Docket No. 11-035-200

Utah Office of Consumer Services Witness

Daniel J. Lawton

Exhibits OCS 1.1SR through 1.3SR

July 18, 2012

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of its Proposed Electric Service Schedules and Electric Service Regulations	§ § § § § § § § § § §	**Docket No. 11-035-200** **Surrebuttal Rate of Return Testimony of Daniel J. Lawton For the Utah Office of Consumer Services**

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SURREBUTTAL TESTIMONY OF
DANIEL J. LAWTON

SECTION I: INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

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

A. Yes I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of this surrebuttal testimony is to address various claims and statements made in the rebuttal testimony of Mr. Williams and Dr. Hadaway on behalf of Rocky Mountain Power Company's ("RMP" or "Company") cost of capital request. In addition, Company witness Williams has updated the RMP overall cost of capital to reflect a recent, March 2012, Company issue of $100 million of long-term debt which has resulted in a change in overall long-term debt proposed by RMP. Given these updated long-term debt cost rates, I provide an updated overall cost of capital in this case.

SECTION II: RESPONSE TO RMP WITNESS BRUCE WILLIAMS

Q. HAVE YOU REVIEWED THE COMPANY'S RECENT FINANCING ACTIVITIES AND ADJUSTED COST OF LONG-TERM DEBT?

A. Yes, I have. At pages 2-3 of his rebuttal testimony, Mr. Williams addresses the March 2012 $100 million long-term debt issue at a cost of 2.95 percent. The proceeds from this issuance were primarily used to redeem about $83.9 million of pollution control revenue bonds having a weighted average coupon rate of 5.72 percent. The net impact of this transaction is to reduce the RMP long-term debt cost from 5.41[1] percent to 5.37 percent.[2]

Q. HAS THE COMPANY UPDATED THE REQUESTED OVERALL COST OF CAPITAL?

A. Yes. The Company has reduced its overall cost of capital from 7.91[3] to 7.89[4] percent. The Company's updated capital structure and cost rates are shown in the following table.

Table 1[5]
Rocky Mountain Power Cost of Capital

Description	Ratio	Cost	Weighted Cost
Long Term Debt	47.6%	5.37%	2.556%
Preferred Stock	0.3%	5.43%	0.016%
Common Stock Equity	52.1%	10.20%	5.314%
TOTAL	100.0%		7.89%

Q. DO YOU RECOMMEND THAT THE COMMISSION ADOPT THE UPDATED LOWER COST OF LONG-TERM DEBT IN SETTING THE OVERALL RETURN IN THIS CASE?

A. Yes, the updated lower cost of long-term debt should be included in the overall return established by the Commission in this proceeding. The following table reflects my updated capital structure and cost rates for this proceeding.

[1] Direct Testimony Bruce Williams at 2:34.
[2] Rebuttal Testimony Bruce Williams at 3:51.
[3] Direct Testimony Bruce Williams at 2:34.
[4] Rebuttal Testimony Bruce Williams at 3:51
[5] *Id*

Table 2
Rocky Mountain Power Cost of Capital

Description	Ratio	Cost	Weighted Cost
Long Term Debt	47.6%	5.37%	2.556%
Preferred Stock	0.3%	5.43%	0.016%
Common Stock Equity	52.1%	9.40%	4.897%
TOTAL	100.0%		7.4669%

My original recommended overall return of 7.4889%[6] has declined slightly to 7.4669% when the updated cost of long-term debt is reflected in my recommendation. I do not propose any other changes to my recommendation.

Q. MR. WILLIAMS, AT PAGE 9:161-163 OF HIS REBUTTAL TESTIMONY, CLAIMS THERE IS A "FLAW" IN YOUR CONCLUSION REGARDING THE COMPANY'S CREDIT METRICS – DO YOU HAVE A COMMENT?

A. Yes. There is no flaw in my conclusion concerning RMP's financial metrics, rather there is a typographical error at page 38:947 of my direct testimony, the designated bond rating reference of "B" should be an "A". All Mr. Williams had to do was to read the next sentence which states "The resulting financial metrics at a 9.4% equity return are consistent with the current single "A" bond rating"[7] to see that the analysis addressed a single "A" bond rating.

The bottom line is that the typographical error referring to ("B") rated bonds has no impact on my analyses or conclusions.

[6] Direct Testimony Daniel Lawton at 36:895
[7] *Id* at 38:948-949.

