Docket No. 13-035-184

Utah Office of Consumer Services Witness

Daniel J. Lawton

May 22, 2014

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. 13-035-184** **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 12600 Hill Country Boulevard, Suite R-275, Austin, Texas 78738.

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 2014, Company bond issuance of $425 million of long-term debt at an all in cost rate of 3.759% resulting in a change in overall long-term debt, capital structure, and overall cost of capital proposed by RMP. Given these updated long-term debt cost rates and slight changes to the capital structure ratios, I provide an updated overall cost of capital based on my recommendations 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 2-4 of his rebuttal testimony, Mr. Williams addresses the March 2014, $425 million long-term debt issue at an overall cost of 3.759%. In addition, Mr. Williams also reduces the expected cost of the March 2015, $300 million pro forma long-term debt issue from 5.119% to 4.630%.[1] These adjustments by RMP witness Williams reflect the reality and continuation of the **declining interest rates and declining capital costs** that I discussed in my direct testimony and I address later in this surrebuttal testimony.

Q. HOW DOES THE COMPANY'S UPDATED OVERALL COST OF CAPITAL IMPACT RMP'S REQUEST IN THIS CASE?

A. The Company has reduced its cost of long term debt from 5.28% to 5.20%. In addition, the size of the March 2014 debt issue was larger than originally projected which has increased the Company's debt ratio from 48.38% to 48.55% (conversely reducing the Company's equity ratio from 51.60% to 51.43%). The Company's updated capital structure and cost rates are shown in the following table.

Table 1[2]
Rocky Mountain Power Updated Cost of Capital

Description	Ratio	Cost	Weighted Cost
Long Term Debt	48.55%	5.20%	2.53%
Preferred Stock	0.02%	6.75%	0.00%
Common Stock Equity	51.43%	10.00%	5.14%
TOTAL	100.0%		7.67%

The net impact of these adjustments is to reduce RMP's overall cost of capital from the original requested 7.72% to the revised proposed level of 7.67%.[3] The revenue requirement impact of this 5 basis point (7.72% - 7.67%) reduction in capital cost is about a $3.5 million annual reduction.[4]

[1] Rebuttal Testimony Bruce Williams at 3:54-60.
[2] *Id*
[3] Id. At 4:66-70.
[4] Id.

Q. DO YOU RECOMMEND THAT THE COMMISSION ADOPT RMP'S UPDATED LOWER COST OF LONG-TERM DEBT AND CHANGED CAPITAL STRUCTURE RATIOS 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.

Table 2
Recommended Rocky Mountain Power Cost of Capital

Description	Ratio	Cost	Weighted Cost
Long Term Debt	48.55%	5.20%	2.53%
Preferred Stock	0.02%	6.75%	0.00%
Common Stock Equity	51.43%	9.20%	4.73%
TOTAL	100.0%		7.26%

My updated recommended overall return of 7.26% has declined by 5 basis points (from 7.31%[5]) when the updated cost of long-term debt is reflected in my recommendation. I do not propose any other changes to my recommendation. My recommended 7.26% cost of capital in this case is also based on the Company's updated capital structure and my recommended 9.20% cost of equity as shown in Table 2 above.

Q. DID MR. WILLIAMS HAVE REBUTTAL COMMENTS WITH REGARD TO YOUR PRO FORMA FINANCIAL METRICS OR FINANCIAL INTEGRITY ANALYSIS?

A. Yes. Mr. Williams stated that my financial integrity evaluation fails to "utilize the current Standard & Poor's methodology, target ranges for ratios or debt adjustments."[6] Mr. Williams is correct; I did not employ the updated Standard & Poor's ("S&P") guidelines he references in his Exhibits RMP_(BNW2R through BNW 5R). Instead, as noted in my direct testimony at Exhibit OCS_1.11D, I examined financial metrics

[5] Direct Testimony Daniel Lawton at 37 Table 7
[6] Rebuttal Testimony Bruce Williams at 7:143-145.

employing the Moody's guidelines; I did not employ S&P metrics as asserted by Mr. Williams.[7] Moody's does not follow the same guidelines and metric calculation 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.[8]

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 receive added opportunity for recovery through rate mechanisms such as the Energy Balancing Account ("EBA") approved in Utah for RMP.

The bottom line is that Mr. Williams' criticisms regarding the changes in the S&P guidelines are not applicable to my testimony. It is true that two of the three primary rating agencies that provide credit ratings for most utility companies, Moody's and S&P, both emphasize similar financial metrics. My analyses are based on Moody's guidelines and these financial metrics are presented in my direct testimony at Exhibit OCS 1.11D[9].

