

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

**In The Matter of the Application of Rocky §
Mountain Power for Authority to Increase §
Its Retail Electric Service Rates in Utah §
and for Approval of Its Proposed Electric §
Service Schedules and Electric Service §
Regulations, Consisting of a General Rate §
Increase of Approximately \$161.2 Million §
Per Year, and for Approval of a New §
Large Load Surcharge §
§
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§**

**Docket No. 07-035-93
Surrebuttal Rate of Return
Testimony of
Daniel J. Lawton
For the Committee of
Consumer Services**

May 12, 2008

DOCKET NO. 07-035-93

Committee of Consumer Services Witness:

Daniel J. Lawton

Exhibits CCS 3.1 SR through 3.3 SR

May 12, 2008

**DIRECT TESTIMONY OF
DANIEL J. LAWTON**

1 **SECTION I: INTRODUCTION/BACKGROUND**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Daniel J. Lawton and my business address is 816 Congress Avenue, Suite
4 1120, Austin, Texas 78701.

5 **Q. ARE YOU THE SAME DANIEL LAWTON WHO PREVIOUSLY SUBMITTED**
6 **DIRECT TESTIMONY ON RATE OF RETURN ISSUES ON BEHALF OF THE**
7 **COMMITTEE OF CONSUMER SERVICES IN THIS PROCEEDING?**

8 A. Yes, I am.

9 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

10 A. The purpose of my surrebuttal testimony is to: (i) address incorrect statements made in
11 the rebuttal testimony of Rocky Mountain Power (“RMP” or “Company”) witnesses A.
12 Richard Walje, Bruce N. Williams and Samuel C. Hadaway; (ii) explain why Dr.
13 Hadaway’s updated cost of equity recommendation is overstated and unreasonable; and
14 (iii) address the numerous errors contained in Dr. Hadaway’s adjustment to my original
15 analysis.

16 **Q. DO YOU HAVE ANY COMMENTS REGARDING THE REBUTTAL**
17 **TESTIMONY OF A. RICHARD WALJE?**

18 A. Yes. Mr. Walje asserts, without analysis, that because I am proposing a return on equity
19 below the requested 10.75% level that I have failed to account for the business risk faced
20 by the Company. (See Walje rebuttal testimony at 1: 11-15).

21 As I discuss in my direct testimony, updating the Company’s cost of capital analysis,
22 based on more current data, supports a 9.85% return on equity. Business risks have not
23 been ignored in my analysis, instead current capital market conditions have been
24 recognized. Only Mr. Walje’s failure to recognize the fact that the Company’s cost of
25 capital analysis does not support a 10.75% equity return leads him to his erroneous
26 conclusion regarding business risk.

27 **Q. PLEASE ADDRESS THE REBUTTAL TESTIMONY OF MR. BRUCE N.**
28 **WILLIAMS.**

29 A. Mr. Williams' disagrees that the interest cost of the Company's proposed pro forma 2008
30 long-term debt issue should be changed. (See Williams Rebuttal at 2:33-40) According
31 to Mr. Williams, this debt issuance may cost 1 basis point more than the original
32 projection *i.e.* 6.53% versus 6.52%.

33 While I agree that the Company cannot borrow at the U.S. Treasury bond rate and I never
34 suggested RMP could borrow at such rates, I am suggesting that the cost of debt will be
35 in the 6.07% range as I outlined in my direct testimony. Furthermore, the Company plans
36 on issuing this debt by the end of 2008. Witness Hadaway's rebuttal exhibits show that
37 corporate borrowing cost is not projected to increase in 2008. (See Hadaway Rebuttal
38 (SCH-2R)). Thus, it would appear the Company's own rebuttal evidence contradicts Mr.
39 Williams' analysis and instead supports the testimony I presented earlier in this case.

40 **Q. WHAT COMMENTS DO YOU HAVE REGARDING DR. HADAWAY'S**
41 **REBUTTAL?**

42 A. As a general matter, Dr. Hadaway has taken the position that no matter how economic
43 conditions change or how out of date his analysis may be he can put together an analysis
44 that supports his original recommendation. Dr. Hadaway accomplishes this by ignoring
45 the evidence in the market and his own evidence in his rebuttal testimony. Where his
46 models no longer work to his advantage, for example capital asset pricing model
47 ("CAPM"), he drops them from consideration and claims the CAPM results "are not
48 consistent with either [the higher] discounted cash flow ("DCF") or traditional risk
49 premium" results. (Hadaway Rebuttal at 17:351-352).

50 To see how inconsistent Dr. Hadaway is with his reasoning for abandoning his CAPM
51 results one only need to examine Dr. Hadaway's rebuttal at page 17:347-351 to lines 356-
52 362. His argument for ignoring his own CAPM analysis is that "government monetary
53 policies...have pushed Treasury bond interest rates down...In this environment CAPM
54 estimates of return on equity ("ROE")...are not reliable." But, on the same page of
55 rebuttal testimony Dr. Hadaway uses these same unreliable Treasury rates to estimate
56 projected single-A rated interest rates for his risk premium analysis. (See Hadaway
57 Rebuttal at 17:356-362 and Exhibit RMP___ (SCH-8R) at footnote 2). Apparently, the

58 impact of the Federal Reserves Monetary Policy on Treasury rates is only detrimental to
59 Dr. Hadaway's updated CAPM results – since he obviously employs Treasury rates in
60 other parts of his analysis.

