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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Questar Gas Company to Increase Distribution Non-gas Rates and Charges and Make Tariff Modifications	Docket No 07-057-13 ROGER J BALL'S RESPONSE TO QUESTAR GAS COMPANY'S MOTION TO STRIKE HIS RATE OF RETURN DIRECT TESTIMONY

On 25 April, Questar Gas Company (QGC, Company) responded to the *Rate of Return Direct Testimony* (*Testimony*) that I had pre-filed on 31 March 2008 by moving the Commission to strike it.

INTRODUCTION

QGC's *Motion* contains two points of significance.

First, it argues that, because of *Bluefield*[1] and *Hope*[2], in determining what rate of return on equity to authorise for the Company, the Commission may only consider:

> the return "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"

and since I had not addressed that particular, my *Testimony* cannot be regarded as expert opinion, and is therefore neither probative nor relevant.

Then, QGC maintains that its contributions, beyond its own profits and through its affiliates, to Questar Corporation's (Questar, Corporation) earnings ought not even to be allowed consideration in the determination of its allowed rate of return.

[1] *Bluefield Water Works Co v Public Service Commission*, 262 US 679, 692 (1923) (*Bluefield*).

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

Trivially, QGC implies that the 19 December 2007 sworn direct testimony of its nine witnesses somehow trumps mine, the more so because the Commission rejected one of my positions regarding test year. Of course, two of the Company's witnesses, Barrie L McKay and David M Curtis, supported a forecasted test period, and the year July 2008 to June 2009 in particular, and all nine of its witnesses based their testimony on that test year. In its 14 February 2008 *Order on Test Period*, the Commission rejected Questar's contention that its forecasted expenses for the year ending June 2009 would best reflect the conditions the Company would experience when new rates would be effective, and instead adopted a calendar 2008 test year recommended by the UAE Intervention Group (UAE). Beyond instancing this example, I will spare the Commission detailed reply to such parts of the Motion, stating only that, by choosing not to answer some of what QGC has written, I am neither agreeing with nor mutely accepting it.

THE COMMISSION IS NOT LIMITED TO STATISTICAL TESTIMONY IN ITS CONSIDERATION OF QUESTAR GAS COMPANY'S RATE OF RETURN

QGC argues that *Bluefield*, *Hope*, et al, require the Commission to consider rates of return among a proxy group of similar utilities in determining what its rate of return shall be. The Company references *Utah Rule of Evidence* 702, which it summarises thus:

> expert opinion evidence must be provided by an expert qualified by *knowledge, skill, experience, training or education*, must be reliable and must be based on facts and methods of analysis generally accepted by relevant experts (emphasis added)

and asserts that:

> Pursuant to this principle, expert witnesses providing probative evidence on ROE utilize financial models to estimate the return expected by investors in utility companies with risks corresponding to those of the company whose rates are being set … Expert witnesses offer informed opinions on the ROE required by investors

in order to imply that the Commission may consider testimony only in that regard, and may not treat any witness as an expert in a rate of return proceeding who does not testify in that regard, and that my *Testimony* is therefore neither probative nor relevant.

But it over-reaches; neither case requires that and, in their direct testimony, its witnesses, John J Reed and Company President Alan K Allred, contradict the position QGC now seeks to argue. They testified that the Company's performance in several regards merits the award of a rate of return higher than comparisons with similarly-situated businesses might warrant. Since Questar concedes that recommendations based upon a wider range of evidence ought to be entertained, is the Commission to suppose that only factors mitigating in QGC's favour should be considered?

The Company complains that my *Testimony* did not counter its witnesses Robert B Hevert's and Mr Reed's statistical analysis, but its *Motion* fails to cite any authority (other than its own) requiring that a rate of return witness must do so. The Commission is hardly deprived of a wide range of opinion, having received rate of return testimony and rebuttal testimony in contradistinction to that of Messrs Hevert and Reed, and with clearly different opinions about the members of proxy groups, and diverse analyses and recommendations, from Utah Division of Public Utilities (Division) witnesses William (Artie) Powell and Charles E Peterson, Utah Committee of Consumer Services (Committee) witness J Randall Woolridge, and UAE Intervention Group (UAE) witnesses Kevin C Higgins and Robert H McKenna.

