Docket No. 09-035-23

Utah Office of Consumer Services Witness:

Daniel J. Lawton

October 22, 2009

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power for Authority to Increase Its Retail Electric Utility Services Rates In Utah and for Approval of its Proposed Service Schedules and Electric Service Regulations	**§ § § § § § § § § § §**	**Docket No. 09-035-23** **Surrebuttal Rate of Return Testimony of Daniel J. Lawton For the Utah Office of Consumer Services**

October 22, 2009

SURREBUTTAL TESTIMONY OF
DANIEL J. LAWTON

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 701 Brazos St, Suite 500, Austin, Texas 78701.

Q. ARE YOU THE SAME DANIEL J. LAWTON WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of this surrebuttal testimony is to respond to the October 2009 rebuttal testimony of Company witnesses Bruce N. Williams and Samuel Hadaway.

Q. WHAT COMMENTS DO YOU HAVE WITH REGARD TO MR. WILLIAMS' REBUTTAL TESTIMONY?

A. I address Mr. Williams' testimony at pages 5:99 through 7:128. Specifically, Mr. Williams' claims that my "Exhibit OCS 1.10 takes a much more superficial approach to the calculation of financial metrics than employed by the rating agencies."[1] My Exhibit OCS 1.10 shows that the resulting financial metrics at my recommended 10% equity return are not very different from the results generated by the Company's requested 11.0% equity return. Thus, granting an equity return at 10% allows the Company to maintain a financial integrity level consistent with that proposed by RMP in its application.

In addition, the resulting financial metrics, whether at an 11% equity return or the 10% equity return I recommend, do not impair RMP's financial integrity. Further, Mr. Williams' own evidence supports the maintenance of a single A bond rating, which states that the "…A- corporate credit rating (CCR) on PacifiCorp reflects its 'excellent'

[1] Rebuttal Testimony B. Williams at 6:110-111.

business profile, evidenced by a diverse and growing service territory, and an 'aggressive' financial profile that reflects a large capital program and the need to shore up its cash flow metrics."[2]

Rating agencies are aware of how the regulatory process works and recognize that cash flow improvement follows the inclusion of capital additions in rates. Again, Mr. Williams' own evidence states, "Standard & Poor's Rating Services expects that management will achieve cash flow metrics more consistent with an 'A' category rating over the next several years."[3]

Q. IS IT UNUSUAL FOR A COMPANY'S CASH FLOW METRICS TO BE BELOW RATINGS GUIDELINES DURING LARGE CAPITAL EXPANSION PERIODS?

A. No it is not unusual, moreover it does not mean a bond rating downgrade will result. As noted above, rating agencies are fully informed of the regulatory process and how cash flow projections change when capital projects are completed and included in rates.

As I discussed in my direct testimony at 34:852, RMP fully intends to take advantage of newly enacted Utah Code Ann.§54-7-13.4, "Alternative cost recovery for major plant additions" and include major additions in rates without the need for major rate proceedings. Such single issue rate setting will accelerate cash flow improvement. As noted earlier, ratings agencies also recognize this will improve cash flow of the next several years.[4]

Q. AT PAGE 6, LINES 110-117, OF HIS REBUTTAL MR. WILLIAMS CRITICIZES YOU FOR FAILING TO IMPUTE $1 BILLION OF ADDITIONAL DEBT AND ABOUT $75 MILLION OF ADDITIONAL INTERST EXPENSE IN YOUR FINANCIAL METRICS ANALYSIS – DO YOU HAVE ANY COMMENTS?

A. Yes. While it is true that for many years Standard & Poor's has viewed certain obligations such as power supply agreements (PPA) as a debt like financial obligation for purposes of calculating financial metrics that does not mean that a regulator should do the

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[2] Rebuttal Testimony B. Williams Exhibit RMP __ (BNW-1R) page 2 of 10.
[3] *Id.* at 2-3.
[4] *Id*

same. Instead, in rate setting and evaluation of cost obligations – regulatory authorities consider only the just and reasonable costs in setting rates. Thus, the inclusion of additional debt obligations and phantom interest expense in the evaluation of a reasonable return is just not appropriate. Certainly, utility companies would object to including phantom interest expense as an additional tax deductible expense to lower revenue requirements.

Again, Mr. Williams misses the point of my Exhibit OCS 1.10. I did not include phantom debt or interest in the financial metric calculation in either the Company's 11% equity return request or my proposed 10% equity return request and the result is a marginal difference in results. If the same phantom debt and interest is included in the Company's request and my proposal – the relative difference between an 11.0% and a 10% equity return remains the same.

