Docket No. 19-057-02

Utah Office of Consumer Services Witness

Daniel J. Lawton

Exhibits OCS 3.1S through OCS 3.11S

December 5, 2019

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF THE APPICATION OF DOMINION ENERGY UTAH TO INCREASE DISTRIBUTION RATES AND CHARGES AND MAKE TARIFF MODIFICATIONS	§ § § § § § § § § § §	**Docket No. 19-057-02 Surrebuttal Rate of Return Testimony of Daniel J. Lawton For the Utah Office of Consumer Services**

December 5, 2019

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Exhibits

SURREBUTTAL TESTIMONY OF
DANIEL J. LAWTON

SECTION I: <u>INTRODUCTION/BACKGROUND/SUMMARY</u>

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 12600 Hill Country Boulevard, Suite R-275, Austin, Texas 78738.

Q. ARE YOU THE SAME DANIEL LAWTON WHO FILED COST OF CAPITAL TESTIMONY IN THIS PROCEEDING?

A. Yes I am.

Q. ON WHOSE BEHALF ARE YOU FILING TESTIMONY IN THIS PROCEEDING?

A. I have been retained to review the Dominion Energy Utah ("Company" or "DEU") cost of capital request, and related financial issues, on behalf of the Utah Office of Consumer Services ("OCS").

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to respond to Company witness Hevert's rebuttal testimony addressing overall cost of capital and return on equity requested by DEU in this case. In addition, I provide an update of my equity return employing current market data including an adjustment to the comparable group database.[1]

Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR SURREBUTTAL TESTIMONY CONCLUSIONS.

A. First, based on my most recent update of cost of capital employing market data through

[1] Consistent with Mr. Hevert's rebuttal analysis at page 3, lines 42-47 I have excluded Chesapeake Utilities Corporation from the comparable group analysis because Chesapeake fails to meet the screen requiring 60% of income from regulated gas operations.

November 2019, I conclude that a return on equity of 9.1% and an overall cost of capital of 6.958% employing the DEU proposed capital structure and long-term debt cost is appropriate. Second, a review of Company witness Hevert's rebuttal testimony in this proceeding has provided no evidence to support the DEU requested 10.50% cost of equity in light of current market capital costs. Mr. Hevert has failed to provide support for a cost of capital recommendation of 10.50% that is over 80 basis points higher than the average authorized 2019 equity returns of 9.68% before considering lower financial risks for DEU.[2]

Mr. Hevert's rebuttal evidence at page 42 lines 772 through 781, acknowledges that my recommendations support a bond rating in the "A" range, but at the lower bound of financial benchmarks. Mr. Hevert argues that additional profit or cushion is required to cover situations where the Company's earnings and cash flow may fall short. Mr. Hevert's 10.50% equity return proposal includes nearly $14 million (the profit difference when 10.5% versus 9.1% equity return is employed) of cushion profit.[3] As I discuss later, these kinds of cushion requests are not supported by costs and certainly are not equitable or justifiable.

Lastly, I have reviewed Mr. Hevert's rebuttal critique of my analysis and have found no reason to change any of my recommendations in this case.

SECTION II: <u>OVERVIEW AND UPDATE OF COST OF CAPITAL RECOMMENDATION</u>

Q. PLEASE SUMMARIZE YOUR PREVIOUS FINDINGS AND CONCLUSIONS RELATED TO DEU'S EQUITY RETURN IN THIS CASE.

A. My analysis provided in my direct testimony of the Company's requested cost of equity

[2] The average authorized equity return in cases decided during the first 9 months of 2019 is 9.68% with an average equity ratio of 52.52%. DEU's proposed equity ratio in this case is 55%. American Gas Association, Rate & Regulatory Update (July 1 through September 30, 2019) at 1. Also see https://www.aga.org/rate-alerts.

[3] The calculation of $14 million of excess profit or cushion is shown in Exhibit OCS 3.9S.

capital in this proceeding is shown in the following table:

Table 1

Cost of Equity Estimates From Direct Case[4]

MODEL	RANGE	MIDPOINT
DCF Model	8.98% - 9.28%	9.13%
Two-stage DCF	8.55% - 9.25%	8.90%
CAPM	8.68% - 8.87%	8.78%
ECAPM	9.54% -9.68%	9.61%
Bond Risk Premium	8.99% - 9.07%	9.03%
Average All Models		9.09%

The 9.1% recommendation is based on the DCF and risk premium model results, and consideration of business and financial risks. When the 9.1% equity return recommendation is combined with the Company's capital structure and debt cost rate projected at December 31, 2020, it results in a recommended return on rate base investment as follows for the DEU request:

[4] Each cost of equity capital estimates is discussed in the testimony and is presented in the direct testimony in Exhibits (OCS-3.7), (OCS-3.8), OCS-3.9), and (OCS-3.10).