Nor does the *Motion* offer any ground for its complaint that my *Testimony* neither mentioned nor rebutted the direct testimony of Messrs Hevert and Reed. I quite understand that it is usual for battling rate of return statisticians to do so, but am unaware of any requirement for a party to counter another's direct testimony in its own, rather than in its rebuttal. Nor am I aware of any reason why a party that wishes to make an entirely different and complementary case without venturing into that fray should be obliged to do so. Certainly, neither *Bluefield* nor *Hope* require either.

QGC's implication that only the testimony of statisticians is relevant to the determination of rate of return is unsupported by anything in its *Motion*. The data, the complexity of the analyses, and the enormous bulk of the testimony presented by Company, Division, and Committee witnesses is considerable, but the Commission should not be persuaded that it is necessarily sufficient. The statisticians plough a furrow that, while it is deep, is also very narrow. Taken alone, DCF and CAPM analysis of rates of return in a proxy group is quite circular. If that is all that any regulatory utility commission ever considered, the tendency would inevitably be towards a single rate for all similar utilities, taking no account of statutory, structural, or other changes affecting one in particular. Expressed differently, the Commission should consider historical changes affecting QGC – things that have changed over time, affecting its value to its ultimate owners – as well as geographical comparisons. (Incidentally to this *Response*, but not insignificantly to the determination of the Company's rate of return, other parties' statisticians seem to take a very broad view of "in the same general part of the country" when selecting comparators. QGC is fond of pointing out what different circumstances Utah has long found itself in from areas of natural gas consumption elsewhere in the continental USA (Mr Justice Jackson's opinion in *Hope* offers a fascinating overview of the geographical differences in the natural gas industry in 1943), yet everybody seems to consider it acceptable to use companies from all over the country as members of their proxy groups.)

Indeed, QGC quotes the Utah Supreme Court in *USWest*:

> We conclude that cost-of-capital estimation is a larger task than mere mathematical application of financial models … We look to be sure witnesses have done the best they can to employ sound, educated judgments.[3]

[3] *Re U S West Communications, Inc*, 1997 WL 875832, *438 (Utah PSC 1997).

Among many other things, in *Hope* the US Supreme Court opined that:

> We held in Federal Power Commission v Natural Gas Pipeline Co[4] … that the Commission was *not bound to the use of any single formula or combination of formulae* in determining rates. Its ratemaking function, moreover, involves the making of '*pragmatic adjustments*.' And when the Commission's order is challenged in the courts, the question is whether that order 'viewed in its entirety' meets the requirements of the Act. Under the statutory standard of 'just and reasonable' *it is the result reached not the method employed* which is controlling. It is *not theory but the impact* of the rate order which counts … The rate-making process under the Act, ie, the fixing of 'just and reasonable' rates, involves a *balancing of the investor and consumer interests*. Thus we stated in the Natural Gas Pipeline Co case that '*regulation does not insure that the business shall produce net revenues*' …The conditions under which *more or less might be allowed* are not important here. (Emphases added.)

It seems that there is extensive support for the notions that the Commission should consider not just the testimony of Questar's, Division's, and Committee's statistical witnesses, but a broader range of opinion, and that the object of the exercise, while by all means taking account of rates of return in similar ventures, is to fix just and reasonable rates that balance the interests of stockholders and ratepayers.

Bluefield refers to a vertically-integrated utility (VIU), a water company; its assets included Bluefield Valley waterworks in Virginia. If regulatory utility commissions elsewhere have neglected the vertical disintegration of natural gas utilities, turning them into local distribution companies (LDCs), in determining rates of return based upon statistical comparisons with other such disintegrating businesses, that surely does not mean that this Commission should do likewise.

In determining just and reasonable rates, the Commission must be able to consider the impact on the balance of interests between ratepayers and stockholders of a vertically-integrated utility when the latter hive off the VIU's wells to a new subsidiary which can earn returns in excess of the disintegrated LDC. The Commission cannot do that if all that can be considered in determining rate of return are those being earned elsewhere.

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[4] *Federal Power Commission v Natural Gas Pipeline Co*, 315 US 575,592, 593 S, 62 SCt 736, 745, 746.

It is not my argument that the Commission should take no account of the methods developed in the 85 years since *Bluefield*, but that there are other aspects the Commission should consider in assessing the entire rate of return landscape.

Mr Hevert's direct testimony refers repeatedly to "risk", "risky", and "risk premium" or "risk premia". He makes it clear that the difference between the rates of interest on borrowings and of return on equity are intended to compensate stockholders for the additional risks they undertake compared with those of secured lenders. It is patent, then, that transfer of a portion of such risk from stockholders to ratepayers – for example when rates cease to be set based upon historical test periods (with or without out-of-period adjustments) and begin to be determined on the basis of entirely forecasted ones – ought in equity to result in lower rates, of return and for natural gas.

