BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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	§	
IN THE MATTER OF THE APPLICATION OF QUESTAR GAS COMPANY TO INCREASE DISTRIBUTION RATES AND CHARGES AND MAKE TARIFF MODIFICATIONS	§	**Docket Nos. 13-057-05**
	§	**Surrebuttal Rate of Return**
	§	**Testimony of Daniel J. Lawton**
	§	**for the Utah Office of**
	§	**Consumer Services**
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January 7, 2014

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DIRECT TESTIMONY OF
DANIEL J. LAWTON

SECTION I: INTRODUCTION/BACKGROUND/SUMMARY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q. ARE YOU THE SAME DANIEL J. LAWTON WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS CAUSE ON BEHALF OF THE UTAH OFFICE OF CONSUMER SERVICES ("OCS")?

A. Yes. I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL?

A. The purpose of my surrebuttal testimony is to update my cost of capital analysis from the October 30, 2013 direct testimony filing to the present and to address the rebuttal testimony of Questar Gas ("Questar" or "Company") witness David Curtis. Specifically, I address why Mr. Curtis' claimed equity return for Questar is overstated and out of touch with current market data. In addition, I show how current market data and recent regulatory decisions in gas utility rate proceedings support an equity return in the range of 9.3 % for the Company.

SECTION II: UPDATED ANALYSIS

Q. HAVE YOU UPDATED YOUR QUESTAR COST OF CAPITAL ANALYSIS EMPLOYING RECENT MARKET DATA?

A. Yes I have. Employing the same comparable group of companies and the same analytical framework as employed in my direct testimony, the cost of capital update into December 2013 indicates a 9.3% equity return is a reasonable estimate in this case. I also continue to recommend that the authorized rate of return be adjusted for the impact of the Infrastructure Tracker Mechanism expansion in this case. I explained in my direct testimony at pages 39 - 41 how a $10,000,000 expansion of the tracker should result in a 5 basis point reduction in equity return. In Table 1 below, I have included a summary table of the equity return update compared to the results presented in my October 2013 direct testimony.

Table 1

UPDATED RETURN ON EQUITY ANAYLSIS

COMPARED TO ORIGINAL ANALYSIS

Original ROE Analysis[1]			Updated ROE Analysis[2]		
Model	**Range**	**Midpoint**	**Model**	**Range**	**Midpoint**
DCF	**8.94-9.61%**	**9.28%**	**DCF**	**9.01-9.66%**	**9.34%**
2-Stage DCF	**8.99-9.41%**	**9.20%**	**2-Stage DCF**	**9.13-9.46%**	**9.30%**
ECAPM	**9.03-9.07%**	**9.05%**	**ECAPM**	**9.23**	**9.23%**
Risk Premium	**9.85-9.88%**	**9.87%**	**Risk Premium**	**9.85-9.91%**	**9.88%**

I have included in my testimony schedules OCS SR 2.1 through OCS SR 2.8 supporting the updated analysis and I included in the work papers the backup schedules for the updated equity

[1] Direct Testimony at 30

[2] See schedules OCS-SR 2.1 through OCS-SR 2.4

return analysis. All of these analyses were explained in my direct testimony and those explanations are not repeated here.

Q. HAVE YOU CHANGED ANY OF YOUR EQUITY RETURN MODELING ASSUMPTIONS IN YOUR UPDATED ANALYSIS?

A. No. I have employed the same comparable group of proxy companies and the same estimating models as employed in my direct testimony. The only change is I have employed more current input data for each of the models. The end result is that an equity return in the range of 9.3% continues to be supported by current market data. The updated constant growth DCF supports a 9.3% equity return and the 2-stage DCF also supports the 9.3% equity return. The risk premium evaluation models produce a 9.23% ECAPM and 9.88% risk premium and taken together fall at 9.56% which is the upper end of the constant growth DCF range shown in Table 1. In my opinion, the above update continues to support a 9.3% equity return for Questar.

SECTION III: RESPONSE TO MR. CURTIS' REBUTTAL ARGUMENTS

Q. AT PAGE 2 LINES 23-24 OF HIS REBUTTAL TESTIMONY MR. CURTIS CLAIMS CAPITAL MARKETS HAVE CHANGED SINCE THE COMPANY'S CASE WAS FILED IN JULY 2013. PLEASE COMMENT.