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. Throughout his rebuttal testimony Dr. Hadaway maintains his opinion that the cost of equity for RMP is 10% and the market cost of capital is not declining. The problem is that Dr. Hadaway's opinion on these matters is

[7] See Exhibit OCS 1.11D
[8] Moody's Rating Methodology: Regulated Electric and Gas Utilities at 32 (August 2009).
[9] See lines 13 - 15 and lines 17 - 19.

not supported by his updated Discounted Cash Flow ("DCF") or risk premium analyses, other evidence in his testimony, market evidence on this matter, or his past testimony. The cost of equity for RMP is below 10%. This is supported by all cost of capital witness analyses in this case and current market evidence. The cost of capital continues to decline as shown by market data.

Q. DID DR. HADAWAY UPDATE HIS COST OF EQUITY DCF AND RISK PREMIUM ANALYSES?

A. Yes, and those updates range from 9.3% to 9.4% for the DCF and 9.7% to 9.8% for the risk premium analysis.[10] Despite the market evidence of declining capital costs and the results of his updated estimates, Dr. Hadaway clings to the notion that "the Company's cost of equity is 10 percent."[11] Dr. Hadaway can only support a 10% equity cost by ignoring all his updated results. Instead, Dr. Hadaway supports his 10% equity return for RMP with his outdated "initial risk premium analysis."[12]

Q. DO YIELDS ON BONDS CONTINUE TO DECLINE?

A. Yes. Bond yields have been declining throughout 2014. The following table summarizes the declining bond yields for the period December 2013 through April 2014.

[10] Direct Testimony Dr. Hadaway at 7:44 through 8:54.
[11] Id. at 1:17.
[12] Id. At 29:587-589.

TABLE 3[13]

MONTHLY BOND YIELDS DECEMBER 2013 – APRIL 2014

DATE	30 YEAR U.S. TREASURY	20 YEAR U.S. TREASURY	10 YEAR U.S. TREASURY	Aaa CORPORATE	Baa CORPORATE
12/30/13	3.89%	3.63%	2.90%	4.62%	5.38%
1/31/14	3.77%	3.52%	2.86%	4.49%	5.19%
2/28/14	3.66%	3.38%	2.71%	4.45%	5.10%
3/31/14	3.62%	3.35%	2.72%	4.38%	5.06%
4/30/14	3.52%	3.27%	2.71%	4.24%	4.90%

As can be seen from Table 3, 30-year U.S. Treasury yields have declined almost 40 basis points during the first four months of the year. This evidence contradicts Dr. Hadaway's earlier claims of increasing interest rates. These 30-year U.S. Treasury yields are currently (May 2014) in the 3.4% range.

The recent declining historical interest trends, current spot market yields, short-term forecasts of yields, and the continued accommodative monetary policy of the Federal Reserve all suggests low yields and lower cost of capital today and the foreseeable future. Dr. Hadaway has no sound basis or evidentiary support to claim otherwise.

Q. DOES DR. HADAWAY ACKNOWLEDGE THAT THE AUTHORIZED EQUITY RETURN FOR UTILITY COMPANIES CONTINUES TO DECLINE?

A. Yes. At page 7, Table 1 of his rebuttal testimony Dr. Hadaway presents authorized equity returns for the period 2010 through the first quarter of 2014. As shown in Dr. Hadaway's Table 1 the average authorized equity return has declined from 10.38% in 2010 to 9.86% in the first quarter of 2014. I discussed this issue in my direct testimony

[13] www.federalreserve.gov

at pages 14 and 15 with regard to the Edison Electric Institute report on this matter. This return data does not support an authorized equity return of 10% as Dr. Hadaway recommends.

Q. AT PAGE 13 LINES 245 – 247 OF HIS REBUTTAL TESTIMONY, DR. HADAWAY STATES "THE MARKET COST OF EQUITY IS NOT LOWER TODAY THAN IT WAS IN 2012". DO YOU AGREE WITH THIS STATEMENT?

A. No. Dr. Hadaway is incorrect and again has no support for this statement. First, as shown above, authorized utility equity returns around the country, which are based on market evidence, show a continued decline since 2010. Obviously, utility regulatory authorities across the country believe that equity costs are declining as evidenced by Dr. Hadaway's Table 1 at page 7 of his rebuttal testimony.

In the last RMP rate case, Docket No. 11-035-200, decided in September 2012, Dr. Hadaway concluded and recommended a 10.2% equity return for RMP.[14] Now, in this case Dr. Hadaway is recommending an equity return of 10% for RMP. Dr. Hadaway's testimony in the last case and this case demonstrates a declining equity cost since 2012, yet his rebuttal testimony at page 13 claims the market cost of equity is not lower than 2012 levels. Dr. Hadaway cannot have it both ways.

All available evidence, including evidence of declining interest rates and declining authorized equity returns, current market data, and Dr. Hadaway's testimony in Docket No. 11-035-200, as well as his testimony in this case, demonstrate equity costs have continued to decline.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[14] See Docket No. 11-035-200, Direct Testimony Dr. Hadaway at 2:29.