Q. DID MR. WILLIAMS HAVE OTHER COMMENTS WITH REGARD TO YOUR PROFORMA FINANCIAL METRICS OR FINANCIAL INTEGRITY ANALYSIS?

A. Yes. Mr. Williams states that my financial integrity evaluation fails to make various adjustments that ratings agencies make for purchase power and other long-term obligations and fails to model key credit metrics.[8]

Q. DO YOU HAVE ANY COMMENTS REGARDING MR. WILLIAMS' CLAIMS RELATED TO YOUR FINANCIAL INTEGRITY ANALYSIS?

A. Yes. First, with regard to S&P's imputation of debt and interest associated with purchase power and other obligations,[9] Mr. Williams is correct; I did not make such adjustments. First, I examined financial metrics employing Moody's benchmarks, not S&P's.[10] Moody's does not necessarily follow the same guidelines outlined by S&P. For example, Moody's guidelines state the following with regard to purchase power agreements:

> If a utility enters into a PPA for the purpose of providing an assured supply and there is reasonable assurance that regulators will allow the costs to be recovered in regulated rates, Moody's may view the PPA as being most akin to an operating cost. In this circumstance, there most likely will be no imputed adjustment to the debt obligations of the utility.[11]

It is also important to consider that in a regulatory rate setting perspective, purchase power agreements are not like debt. In a regulated rate environment rates are set to allow all reasonable and necessary costs (including PPA's) plus an opportunity to earn a reasonable return on investment. Regulatory authorities allow adequate opportunity to afford cost recovery including cost recovery for PPA's. Moreover, fuel cost and PPA cost recovery often receives added opportunity for recovery through rate mechanisms such as Energy Balancing Accounts ("EBA") recently approved in Utah.

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[8] Rebuttal Testimony Bruce Williams at 8:156-160.
[9] *Id* at 7:135-136
[10] See Exhibit OCS 1.9D
[11] Moody's Rating Methodology: Regulated Electric and Gas Utilities at 32 (August 2009).

To increase return and bolster financial metrics for risk of recovery of PPA's where, absent a prudence disallowance, there is little risk, given the recovery mechanisms, is just not appropriate. Moreover, any risk of disallowance due to imprudent action by management is not a customer risk, but rather a management/shareholder risk. Thus, Mr. Williams' criticism on this matter should be given no weight. While S&P may follow this adjustment path in evaluating financial ratios, the Commission should not follow such an approach as PPA recovery is at little risk.

Q. DO YOU HAVE ANY COMMENTS RELATED TO MR. WILLIAMS' CLAIM THAT YOU DID NOT MODEL KEY CREDIT METRICS?

A. Yes, Mr. Williams is incorrect. The two primary rating agencies that provide credit ratings for most utility companies are Moody's and Standard & Poors ("S&P") and both emphasize similar credit metrics. For example, among the key financial metrics considered by Moody's are: (i) cash from operations as a percentage of debt (CFO/Debt), (ii) cash from operations plus interest divided by interest (CFO/Interest), and (iii) Debt/Capitalization. Financial metrics such as CFO/Debt and CFO/Interest are measures of cash flow, while Debt/Capitalization measures the degree to which debt leverage is used to fund operations. These three financial metrics are presented in my direct testimony at Exhibit OCS 1.9D.

S&P employs three similar financial metrics in evaluating financial integrity and ratings of a company. For example, S&P employs (i) Funds From Operations as a percentage of Debt (FFO/Debt). This financial measure evaluates cash flow support of debt, which is similar to Moody's CFO/Debt measure. Another S&P metric is the size of debt compared to earnings before income tax, depreciation and amortization (Debt/EBITDA). This metric (Debt/EBITDA) is a measure of a company's ability to pay off debt and is similar to Moody's (CFO/Interest) metric. A third S&P financial metric is Debt to

Capital (Debt/Capital) and is the same indicator of financial leverage employed by Moody's as discussed earlier.

Q. HAVE YOU REVIEWED A RECENT S&P CREDIT RESEARCH REPORT FOR PACIFICORP?

A. Yes, I have reviewed the April 26, 2012 Standard & Poor's Credit Research Report for PacifiCorp. In that report S&P states that the A- corporate credit rating on PacifiCorp[12] reflects the company's "excellent" business risk profile and "significant" financial risk profile as measured by S&P's criteria.

In terms of cash credit metrics that S&P expects PacifiCorp to achieve for 2012 are as follows:

Metric	Measure[13]
FFO/Debt	20%
FFO/Interest	4.6%
Debt/Capitalization	51.0%

A review of my Exhibit OCS 1.2SR shows that all three credit metrics expectations are satisfied at a 9.4 percent equity return.

Q. DOES RMP ACHIEVE ADEQUATE METRICS UNDER YOUR UPDATED CAPITAL STRUCTURE AND RECOMMENDATION IN THIS CASE?

A. As stated above, the S&P short-run expectations for PacifiCorp and the S&P credit metrics benchmarks are met at a 9.4 percent return on equity. I have also included in this analysis the proposed adjustments to rate base and depreciation that are included in the OCS overall recommendation in this proceeding. The bottom line conclusion is that the Company's financial integrity will not be harmed or weakened by the rate recommendations in this case.

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[12] S&P rates PacifiCorp's first mortgage bonds as "A", a notch higher than the A- issuer credit rating. See Standard & Poor's Credit Research PacifiCorp (April 26, 2012) at 2.