Table 2

Recommended Capital Structure and Cost Rates for

Dominion Energy Utah[5]

DESCRIPTION	RATIO	COST	WEIGHTED COST
LONG-TERM DEBT	45.00%	4.34%	1.953%
COMMON EQUITY	55.00%	9.10%	5.005%
TOTAL CAPITAL	100.00%		6.958%

In my opinion, these recommended return levels (9.1% equity return and 6.958% overall cost of capital) continue to be consistent with current market capital costs in the utility industry and consistent with just and reasonable rates for customers. My analyses of the Company's requested and Mr. Hevert's recommended 10.50% equity return and overall return request of 7.728% (see DEU witness Stephenson direct testimony at page 20), including analysis of the rebuttal testimony and DEU updates, indicates that the Company's request is overstated and is not consistent with just and reasonable rates for customers given current market capital costs.

Q. HAVE YOU UPDATED YOUR ANALYSIS IN THIS CASE?

A. Yes. I have updated each model and as I stated earlier, I have removed Chesapeake Utilities Corp from the comparable group as Chesapeake no longer generates at least 60% of its income from regulated gas operations. The results of this update is shown in the following table.

[5] See Direct Testimony at Exhibit OCS 3.11.

Table 3

Updated Cost of Equity Estimates[6]

MODEL	RANGE	MIDPOINT
DCF Model	8.97% - 9.50%	9.24%
Two-stage DCF	9.17% - 9.52%	9.35%
CAPM	8.62% - 8.83%	8.73%
ECAPM	9.49% -9.65%	9.57%
Bond Risk Premium	8.99% - 9.00%	9.00%
Average All Models		9.178%

The updated analysis including the removal of Chesapeake Utilities Corp from the comparable group increases the average results by approximately 9 basis points (9.09% Table 1 compared to 9.18% Table 3).

Based on my analyses I make the following conclusions and recommendations:

(i) A return of 9.1% on shareholder equity is consistent with current market capital cost requirements and is more than adequate for the Company to maintain its financial integrity and creditworthiness;

(ii) The Company's cash flows and liquidity at an overall rate of return on rate base investment of 6.958% is more than adequate to meet cash operating and construction requirements;

(iii) The Company's overall cost of capital, employing the Company's proposed capital structure and cost rates for debt and my recommended equity return of 9.1%, to be earned on rate base investment should be set at 6.958% for setting just and reasonable rates for customers in this proceeding;

[6] See Exhibits (OCS-3.5S through OCS-3.8S) Attached.

(iv) The Company's proposed 10.50% return for equity shareholders is an overstatement of the required return on equity to hold and attract equity capital;

(v) The Company's proposed 7.73% overall return on investment is overstated and should not be adopted as representative of the Company's cost of capital requirements; and

(vi) DEU's rebuttal analysis fails to support a cost of equity substantially above the current market cost of equity and is over 80 basis points above current average authorized returns around the country.

Q. AT PAGE 4, LINE 66 OF HIS REBUTTAL TESTIMONY, MR. HEVERT CLAIMS THAT NO ONE FINANCIAL MODEL IS MORE RELIABLE UNDER ALL MARKET CONDITIONS. PLEASE COMMENT.

A. Mr. Hevert states "[i]t is important to keep in mind that no one financial model is more reliable than others at all times and under all market conditions." As a general matter his statement is correct. However, a review of Mr. Hevert's rebuttal testimony at page 4, Table 1 (reproduced below) shows the results from four different witnesses employing similar cost of capital models concluding very similar results in the 9.0% equity return range. Only Mr. Hevert using these similar financial models to estimate equity cost, but employing his unique assumptions, arrives at an outlier recommendation at 10.50%. These results suggest it is not the models that should be of concern. Instead it is Mr. Hevert's assumptions and application of the models that have led to the outlier result. I addressed in my direct testimony the problems with Mr. Hevert's analysis.