I first addressed the question of the shift of risk from stockholders to ratepayers in this first QGC general rate case in which the Commission intends to use an entirely projected test period in my 28 January 2008 *Test Year Testimony* and again in my 5 February *Test Year Rebuttal Testimony*. My *Testimony* and 28 April *Rate of Return Rebuttal Testimony* expanded upon the matter. Dissenting parties have had ample time to put forward their countervailing testimony, but none have.

No other party, not even QGC, has chosen to file testimony on the impact of a future test year and Questar's corporate structure on the Company's rate of return. Instead, QGC moves the Commission to strike mine, the only testimony that has been filed on these issues. The Company's Motion might be considered a measure of desperation in the face of testimony that it cannot counter with evidence. QGC has an extensive track record of working to keep out of the public arena facts unfavourable to the image it wishes to project of itself; this is another such occasion.

In its *Utah Rule of Evidence* 702 argument to strike my *Testimony*, the Company forbears to mention *Rule* 705, which provides that "(t)he expert may testify in terms of opinion or inference and

give reasons therefor without prior disclosure of the underlying facts or data, unless the court requires otherwise." The Commission will doubtless have noted that QGC hasn't attempted in its *Motion* to impugn my "knowledge, skill, experience, training or education". Qualification as an expert and the basis for an opinion are separate, consecutive concepts: an expert can state a view without giving the foundation for it. QGC puts the cart before the horse by arguing that, if you don't provide the groundwork for your judgment, you do not qualify as an expert. And the Company correctly reminds the Commission that it "is not bound by the technical rules of evidence". UCA §R746-100-10F1 trumps *Rule* 702, allowing the Commission to "receive any oral or documentary evidence". However, I would point out that my Testimony does contain sourced "underlying facts and data", including at lines 53-55 and 80-82.

QGC baldly asserts that my testimony about its earnings since its last rate case has no bearing on the determination of its rate of return in this one. My testimony pointed to Mr Allred's Exhibit 2.9, which showed that the Company's return on equity, 10.05% for 2004, rose to 10.68% for 2005, and again to 10.78% for 2006. QGC's forecast that it will be only 7.52% for 2008 is entirely speculative; it is not impossible that it will again be of a similar order of magnitude to rates achieved in recent years.

Of course my *Testimony* is relevant, it is unique in this case, and it ought to be considered by the Commission in determining an authorised rate of return for the Company, not stricken.

QUESTAR CORPORATION'S EARNINGS ARE DIRECTLY RELEVANT TO QUESTAR GAS COMPANY'S RATE OF RETURN ESTABLISHED IN THESE PROCEEDINGS

My uncontroverted *Testimony* provided evidence that Questar's structure enables it to earn profits from its utility operations significantly in excess of the rate of return authorised by the Commission for the Company, and no other party has addressed the issue in its direct or rebuttal testimony. QGC avers that "none of this discussion has any bearing on the cost of equity capital of Questar

Gas." It is understandable that the Company would like the Commission to ignore my testimony in that regard, but claiming it doesn't make it so.

My *Testimony* described how Questar's corporate strategy has changed the nature of the rate of return landscape here in Utah. It has shifted income from what was a VIU to newly created subsidiaries of the Corporation (and affiliates of QGC), enabling it to earn profits from those affiliates' activities that are ultimately paid for by QGC's ratepayers, essentially without Commission oversight. Previously, those activities were conducted by the VIU and subject to regulation by the Commission. Specifically, all of those profits would earlier have been taken into account in determining the VIU's rates.

Let's consider how this might be done in the case of an hypothetical VIU, A, whose ratebase consists one-third of distribution, one-third of transmission, and one-third of production, assets. A parent company, B, is created, which becomes the entity owned by the stockholders who previously directly owned A.

B creates a new subsidiary, C, and transfers ownership of all A's gas wells to C. The rate base of A is now two-thirds of what it was previously; C has the other third. C is obliged to sell all the gas it produces to A, but is permitted to make a rate of return double that authorised for A before or after the transfer. B continues to be able to earn the authorised rate of return on A, two-thirds its previous income, but twice as much on C, again two-thirds A's previous income, so B's stockholders receive a total of one and one-third the profits they had made from A as a VIU.

