, Mr. Hevert draws distinctions between the rate stabilization mechanism proposed by Centerpoint and the CET approved for QGC. However, these distinctions merely concern the details of fundamentally similar mechanisms: they provide absolutely no basis for concluding that Mr. Hevert's recommendation in Arkansas is consistent with *Hope* and *Bluefield,* whereas a similar recommendation in this proceeding by Mr. McKenna and me somehow is not.

Q. Your recommendation in this proceeding addresses how the CET should be considered within the range of reasonable returns. Has QGC also made recommendations in this proceeding concerning where within the range of reasonable returns its return on equity should be established?

A. Yes. QGC witness John J. Reed presents a benchmarking study in which QGC's financial and operating performance is compared to that of other companies. Mr. Reed concludes that the benefits provided by the Company's performance warrant the

[2] Arkansas Public Service Commission, Docket No. 06-161-U, pp. 54-62. See DPU Exhibit 3.3.

establishment of its return on equity in the upper end of the range recommended by Mr. Hevert.

Q. Is the set of companies used in Mr. Reed's benchmarking study the same as that used in Mr. Hevert's analysis of return on equity?

A. No. In his direct testimony, Mr. Reed states that his inclusion of companies outside the peer group used by Mr. Hevert does not affect the relevance of his results, even though Mr. Reed makes recommendations for QGC's return on equity.[3]

Q. Is Mr. Reed's recommendation that QGC's return be established in the upper end of the reasonable range based solely on QGC's performance in his benchmarking study?

A. No. Mr. Reed goes beyond the metrics in his benchmarking study and analyzes QGC's performance in isolation from other companies.[4]

Q. Does Mr. Hevert or Dr. Powell criticize Mr. Reed's recommendation for setting QGC's return in the upper end of the reasonable range even though Mr. Reed's analysis does not consider the comparable risk of the proxy group used in Mr. Hevert's analysis?

A. No, they do not.

Q. What conclusion do you draw with respect to the criticism that Mr. McKenna's analysis is inconsistent with *Hope* and *Bluefield*?

[3] Direct testimony of John J. Reed, p. 6, lines 162-163

A. This criticism is obviously being selectively applied to UAE's testimony. QGC is advocating that its return be set in the upper end of the reasonable range based on analysis outside Mr. Hevert's proxy group, but QGC claims (through Mr. Hevert) that analysis which considers the benefit to QGC from the CET should not be considered because doing so would somehow be a violation of *Hope* and *Bluefield*. QGC's positions on this point, like Dr. Powell's, are clearly inconsistent. The criticism that Mr. McKenna's analysis should not be considered because it would somehow violate *Hope* and *Bluefield* should be rejected by the Commission.

Q. Do you have any additional comments regarding Dr. Powell's criticism of Mr. McKenna's analysis with respect to *Hope* and *Bluefield*?

A. Yes. I note that, even though Dr. Powell argues in his rebuttal testimony that Mr. McKenna's analysis is inconsistent with *Hope* and *Bluefield*, Dr. Powell nonetheless offers in his direct testimony a recommendation similar to that of UAE regarding the CET – a recommendation he describes as "partially supportable." Specifically, Dr. Powell initially states that to the extent that QGC's comparable companies have rate stabilization mechanisms similar to the CET, any adjustments to QGC's cost of equity should be captured in the analysis establishing a reasonable range, and that further, the analysis performed by DPU witness Charles Peterson captures any such potential adjustments. On that basis, Dr. Powell states that no reduction in QGC's cost of equity

[4] Ibid., pp. 22-24.

capital is warranted at this time. But then Dr. Powell goes on to state that based on Mr. Hevert's analysis and recommendation in the Arkansas case, a reduction in the cost of equity for QGC in the range of 10 to 25 basis points may be partially supportable.[5]

The fact that Dr. Powell is willing to recognize that a reduction in the cost of equity for QGC may be partially supportable demonstrates that his arguments concerning *Hope* and *Bluefield* are far from black and white. Further, Dr. Powell acknowledges that a reduction in the cost of equity may be appropriate based on Mr. Hevert's analysis and recommendation in Arkansas. Certainly, Mr. McKenna's analysis of the benefit to QGC from the CET is no less useful to the Commission than Mr. Hevert's analysis of the benefits to Centerpoint in Arkansas. Dr. Powell's recommendation to give little weight to Mr. McKenna's analysis is inconsistent with Dr. Powell's own direct testimony and is inconsistent with Dr. Powell's reliance on Mr. Hevert's testimony in Arkansas. I recommend that Dr. Powell's recommendation to give little weight to Mr. McKenna's analysis should be rejected by the Commission.

Q. Do you have any comments with respect to the analysis performed by Dr. Powell and Mr. Hevert with respect to the impact of the CET on QGC's cost of equity?

A. Yes. Both Dr. Powell and Mr. Hevert attempted to identify whether a lower cost of equity was discernible for the companies with rate stabilization mechanisms in Mr. Hevert's proxy group of gas utilities. Mr. Hevert could not identify such a trend among

[5] Direct testimony of William A. Powell, p. 19, lines 330-339.

his proxy group.[6] Dr. Powell addressed this question by performing a regression analysis and could not identify statistically significant evidence of a reduction in the cost of equity attributable to rate stabilization mechanisms for the proxy group.[7] However, in interpreting Dr. Powell's results we must bear in mind that the proxy group produces only eight observations to be used in the regression analysis, and that producing statistically significant coefficients is particularly difficult for such a small sample size, all other things being equal. Thus, the inconclusive results produced by Dr. Powell's regression analysis is not terribly surprising.

The inability of either Dr. Powell or Mr. Hevert to identify an impact in the cost of equity related to rate stabilization mechanisms for the proxy group underscores the importance of Mr. McKenna's QGC-specific analysis in providing useful information to the Commission. This Commission has already found that the CET reduces QGC's risk.[8] It is important for the Commission to have an understanding of the value of this risk reduction. Neither Dr. Powell nor Mr. Hevert could produce a useful measure of the impact of the risk reduction on QGC's cost of equity. Mr. McKenna's analysis provides the most useful evidence in this record as to the value of that risk reduction to QGC.

Q. Does the rebuttal testimony of Mr. Hevert or Dr. Powell cause you to modify your recommendation to the Commission on this matter?

[6] Direct testimony of Robert B. Hevert, p. 14, line 97- p. 15, line 140.
[7] Direct testimony of William A. Powell, pp. 11-16.
[8] Order, Docket No. 05-057-T01 at 11-12.

A. No. I continue to recommend that the Commission use the information in Mr. McKenna's analysis to help guide its decision on QGC's allowed return on equity. This information should be factored into the Commission's decision on where within the range of reasonable returns QGC's return on equity should be set. All things equal, the CET should cause QGC's allowed return to be reduced within the reasonable range.

Q. Does this conclude your surrebuttal testimony with respect to rate of return?

A. Yes, it does.