Mr. Hevert's Rebuttal Table 1: Summary of ROE Recommendations

Witness	ROE Range		ROE Recommendation
	Low	High	
Mr. Coleman (Division)	8.09%	9.55%	9.25%[4]
Mr. Lawton (OCS)	8.55%	9.68%	9.10%[5]
Mr. Gorman (FEA)	8.70%	9.00%	9.00%[6]
Mr. Oliver (ANGC)	8.50%	9.50%	9.50%[7]
Mr. Higgins (UES)	NA	NA	NA[8]
Mr. Hevert (DEU)	9.90%	10.75%	10.50%

4 Direct Testimony of Casey J. Coleman, at 17.
5 Direct Rate of Return Testimony of Daniel J. Lawton, at 3.
6 Direct Testimony and Exhibits of Michael P. Gorman, at 68; low recommendation represents his Risk Premium-based and CAPM-based estimates, and the high recommendation represents his DCF-based recommendation. *See*, Mr. Gorman's Table 10.
7 Direct Testimony of Bruce R. Oliver, at 4.
8 Mr. Higgins does not perform an independent analysis of the Company's Cost of Equity.

SECTION III: <u>RESPONSE TO MR. HEVERT'S REBUTTAL ANNALYSIS</u>

Q. WHAT ISSUES DO YOU ADDRESS IN THIS SECTION OF YOUR TESTIMONY?

A. In this part of my testimony I address several comments and arguments made by Mr. Hevert in his rebuttal testimony that are specific to my recommendations in this case. These issues include:

- the current level of authorized equity returns for gas utility operations,
- the level of interest rates and
- the impact of the cost of equity on DEU's financial metrics.

Q. MR. HEVERT STATES AT PAGE 28, LINES 523 TO 525 OF HIS REBUTTAL TESTIMONY THAT YOUR RECOMMENDED 9.1% EQUITY RETURN IS OUT OF LINE WITH THE 9.7% AVERAGE CURRENT AUTHORIZED EQUITY RETURN FOR A GAS UTILITY. DO YOU AGREE?

A. No. I do not agree. Mr. Hevert's analysis tells only half the story, is incomplete, and the facts discussed below support my argument. First, the average authorized return on equity for gas utilities was 9.68% for cases decided in 2019.[7] Second, what is equally important is that the average allowed equity ratio for gas utilities in the first nine months of 2019 was 52.52%.[8] This means there is less financial risk for companies such as DEU with a 55% equity ratio. In other words, the average authorized equity return for a company with a 52.52% equity ratio is not directly comparable to DEU with a 55% equity ratio.

Q. CAN YOU POINT TO STUDIES IN FINANCIAL LITERATURE THAT EVALUATE THE IMPACT OF INCREASED FINANCIAL LEVERAGE IN THE CAPITAL STRUCTURE AND EQUITY COST?

A. Yes. There are numerous studies in the financial literature, both empirical and theoretically based, that attempt to quantify the effects of leverage on common equity costs.[9] These studies suggest an increase in common equity costs in a range of 7.6 to 13.8 basis points for every one percent increase in the debt ratio within the 40% to 50% range of leverage.[10] Thus, on average, there is about a 10.7 basis point increase [(7.6% + 13.8%)/2] in equity cost for every 1% increase in debt in capital structure.[11]

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[7] American Gas Association, Rate & Regulatory Update (July 1 through September 30, 2019) at 1. Also see https://www.aga.org/rate-alerts.
[8] American Gas Association, Rate & Regulatory Update (July 1 through September 30, 2019) at 1. Also see https://www.aga.org/rate-alerts.
[9] See Morin, Roger: New Regulatory Finance, Public Utility Reports, 2006, at 468-469.
[10] See Morin, Roger: New Regulatory Finance, Public Utility Reports, 2006, at 468-469.
[11] See Morin, Roger: New Regulatory Finance, Public Utility Reports, 2006, at 468-469.

Q. DOES THE FACT THAT THE AVERAGE 2019 ALLOWED CAPITAL STRUCTURE HAS A 52.52% EQUITY RATIO WHILE THE COMPANY'S APPLICATION EMPLOYED A 55% EQUITY RATIO IMPLY THAT DEU IS LESS RISKY IN TERMS OF FINANCIAL RISK THAN THE 2019 GROUP FOR WHICH THE AVERAGE AUTHORIZED RETURN WAS DETERMINED?

A. Yes. The Company's 55% equity level exceeds the group (2019 company group employed to determine the average authorized return) equity average. Thus, DEU's financial risks are less than the risks faced by the companies that produced the 2019 average authorized 9.68% equity return. The 2.5 percentage point difference (55% equity ratio - 52.5% equity ratio) translates into about a 34.5 basis points (2.5 percentage points x 13.8 basis points)[12] equity cost reduction for the Company relative to the 2019 authorized return results. I have rounded the adjustment to 35 basis points.