A. Capital markets change everyday. The key question is whether capital markets have changed sufficiently to require a change in the recommended cost of capital. The obvious answer is no. Mr. Curtis acknowledges that capital markets have not changed his fundamental recommendation because he continues to support his 10.35% equity return. As I discussed above, my update to current market data has not changed my recommended 9.3% equity return in this proceeding. The issue remains what equity return this Commission should authorize in this case. Current market data under my analysis supports a 9.3% equity return for Questar.

Q. MR. CURTIS ALSO POINTS OUT THAT INTEREST RATES HAVE INCREASED SINCE HIS JULY 2013 FILING IN THIS CASE. PLEASE COMMENT.

A**.** I pointed out in my direct testimony at 11:277-278 that rates have been increasing since May 2013. Again, current or updated interest rate levels have not resulted in a change in the Company's or my recommendation.

Q. ARE REGULATORY AUTHORITIES CONTINUING TO AUTHORIZE UTILITY EQUITY RETURNS AT OR BELOW 9.80% FOR ELECTRIC AND GAS UTILITY OPERATIONS?

A. Yes. On December 13, 2013, the Public Service Commission of Maryland in Case No. 9326 set the Baltimore Gas and Electric Company ("BGE") equity return at 9.75% and 9.60% for electric and gas operations respectively. On December 16, 2013, the Public Utilities Commission of Nevada in Docket No. 13-06002 issued a final order for Sierra Pacific Power Company operations, authorizing an equity return of 9.8% and 9.7% for electric and gas operations respectively.

Q. HOW DO THE FINANCIAL CHARACTERISTICS OF BGE AND SIERRA PACIFIC COMPARE TO QUESTAR?

A. BGE's equity ratio is lower creating more financial risk than Questar and BGE does not have the benefits of a forecasted test period for setting rates resulting in higher regulatory risk for BGE. Given BGE's gas operations higher financial and regulatory risk relative to Questar the 9.6% equity return recently authorized in Maryland is in line with a 9.3% equity return for the lower risk Questar gas operations.

With an equity ratio below 47%, the Sierra companies have more financial risk than does Questar or BGE (discussed above) and do not enjoy the benefits of the forecasted test period employed in Utah rate making. Given the higher financial and regulatory risks for the Nevada gas operations relative to Questar, a 9.7% equity return in Nevada is consistent with the 9.3% recommended level for the lower risk Questar operations.

Q. PLEASE EXPLAIN HOW CAPITAL STRUCTURE AND HIGHER EQUITY RATIOS LOWER FINANCIAL RISK.

A. Financial risk is based on the method employed to finance investment. Even though debt or leverage is a lower cost alternative to equity financing, adding more debt capital increases financial risk to shareholders due to increased contractual fixed obligations (interest payments) being removed from the income stream leaving less bottom line earnings for shareholders.

A number of empirical studies available in the financial literature quantify the impact of increased leverage or debt on the cost of equity. These studies are summarized in the book New Regulatory Finance which concludes a reasonable adjustment is "…a range of 7.6 to 13.8 basis points per one percentage increase in the debt ratio."[3] Assuming on average a 10.7% ((7.6% + 13.8%)/2) basis point equity change per one percent change in debt ratio and applying such results to the facts of the recent Nevada and Maryland decisions discussed above, results

[3]Morin, Roger New Regulatory Finance, Public Utilities Reports, Inc. (2006) at 469

in the following equity return given the Questar capital structure and lower financial risk.

	A	B	C	D
CASE	**GAS ROE**	**EQUITY RATIO**	**QUESTAR EQUITY RATIO**	**RISK ADJUSTED ROE**
BGE MARYLAND	9.60%	51.05%	52.07%	9.50%
NEVADA SIERRA	9.70%	46.94%	52.07%	9.15%
AVERAGE				**9.33%**

Thus, adjusting the recent Nevada and Maryland gas utility equity return decisions for differences in Questar's less leveraged capital structure indicates an equity return of 9.3% for Questar is consistent with the current market and regulatory environment.

On December 30, 2013, the Arkansas Public Service Commission in Docket No. 13-028-U issued a Final Order for Entergy Arkansas, Inc. electric operations authorizing an equity return of 9.3%. While this Arkansas proceeding involved an electric utility, the risks of electric operations are generally more risky than those of gas operations like Questar. Regulatory authorities continue to authorize lower equity returns even as market interest rates have increased above historical low levels. Thus, the current market data and recent regulatory rulings on equity return support returns well below the 10.35% being requested by Questar.