[13] *Id*

SECTION III: <u>RESPONSE TO RMP WITNESS DR. SAMUEL HADAWAY</u>

Q. DO YOU HAVE ANY COMMENTS WITH REGARD TO DR. HADAWAY'S REBUTTAL?

A. Yes, I have a number of comments. Basically, Dr. Hadaway claims if you recalculate my analyses employing his unsupported growth rate inputs, the cost of equity range would be in excess of 10 percent.[14] While it may be an interesting academic exercise to perform such a calculation, I certainly do not agree that my growth rate assumptions need to be modified or changed. If anything – given current economic conditions, growth expectations may be declining further.

Q. PLEASE EXPLAIN WHY YOU BELIEVE CURRENT ECONOMIC CONDITIONS MAY CAUSE GROWTH EXPECTATIONS TO BE LOWER.

A. Following the recent June 20, 2012 Federal Reserve Open Market Committee the Federal Reserve stated:

> …growth in employment has slowed in recent months, and the unemployment rate remains elevated. Business fixed investment has continued to advance. Household spending appears to be rising at a somewhat slower pace than earlier in the year. Despite some signs of improvement, the housing sector remains depressed. Inflation has declined, mainly reflecting lower prices of crude oil and gasoline, and longer-term inflation expectations have remained stable.[15]

As a result of the most recent assessment of the economy and its slower growth, the Federal Reserve lowered near term and longer run GDP growth estimates, increased short-term (2012-2014) unemployment projected levels over the April projections and lowered short-term projections of inflation. I have included the Federal Reserve June 20, 2012 press release and updated economic projections in my Exhibit OCS 1.3SR.

The current economic reality is slower growth which does not support Dr. Hadaway's more robust growth expectations. While the economic outlook does not forecast another recession, the reality is one of cautious optimism and slower growth.

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[14] Rebuttal testimony Samuel Hadaway at 22:435-23:458.

[15] Board of Governors of the Federal Reserve System Press Release June 20, 2012.

Q. GIVEN DR. HADAWAY'S CLAIMS IN HIS REBUTTAL TESTIMONY AND THE RANGE OF ROE RECOMMENDATIONS OF THE PARTIES, WHAT GUIDANCE CAN YOU PROVIDE THE COMMISSION ON THIS MATTER?

A. In my opinion, that guidance has been provided by DPU witness Peterson at page 2:30-38 of his rebuttal testimony where he points out that three different witnesses (Lawton, Gorman and Peterson) approached the problem of estimating the current market expectation of cost of equity for an electric utility like PacifiCorp and "…in spite of somewhat different methodologies, data inputs and comparable companies, all of us came to similar conclusions. All three of us agree that the appropriate cost of equity point estimate for PacifiCorp should fall within a narrow range of 15 basis points (9.25 percent to 9.40 percent)."

Other factual evidence before this Commission is that the economy, while growing, is expanding at a slower rate than previous forecasts predicted. Thus, Dr. Hadaway's reliance on projections of short-term interest rate increases[16] should be discounted.

Lastly, Dr. Hadaway's own updated model results of 9.55 percent to 10.2 percent fall mostly below 10 percent.[17] There is just no good evidence to support Dr. Hadaway's claim that the current cost of capital exceeds 10 percent.

Q. AT PAGES 23 AND 24 OF HIS REBUTTAL TESTIMONY, DR. HADAWAY STATES YOUR ASSESSMENT OF UTAH REGULATORY MECHANISMS, LIKE MPA AND EBA, IS INCORRECT. DO YOU HAVE ANY COMMENTS?

A. Yes. There is no question that regulatory mechanisms like the EBA and MPA that assure regulatory recovery and limit regulatory lag associated with cost recovery reduce risk. A fundamental risk facing all businesses – including utility operations – is the risk associated with revenue and cost recovery. Regulatory mechanisms that assure and/or enhance this recovery eliminate this fundamental risk.

Ratings agencies such as S&P have addressed this issue and concluded that these regulatory recovery mechanisms support bond ratings.[18] S&P concluded:

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[16] Rebuttal testimony Dr. Hadaway at 8:115-118
[17] *Id* at 33:675-685

> …we believe innovative ratemaking techniques and alternatives to traditional base rate case applications and large rate hikes will become more critical to the utilities' ability to maintain cash flow, earnings power, and ultimately credit quality.[19]

Thus, while Dr. Hadaway may not believe that Utah's EBA and MPA are worthy of consideration the financial ratings community differs with his position.

S&P goes on to state that it views rate recovery mechanisms:

> …that allow for timely adjustment of rates to changing commodity prices and other expenses, outside of a fully litigated rate proceeding, as beneficial to utility creditworthiness.[20]

Both the EBA and MPA allow rate adjustments for changing prices and costs outside a fully litigated rate case proceeding. Both the EBA and MPA allow for timely recovery of costs. The evidence from the financial community does not support Dr. Hadaway's claims on this matter.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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[18] Standard & Poor's Ratings Direct, Recovery Mechanisms Help Smooth Electric Utility Cash Flow and Support Ratings (March 9, 2009).

[19] *Id* at 2

[20] *Id*