The average authorized return for the first nine months of 2019 was 9.68% for gas utilities that on average had a capital structure with 52.5% equity. Adjusting the 2019 average authorized equity return to be comparable to a company with a 55% equity ratio implies a 9.33% equity return, which is quite close to my recommended 9.1% equity return. On the other hand, Mr. Hevert's recommended 10.5% equity return remains an outlier to what Commissions around the country are authorizing. Mr. Hevert provides no reasonable basis to award such an enormous annual profit to DEU.

Q. ARE YOU FAMILIAR WITH A RECENT COST OF CAPITAL DECISION THAT SUPPORTS A LOWER EQUITY RATE AND IS RELEVANT IN THIS CURRENT CASE?

A. Yes. On November 21, 2019, the State Corporation Commission of Virginia issued a Final Order for Virginia Electric and Power Company in Case No. PUR-2019-00050 and concluded an equity range of 8.3% to 9.3% and a point estimate of 9.2% was appropriate

[12] This calculation employs the upper end of the 7.6 to 13.8 basis point adjustment range discussed above.

and supported by the evidence.[13] This recent case is relevant because Virginia Electric and Power Company is part of the overall Dominion operations and Mr. Hevert was the cost of capital witness recommending a 10.75% equity return in this recent case. The Virginia Commission did not look kindly on Mr. Hevert's recommended equity range of 10.0% to 11.0% with a point estimate of 10.75% and stated the following:

> Dominion's cost of equity of 10.0% to 11.0% represents neither the actual cost of equity in the marketplace nor a reasonable ROE for the Company. Nor is Dominion's proposed ROE of 10.75% consistent with the public interest. … Moreover, the Commission notes that Company witness Hevert proposes certain methodologies that the Commission has previously discounted or rejected, and for which we continue to give little or no weight.[14]

Q. DO YOU HAVE ANY COMMENTS REGARDING MR. HEVERT'S DISCUSSION AT PAGE 29 (LINE 535) THROUGH PAGE 30 (LINE 551) IN HIS REBUTTAL TESTIMONY OF CAPITAL MARKET CONDITIONS AND INTEREST RATES?

A. It appears that while Mr. Hevert agrees that interest rates are "low relative to historical levels", he asserts that the equity returns for regulated gas utilities do not "follow in lock-step."[15] While it is true equity returns and interest rates are not linearly related in that they change in the exact same amount at the same time, evidence shows that when interest rates are low, declining equity costs are not far behind. They may not move by the same magnitude but they certainly tend to move in the same direction. The supporting evidence of the interest rate and authorized return relationship can be found in Exhibit OCS 3.8S. From 1981 through 2018, 30-year U.S. Treasury bond yields have declined and authorized

[13] Commonwealth of Virginia State Corporation Commission, Virginia Electric and Power Company Application For the determination of the fair rate of return on common equity pursuant to § 56.585.1:1 C of the Code of Virginia Case No. PUR-2019-00050, Final Order at page 5, (November 21, 2019) at page 5.
[14] Commonwealth of Virginia State Corporation Commission, Virginia Electric and Power Company Application For the determination of the fair rate of return on common equity pursuant to § 56.585.1:1 C of the Code of Virginia Case No. PUR-2019-00050, Final Order at page 5, (November 21, 2019) at page 6.
[15] Rebuttal testimony Mr. Hevert at page 29 lines 541 – 542.

returns have decreased as well, albeit at a slower rate.

As discussed at page 10 of my direct testimony, monetary policy is expected to continue to be accommodative with low interest rates. Thus, one would reasonably expect equity cost requirements to remain low as well.

As to Mr. Hevert's assertion that treasury yields are increasing despite Federal Reserve actions to lower the federal funds rate one must look at a longer view of interest rates before concluding the Federal Reserve actions have failed policy goals. The Federal Reserve cuts to the federal funds rate started on July 31, 2019 and continued on September 18, 2019 and October 31, 2019. The current 30-year U.S. Treasury yield is 2.2% - a year ago the same yield was 3.36%.[16] Monetary policy is having an impact on interest rates and capital costs.