B now creates another new subsidiary, D, and transfers ownership of all A's interstate pipelines to it. A's ratebase is halved, to one-third of what it was as a VIU, and it is now only a local distribution company (LDC). Initially, D does little more than ship gas from C's wells to A's distribution system. Because these are in different states, it is subject to rate-of-return regulation by FERC. A's

ratepayers see little impact on their gas bills. In other words, A's rates used to include depreciation and rate of return on the interstate pipes when they were in its VIU ratebase, and has continued to include them as a transportation expense item while paying D FERC-approved shipping rates. But as time passes, D begins to find opportunities to ship gas for other producers and consumers using spare capacity on the system that used to be in A's ratebase. While FERC continues to set D's rates, and the state regulatory utility commission (SRUC) to set A's rates, based upon historical revenues and expenses, D is earning increasing revenues from previously unused capacity, helping to increase profits for B's stockholders. A's ratepayers contribute to that windfall until FERC and the SRUC in consecutive future rate cases take account of it, and it is happening essentially out of the sight of the SRUC.

One day, D sees an opportunity to carry natural gas from an unaffiliated producer to an unaffiliated buyer. The gas has a significantly different chemical composition and different combustion characteristics than supplies it has previously transported. Until now, gas has been accepted and delivered by D based upon its heat content, but the variation hasn't been significant to A as an LDC. Now A becomes concerned. The topology of D's pipeline network means that an increasing proportion of the gas A is receiving has combustion characteristics different than is customary. There may be significant liability issues for A, which fears its ratepayers' appliances will not burn it entirely safely. One solution is to process the gas, but that will incur additional costs. Carefully not mentioning either the liability or the additional profits that D's managers' decisions have incurred for B, A's managers persuade the state utility regulatory commission to increase its rates to cover those costs. While ratepayers face higher bills, stockholders enjoy increase returns.

Meanwhile, B creates another new subsidiary, E, to find and produce new gas supplies which will be sold into the emerging national unregulated market. C no longer seeks new sources of gas, and as A's load grows it goes to the market to meet demand in excess of C's production. Ratepayers

are exposed to all the risks of the marketplace; as market prices rise, their rates increase. On the other hand, so do E's – and therefore B's – profits, and stockholders enjoy increase returns.

Clearly, ratepayers are contributing to B's increasing earnings not only through A's rate of return, but through C's excess rate of return, and through D's and E's increasing revenues, yet none of these LDC ratepayer contributions to B's bottom line are taken into consideration by the regulatory utility commission in determining A's rate of return or rates.

QGC dismisses my testimony as having no bearing on the cost of its equity capital, all of which comes from Questar. Of course it has a bearing, a very significant bearing, on the Corporation's willingness to invest in the Company when it knows it will earn far – far – more on the venture than the rate of return authorised for QGC by the Commission. Naturally, the Company doesn't want the Commission to think about these aspects during this phase of its General Rate Case; naturally QGC would like my *Testimony* stricken; but it is highly relevant, and the Commission should consider it.

Hope provides a fine example of what happens when a parent (whether Standard Oil Co in that case, or Questar Corp in ours) wholly owns subsidiaries (Hope Natural Gas Co there, or Questar Regulated Services and Questar Market Resources here), which in turn control local distribution companies (five in Ohio and Pennsylvania then, Questar Gas Company now). Hope produced, purchased and marketed natural gas in West Virginia, and sold "the great bulk of it" to those affiliated companies at the state line. Wexpro produces natural gas and sells all of it to QGC, meeting about half its needs. Questar Exploration & Production (QE&P) produces natural gas and sells it into the market, whence QGC purchases the balance of its needs. QPC collects gas from Wexpro and QE&P wells and delivers gas to QGC and elsewhere. Wexpro, QE&P, and QPC all

make profits at the expense of QGC ratepayers, and QGC's earnings (its rate of return) are not the only contribution its ratepayers make to Questar Corporation's bottom line.

By hiving off Wexpro and Questar Pipeline Company (QPC) from the utility, and by diverting its exploration and production activities to its unregulated QE&P subsidiary, leaving utility ratepayers heavily exposed to the marketplace, Questar has increased its profits at their expense. One way for the Commission to restore some balance between ratepayers and stockholders, and to set just and reasonable rates, is to impute those profits. Another is to reduce rate of return accordingly. These arguments are entirely relevant to the rate of return phase of QGC's General Rate Case.