61 **Q. AT PAGES 4 THROUGH 6 OF HIS REBUTTAL TESTIMONY DR. HADAWAY**
62 **DISCUSSES CORPORATE INTEREST RATE SPREADS. DO YOU HAVE ANY**
63 **COMMENTS ON THIS ISSUE?**

64 A. Yes. First, I disagree with his conclusion that the recent increasing difference between
65 corporate borrowing costs and rates on U.S. Treasury bonds are signaling increased costs
66 for corporate borrowing. For example, included in my Exhibit CCS 3.1 SR is an analysis
67 of corporate risk spreads on an annual basis for the period 1993 to 2007. In the years
68 2001-2003 the risk spreads were the largest, but the cost of borrowing for corporate debt
69 declined during this period. Treasury rates were declining more rapidly than corporate
70 borrowing rates causing the increase in the spread between corporate borrowing costs and
71 Treasury bond rates.

72 It is interesting to note that during 2001 when the risk spread increased significantly over
73 the 2000 level, the Federal Reserve was quite active and lowered the Federal Funds Rate
74 11 times. The historical changes to the Federal Funds rate are shown in my Exhibit CCS
75 3.2 SR. Because Treasury rates dropped more than corporate borrowing rates during this
76 period the spread or difference between the two rates became larger. However, corporate
77 borrowing cost did not increase, it in fact decreased albeit more slowly than the Treasury
78 rates.

79 **Q. HAS THE FEDERAL RESERVE BEEN ACTIVELY REDUCING THE**
80 **FEDERAL FUNDS RATE AS PART OF MONETARY POLICY?**

81 A. Yes, as can be seen in my Exhibit CCS 3.2 SR, since September 18, 2007 the Federal
82 Funds rate has been lowered seven times in seven months from 5.25% to the current
83 2.0% level. This has resulted in declining cost rates for Treasury bonds causing the
84 spread relative to corporate costs to grow, but does not mean corporate borrowing costs
85 are increasing.

86 **Q. DR. HADAWAY STATES AT PAGE 12, LINE 242 OF HIS REBUTTAL**
87 **TESTIMONY THAT CORPORATE BORROWING COSTS ARE INCREASING,**
88 **DO YOU HAVE ANY COMMENTS?**

89 A. Not only is Dr. Hadaway wrong, his own evidence shows he is incorrect. For example, in
 90 his direct testimony Dr. Hadaway relied on a forecast that projected fourth quarter 2008
 91 corporate bonds to be at 6.5%.¹ Now that same forecast updated through March 2008,
 92 projects the fourth quarter 2008 corporate bond rate to be at 5.5%.² Given that the fourth
 93 quarter 2007 corporate borrowing rate is reported at 5.5% Dr. Hadaway's own data
 94 source projects no increase in corporate bond rates through 2008.

95 Dr. Hadaway's presentation of monthly historical data at Table 1³ of his rebuttal
 96 testimony fails to support his contention of increasing financing costs. Instead, the
 97 single-A borrowing costs at February and March 2008 is at or below the same levels as
 98 the summer of 2007 when the Company was putting this case together. Again, there is no
 99 support for the claim that corporate borrowing costs are increasing.

100 **Q. AT PAGE 6 LINES 105-111 OF DR. HADAWAY'S REBUTTAL TESTIMONY,**
 101 **HE CONTENDS RECENT STANDARD & POOR'S ("S&P") FORECASTS**
 102 **SUPPORT HIS INCREASING DEBT COST CLAIMS, PLEASE COMMENT.**

103 A. I discussed in my direct testimony the problems with relying on interest rate forecasts.
 104 For example, Dr. Hadaway has provided two forecasts of interest rates from S&P, one
 105 dated October 2007⁴ and the other dated March 2008⁵, or five months apart. The
 106 following is a comparison of the forecasts just five months apart:

Description	Oct. 2007 Est. for 2008	March 2008 Est. for 2008
10 Year Treasury	5.1%	3.7%
30 Year Treasury	5.3%	4.3%
New-Issue Corporate Bonds	6.2%	5.5%

107 What is obvious is that S&P has substantially lowered its estimates for 2008. Moreover,
 108 the newest forecast of 10-year and 30-year Treasury rates is consistent with current
 109 Treasury rates. Thus, there is no forecasted increase for these securities throughout 2008.

¹Dr. Hadaway direct testimony, Exhibit RMP__ (SCH 2) page 3 of 3.

² Dr Hadaway rebuttal testimony, Exhibit RMP__ SCH-2R, p.1. of 1.

³ *Id.* at page 5.

⁴ Hadaway direct testimony at (SCH 2) p. 3 of 3).

⁵ Hadaway rebuttal testimony at (SCH 2R) p. 1 of 1.