Q. AT PAGE 42, LINES 770 TO 781 OF MR HEVERT'S REBUTTAL HE CHALLENGES THE ROBUSTNESS OF THE DEU *PRO FORMA* FINANCIAL METRICS WITH YOUR 9.1% EQUITY RETURN. PLEASE COMMENT.

A. Mr. Hevert's first concern is that one *pro forma* metric is "barely within the lower-bound of S&P's range for an 'A' rating."[17] Mr. Hevert points out that with his recommended 10.5% equity return the pro forma metrics are "safely within the 'A' range."[18] Mr. Hevert's argument suggests that while a 9.1% equity return will maintain DEU's "A" rating and financial integrity, apparently there is not enough room or cushion to safely stay within the financial metric boundaries. Given that a 10.5% equity return versus a 9.1% equity return would provide DEU approximately $14 million[19] more in profits and cash flows per year Mr. Hevert concludes his 10.5% equity return is a better alternative.

Mr. Hevert's argument has no merit. He acknowledges that a 9.1% equity return would maintain DEU's financial integrity and be within the "A" range for financial metrics. But in rebuttal, Mr. Hevert now suggests an additional margin of safety above what is reasonable or needed to assure maintenance of financial metrics. So, he recommends a $14

[16] Exhibit OCS 3.1S November 2018 and October 2019.
[17] Mr. Hevert Rebuttal testimony at page 42 line 774-775.
[18] Mr. Hevert Rebuttal testimony at page 42 line 774-775.
[19] See Exhibit OCS 3.9S.

million profit adder for safety or cushion. (It should be noted that a $14 million profit adder increases rates by about $17.8 million to account for taxes. See Exhibit OCS 3.9S.) Mr. Hevert's approach is not cost based, is not sound regulatory practice and would lead to unjust and unreasonable rates.

Mr. Hevert's second reason for safety or financial cushion is that you cannot assume that the Company will actually earn its "authorized return, and that its Funds From Operations will not be diluted by regulatory lag, additional capital spending, or any other factors that dilute earnings and cash flow."[20] It is up to the Company to control spending. If circumstances get beyond Company control then the mechanism is to file a new case supporting a rate increase. Mr. Hevert's proposal of providing additional cushion profits is not fair to customers and does not incentivize the Company to control costs.

Q. STARTING AT PAGE 35 (LINE 660) THROUGH PAGE 41 (LINE 769) OF MR. HEVERT'S REBUTTAL, HE DEVELOPS A DISCUSSION OF THE BOND RATINGS PROCESS. PLEASE COMMENT.

A. I agree that a bond rating review considers a broad range of factors beyond cash flow financial metrics. But my analysis was not to review DEU's bond ratings, but rather an analysis of the impact of a regulatory equity return decision would have on cash flow metrics. Mr. Hevert's rebuttal at pages 35 through 41, while interesting, has nothing to do with my testimony or analysis in this case. A bond rating review considers in addition to financial cash flow metrics other qualitative and quantitative factors. Such additional factors would consider the company's regulatory framework, ability to recover authorized costs, and diversification. Such qualitative factors could not be considered in the context of a rate proceeding. Instead, the one quantitative factor that is impacted by a rate case are the cash flows and financial metrics. That is what I address in my direct testimony.

Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

A. Mr. Hevert's equity return calculations are overstated and do not represent market capital cost or current authorized equity returns. Mr. Hevert's updated analysis suffers the same

[20] Mr. Hevert Rebuttal testimony at page 42 line 777-780.

infirmities that were contained in his direct testimony. I previously addressed these problems with Mr. Hevert's analysis in Section XI of my direct testimony and will not repeat those arguments here.

Market evidence on capital costs continues to show low yields by historical standards.[21] A review of 2019 average authorized equity returns for gas utilities shows authorized equity returns are also low by historical standards.[22] Moreover, a recent Dominion Energy case in Virginia concluded the current market equity return for a utility is in the range of 8.3% to 9.3% before settling on 9.2%.[23] Like his direct testimony Mr. Hevert's rebuttal testimony and analysis fails to support his recommendations in this case.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes.

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[21] See Exhibit OCS 3.1S and 3.8S.

[22] See Exhibit OCS 3.10S AGA Rate and Regulatory Update (July 2019 – September 2019).

[23] Commonwealth of Virginia State Corporation Commission, Virginia Electric and Power Company Application For the determination of the fair rate of return on common equity pursuant to § 56.585.1:1 C of the Code of Virginia Case No. PUR-2019-00050, Final Order at page 5, (November 21, 2019) at page 5. See Exhibit OCS 3.11S.