Q. PLEASE CONCLUDE YOUR COMMENTS REGARDING MR. WILLIAMS REBUTTAL TESTIMONY.

A. The resulting financial metrics of the Company when a 10% equity return is authorized continue to support an "A" rating. Moreover, various financial measures change only marginally when my recommended 10% equity return is employed. While it is true that S&P's view of a standalone PacifiCorp has current financial metrics consistent with a "BBB" rating, S&P also recognizes that one of the benefits of the MidAmerican Energy Holdings, Co. ("MEHC") purchase is additional credit support for PacifiCorp. This was a claimed benefit of the PacifiCorp acquisition by MEHC. Further, it is true that the capital expansion of PacifiCorp and specifically RMP is being included in rates and enhancing cash flow metrics.

The bottom line is that a 10% equity return will not harm RMP's financials as the financial metrics continue to support its "A" rating.

Q. DO YOU HAVE ANY COMMENTS REGARDING DR. HADAWAY'S REBUTTAL TESTIMONY?

A. Yes, I have a number of comments.

Q. HAS DR. HADAWAY UPDATED HIS COST OF CAPITAL ANALYSIS?

A. Yes he has. While Dr. Hadaway continues to support his 11.0% recommended equity return – his own updates show declining capital costs.[5] Dr. Hadaway's own updates indicate his initial DCF analysis should be lowered by about 50 basis points and his initial risk premium results should be lowered by about 30 to 40 basis points.

Despite these declines in capital costs and Dr. Hadaway's acknowledgement that utility interest rates have dropped,[6] he insists on maintaining his 11.0% equity return – because his original recommendation of 11.0% "…was never based on those extreme data."[7]

Q. IF DR. HADAWAY'S 11.0% EQUITY RETURN RECOMMENDATION WAS NOT BASED ON WHAT HE CATEGORIZES AS "EXTREME" RESULTS, WHAT DID HE BASE HIS RECOMMENDATION ON?

A. I relied on Dr. Hadaway's statements in his direct testimony where he states:

> "…the lower end of the DCF range and equity risk premium estimates based on historical risk premium relationships represent very conservative estimates of the cost of equity. From this perspective, and with consideration of the Company's large on-going capital requirements, the minimum fair cost of equity capital for RMP is 11.0 percent."[8]

The low end of his DCF in the direct testimony is 11.5%.[9] The low end of his historical risk premium estimates of 10.17% to 10.77% average about 10.5%.[10] Thus, Dr. Hadaway's original range was 10.5% - 11.5% and he appears to have selected the 11.0% midpoint.

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[5] Rebuttal Testimony Samuel Hadaway at 2:27-35.
[6] *Id.* at 2:41.
[7] *Id.* at 2:43.
[8] Hadaway direct testimony at 35:752-756.
[9] *Id.* at 35.
[10] *Id.*

Now, in rebuttal he appears to abandon his direct testimony and claim his 11.0% recommendation "…was never based on those extreme data."[11] His rebuttal testimony is not consistent with his direct testimony.

Q. HAD DR. HADAWAY PERFORMED A COMPLETE UPDATE AND EMPLOYED THE LOWER END OF HIS HISTORICAL RISK PREMIUM AND DCF RESULTS IN THE SAME FASHION AS OUTLINED IN HIS DIRECT TESTIMONY, IS AN 11.0% EQUITY RETURN SUPPORTED?

A. No. Dr. Hadaway concedes that the low end of his updated DCF is 11.0%. Dr. Hadaway's historical risk premium calculations employing the Ibbotson Risk Premium of 3.7% to 5.5% combined with Dr. Hadaway's updated Single "A" debt cost estimate of 5.96% indicates a risk premium estimate of 9.66% to 11.46%. Dr. Hadaway's other updated historical risk premium estimate shown at his Exhibit __(SCH-6R) shows a range of 10.47% to 11.21%. Relying on the lower end of the two risk premium results indicates a cost of equity of 9.66% to 10.47% or about 10%. Thus, Dr. Hadaway's updates, if done in the same fashion as his direct testimony, indicate a DCF result of 11.0% and a risk premium result of 10%.

The lower end of Dr. Hadaway's analyses is consistent with my recommended range of 9.5% to 10.5%. Moreover, my recommended 10% equity return is consistent with a corrected update of Dr. Hadaway's analysis.

Q. AT PAGE 14 OF HIS REBUTTAL TESTIMONY DR. HADAWAY STATES THAT CAPM RESULTS SHOULD BE DISMISSED – DID YOU RELY ON THE CAPM RESULTS?