110 Instead of relying on the 2008 updated interest rate projections proposed in his direct
111 testimony, which I have shown are not increasing, Dr. Hadaway now asks the
112 Commission to consider 2009 interest rate estimates. I urge the Commission to decline
113 relying on such estimates. I have already established that the original estimates were
114 substantially overstated and there is no reason to believe the 2009 estimates are any
115 better. Moreover, this Commission when deciding the test year issue concluded, “[I]n
116 this time of expanded utility investment, potentially increasing costs, and greater
117 uncertainty of economic conditions, more frequent rate cases may be necessary to ensure
118 just and reasonable rates.” (emphasis added) In my opinion, reliance on 2009 interest
119 rate estimates in a time of “uncertainty of economic conditions” is not consistent with the
120 goal of ensuring “just and reasonable rates.”

121 **Q. DO YOU HAVE ANY COMMENTS REGARDING DR. HADAWAY’S UPDATED**
122 **ANALYSIS?**

123 A. Yes. Once again, Dr. Hadaway attempts to support an overstated return on equity by
124 relying on multiple averages of a Gross Domestic Product (“GDP”) growth history,
125 ignoring his CAPM results and adopting the updated results from his constant growth
126 DCF model which in his direct testimony he claimed produced unreasonable results. Dr.
127 Hadaway now asserts a DCF range of 10.4% to 11.3% with a 10.85% midpoint.

128 Simply employing more reasonable growth rate projections in Dr. Hadaway’s updated
129 analysis results in a DCF range of 10.1% to 10.2%. Updating the CAPM and Risk
130 Premium analyses indicate a cost of equity in the 9.4% range as shown in my Exhibit
131 CCS 3.3 SR. The midpoint of the DCF and CAPM and risk premium results employing
132 much of Dr. Hadaway’s updated data is 9.8% (9.4% to 10.2%).

133 **Q. WHAT ADJUSTMENTS DID YOU MAKE TO DR. HADAWAY’S UPDATED**
134 **ANALYSIS TO ARRIVE AT A 9.85% COST OF EQUITY?**

135 A. The complete analysis is presented in my Exhibit CCS 3.3 SR. For the traditional
136 constant growth I used the most current earnings per share forecasts by Zacks, Value
137 Line Investment Survey and at Yahoo Finance. The end result is an ROE of 10.2%. In
138 terms of the constant growth DCF employing historical GDP growth I have employed a
139 5.5% growth rate. I addressed this issue in my direct testimony and will not repeat those
140 arguments here. The ROE employing GDP growth results in an ROE of 10.2%.

141 For the two stage DCF, I employed Dr. Hadaway's updated data along with a 5.5% GDP
142 growth rate. The end results of this model indicate a 10.1% ROE.

143 **Q. DID YOU UPDATE THE CAPM AND RISK PREMIUM MODELS?**

144 A. Yes. These results are presented on my Exhibit CCS 3.3 SR. For the CAPM I performed
145 the exact same analysis presented in Dr. Hadaway's direct testimony except I employed
146 more current data. For the 30-year Treasury Bonds and three-month Treasury Bills I
147 employed the most recent three months of data (February – April 2008) from the Federal
148 Reserve website. The ROE results are 8.5% to 9.3% as shown in my Exhibit CCS 3.3
149 SR.

150 Lastly, the risk premium was calculated employing Dr. Hadaway's updated analysis,
151 except rather than employing forecasted 30-year Treasury rate data to estimate single-A
152 debt cost I employed the most recent 30-year Treasury rate data available.

153 The bottom line results for the DCF and risk premium/CAPM approaches is an ROE
154 range of 9.4% to 10.2%. The midpoint of that range is 9.85%.

155 **Q. WHAT ARE THE MAJOR DIFFERENCES BETWEEN YOUR ANALYSIS AND**
156 **DR. HADAWAY'S ANALYSIS?**

157 A. The key difference between our DCF analyses is the GDP growth rate. This Commission
158 will decide whether Dr. Hadaway's 6.5% based on an averaging of six different averages
159 is reasonable. Alternatively, a simple 20-year average of GDP growth for the period
160 1988-2007 produces a 5.5% GDP growth rate, which I recommend. A 5.5% growth
161 estimate is consistent with recent analysts forecast of earnings per share ("EPS") growth
162 for the comparable companies.

163 In terms of the CAPM approach that Dr. Hadaway now claims should be ignored, there is
164 no difference in methodology between our approaches. I simply use more current data
165 and I do not discard a model result based on some arbitrary bottom line that must be
166 achieved. In my opinion, the Commission should consider these CAPM ROE results.

167 Lastly, with regard to risk premium the only difference between Dr. Hadaway's and my
168 results is that he employs forecasted interest rates while my analysis relies on the most
169 recent actual results. Given that the original forecast presented by Dr. Hadaway was

170 quite wrong it is difficult to place much reliance on the new interest rate forecast for 2009
171 interest rate data.

172 In conclusion, if the Commission favors the DCF growth estimates I have presented and
173 current actual data rather than 2009 forecasts of interest rates I believe they will conclude
174 that Dr. Hadaway's estimates are overstated. In fact, utilizing these reasonable
175 assumptions which I employ specifically supports the 9.85% previously put forward by
176 the Committee.

177 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL**

178 A. Yes.