Questar has created a corporate structure replete with smoke and mirrors, opportunities for legerdemain, distraction, and illusion. It needs thorough investigation and understanding, so a rate of return can be determined which will be balanced as between ratepayers and stockholders, leading to just and reasonable rates. This may be a perfect opportunity for the Commission to initiate such a review. If QGC follows PacifiCorp's path and initiates another rate case very soon, an investigation in the interim could timely provide the information needed. If the Company holds back because it fears the impact of such an investigation, it could provide the impetus for a show cause order. In the meantime, all the information the Commission needs to set a rate of return adjusted for Wexpro's profits are publicly available for the Commission to take judicial notice of.

QGC proceeds in its *Motion* to testify in rebuttal of my *Testimony* regarding Wexpro. Of course, the appropriate place to rebut my *Testimony* was in the Company's *Rebuttal* filed on 28 April, but it forwent that opportunity, so it should not be permitted to do so in argument and the Commission should strike such parts of QGC's *Motion*. The Company argues that, because the Commission and FERC approved various corporate restructurings, and because the Utah Supreme Court and the US 10th Circuit Court of Appeals upheld certain decisions, they are res judicata and concludes

that my testimony is therefore barred. My testimony doesn't dispute any of those decisions, rather it asks the Commission to take account of them and their financial consequences on both ratepayers and stockholders in determining what rate of return to authorise for the Company in this proceeding.

As long ago as 1776, a year of particular meaning for these United States, in *The Wealth of Nations*, a book of fundamental significance in the economic underpinnings we have chosen for our society, Adam Smith wrote:

> consumption is the sole end and purpose of all production; and the interests of the producer ought to be attended to, only in so far as it may be necessary for promoting that of the consumer. This maxim is … perfectly self-evident.

For "approximately 30 years", to quote QGC's Motion, Questar has enjoyed the increasing profits, and its stockholders the steadily growing dividends and, particularly during the decade of the 2000s, rapidly escalating capital valuation, which have come from its restructuring of the original VIU which dates back to 1928. Now is the time for the Commission to recognise how out of balance the relationship between those stockholders and the Company's ratepayers has become, and act to restore it.

It may be appropriate at this point to mention UCA §54-7-13(1), providing that:

> The commission may at any time, upon notice to the public utility affected and after opportunity to be heard, rescind, alter, or amend any order or decision made by it.

And, interestingly, the Commission, Division, Committee and QGC – respondents to the *Petition for Judicial Review* of Roger Ball, Claire Geddes, et al, to the Utah Supreme Court *In the Matter of the Application of Questar Gas Company to Adjust Rates for Natural Gas Service in Utah*, Nos 20060279 and 20060280 – asserted:

> that the 2004 Order does not bar cost recovery in the Approval Order because ratemaking is a legislative function of the Commission to which res judicata does not apply.[5]

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[5] Paragraph 24 of the Court's opinion, filed 12 October 2007.

CONCLUSION

My *Testimony* is distinctive, and is directly relevant to the question of rate of return now before the Commission, which has scheduled it for hearing on 21 May. When I requested intervention in this Docket, on 24 December 2007, I explained that my legal rights and interests might or might "not coincide with the public interest" that the Utah Division of Public Utilities (Division) is statutorily mandated to act in, or "those of 'a majority of residential consumers as determined by the'" Utah Committee of Consumer Services (Committee). Neither agency has chosen to provide testimony on the issues that I have; nor has Questar Gas Company. The Commission has a duty to set rates that will be just and reasonable; it cannot do that without weighing the balance between ratepayers and stockholders in determining the rate of return the Company will be authorised to earn following this General Rate Case; and it cannot do that without considering the impact upon QGC's rate of return, and therefore upon rates, of choosing an entirely forecasted test year – at an uncontroverted cost of $22M – for the Company for the first time, and of the additional and excess earnings from its Wexpro, Questar Pipeline Company, and Questar Exploration & Production Company for Questar Corporation that are entirely attributable to rates paid by the LDC's ratepayers.

The Commission cannot do that, it cannot fulfill its duty, it cannot set just and reasonable rates, absent my *Testimony*. It should not strike my *Testimony*, rather it should deny QGC's *Motion*.

Respectfully submitted on 28 January 2008,

/s/

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Roger J Ball

CERTIFICATE OF SERVICE

I hereby certify that, on 12 May 2008, a true and correct copy of the foregoing Roger J Ball's Response to Questar Gas Company's Motion to Strike His Rate of Return Direct Testimony in Docket 07-057-13 was mailed electronically to the following:

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