A. No. Dr. Hadaway is attempting to create an issue where no issue exists. If you look at page 28 of my direct testimony I summarize the results of each analysis. Based on the range of results, I concluded the "…relevant range of results indicates a cost of equity from 9.5% to 10.5%, with 10.0% as a midpoint."[12] (Technically the relevant range is 9.52% to 10.62%; I took the liberty of rounding the ranges). By not including any results

[11] Hadaway Rebuttal Testimony at 2:43.
[12] Lawton Direct Testimony at 28:718-719.

below 9.5% in the “relevant range” I specifically excluded the ECAPM results. Moreover, at page 27, lines 707-716 of my direct testimony I again pointed out only the higher end of the ECAPM should be considered reasonable estimates. But, the end result is that I did not employ any of the ECAPM or CAPM estimates in my estimate of final relevant cost of equity range for RMP, and my direct testimony is clear on this matter.

Q. AT PAGE 3 OF HIS REBUTTAL TESTIMONY DR. HADAWAY CRITICIZES YOU FOR RESORTING TO THE GEOMETRIC MEAN RISK PREMIUM TO ARRIVE AT A LOWER ESTIMATE OF ROE – DO YOU HAVE ANY COMMENTS?

A. Yes. I did not “resort” to employing the geometric mean risk premium – the geometric average is the appropriate measure to employ. Moreover, Dr. Hadaway’s direct testimony at page 34, lines 733 to 735 uses the very same geometric average in his own risk premium analysis. This is how Dr. Hadaway calculates his 10.17% risk premium equity return result shown at page 34, line 737, page 35, Table 4, and in part relies upon this 10.17% result in making his final recommendation.[13]

Given Dr. Hadaway’s significant reliance on employing the geometric mean risk premium – I am baffled by his criticism when I employ the same approach.

Q. AT PAGE 10 OF HIS REBUTTAL TESTIMONY DR. HADAWAY SUGGESTS YOUR RECOMMENDED EQUITY RETURN IS BELOW THE AVERAGE AUTHORIZED RETURNS ALLOWED IN 2009, DO YOU HAVE ANY COMMENTS?

A. Yes. While my recommendation is below the average authorized equity return, it does not mean my recommendation is not appropriate or is out of line with the main stream. Obviously, to average 10.29% (Quarter I) or 10.52% (Quarter II) some returns were below 10.29% or 10.52% and some above. Dr. Hadaway’s analysis of average authorized equity returns should not dictate whether a specific recommendation is high or low – each case must be judged on its facts and circumstances. Lastly, if we were to

[13] Hadaway Direct Testimony at page 2:38-43.

listen to Dr. Hadaway on this matter – then his 11.0% is about 50 basis points above the average authorized equity returns - but Dr. Hadaway never mentions this.

Q. AT PAGE 4, LINES 86-88 OF DR. HADAWAY'S REBUTTAL TESTIMONY HE STATES "OTHER PARTIES SEEM TO HOLD A MISTAKEN BELIEF THAT EQUITY CAPITAL COSTS FOR UTILITIES HAVE DECREASED, NOT INCREASED, OVER THE PAST SEVERAL MONTHS. THIS CONTENTION IS SIMPLY WRONG". DO YOU AGREE WITH DR. HADAWAY?

A. No, and once again Dr. Hadaway is inconsistent with the facts and realities of the market. Dr. Hadaway filed his direct testimony in June 2009. Now, several months later he files rebuttal testimony and states:

> My updated discounted cash flow (DCF) analysis indicates an ROE range of 11.0 percent to 11.5 percent, as compared to the DCF range in my June 23, 2009 direct testimony of 11.5 percent to 12.0 percent. …This analysis shows that my initial ROE recommendation was extremely conservative, given then existing market conditions,…[14]

Now, page 2 of his rebuttal concedes equity capital cost as measured by his own analyses have declined. He even points out how conservative his estimate was given the June 2009 time frame market conditions.

At page 4 of his rebuttal testimony, Dr. Hadaway shifts gears and concludes equity capital costs for utilities have not decreased.[15] Dr. Hadaway is once again arguing opposite and inconsistent positions albeit on different pages of his rebuttal.

Q. HAS DR. HADAWAY PROVIDED ANY CREDIBLE EVIDENCE THAT WOULD CAUSE YOU TO CHANGE YOUR RECOMMENDATION IN THIS CASE?

A. No. I recommend a 10% equity return and the evidence presented in this case supports a 10% equity return is a just and reasonable result. Moreover, Dr. Hadaway's own updated analysis supports a 10% equity return.

[14] Rebuttal testimony Hadaway at 2:27-34.
[15] *Id.* at 4:86-89.

I have also addressed earlier how Dr. Hadaway's rebuttal testimony is inconsistent with itself, inconsistent with his direct testimony such that little confidence can be had in his arguments. Moreover, I have shown how Dr. Hadaway has attempted to raise arguments or issues that are irrelevant or non-issues or has complained about my reliance on geometric mean risk premium estimates when he also relied on the same approach.

Dr. Hadaway has not rebutted my analysis and recommendations, but instead attempted to raise arguments that tend to confuse and distort the important issues this Commission is addressing in this case.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.