Q. AT PAGE 4 LINES 69-71 OF HIS REBUTTAL TESTIMONY MR. CURTIS POINTS OUT THAT THE ALABAMA PUBLIC SERVICE COMMMSION RECENTLY AUTHORIZED A 10.5% TO 10.95% EQUITY RETURN RANGE FOR ALABAMA GAS CORPORATION. DO YOU HAVE ANY COMMENTS?

A. First, Mr. Curtis is correct that the Alabama Gas Corporation's, ("Alagasco") Rate Stabilization and Equalization ("RSE") mechanism was recently adjusted to include the 10.5% to 10.95% equity return range. I would note that my review of the Alabama Order indicates that the Alagasco rate employing the RSE mechanism is a formulaic based rate plan. Under such plans or mechanisms annual base rate costs are reconcilable up or down, which is not the case under the standard rate making paradigm employed in Utah and most other states. My review of such formulaic rate making mechanisms over the years has consistently shown higher equity return ranges have been authorized for formulaic rate plans compared with standard rate making paradigms.

The bottom line is that the Alabama ratemaking model is not similar to the current Questar situation or the ratemaking models employed in Maryland, Nevada, or Arkansas discussed earlier.

Q. AT PAGE 2 LINE 77 THROUGH PAGE 7 LINE 162 OF MR. CURTIS' REBUTTAL HE DISCUSSES THE IMPACT OF ALLOWED RETURNS LESS THAN 10.35% ON QUESTAR'S FINACIAL METRICS AND BOND RATINGS. PLEASE COMMENT.

A. There is no evidence to support a claim of financial harm or lowering of Questar's bond rating in this case. A review of Mr. Curtis' own analyses at his QGC Exhibit 2.3 R shows the financial metrics of the Company resulting in the same "indicated rating" at a 10.35% ROE or a 9.3% ROE.[4] Mr. Curtis provides no support of any claimed financial harm to Questar at the lower market based equity return of 9.3% that I recommend.

Q. AT PAGE 9 OF MR. CURTIS' REBUTTAL TESTIMONY HE BEGINS HIS DISCUSSION OF THE CONSTANT GROWTH DCF MODEL. DO YOU HAVE ANY COMMENTS?

A. Yes. I addressed the key problems with Mr. Curtis' DCF analysis at pages 37-39 of my direct testimony in this case. Mr. Curtis' DCF analysis when employing analyst growth forecasts supports an equity return below 10 percent.[5] Only when employing historical five and ten year growth rates combined with his estimate of "Industry Earnings" in his DCF model does Mr. Curtis find a result above 10 percent equity return.[6] Mr. Curtis then suggests that because gas industry companies in general and his comparable group proxy companies in particular are not widely traded that "I don't believe published analyst growth expectations should be the only source of growth estimates in the discounted cash flow model."[7]

Mr. Curtis has the analysis woefully wrong. Growth estimates used in the DCF model should be based on investor expectations. If investors rely on analyst forecasts, then analyst forecasts should be used in the DCF whether the stock is thinly traded or not. If investors believe the growth rates and Company performance over the past five and/or ten years will be repeated in the future then historical growth rates should be employed again no matter how thinly traded the company.

[4] See David Curtis Rebuttal at QGC Exhibit 2.3 R lines 22,26,30,36, and 40.
[5] Rebuttal Testimony David Curtis at 3.

[6] Id

I know of no regulatory authority or stock analyst that projects that the historical growth rates and performance of the natural gas industry over the past five or ten years are the expectations of the future. There is just no support for employing historical growth rates in this case.

Based on the presentation in the third quarter earnings release from October 31, 2013 the current Questar Corporation long-term earnings growth forecast is 4% to 6%. As shown in my schedule OCS SR 2.5, I employ growth rates of 5.5% to 6.0% consistent with the high end earnings growth forecast of 4.0% to 6.0% for Questar Corporation. Instead, it is Company witness Curtis that employs 10-year growth rates as high as 13.76% to support his 10.35% equity return claim in this case.[8]

Q. DO YOU HAVE ANY COMMENTS ON MR. CURTIS' CALCULATION OF THE INDUSTRY EARNINGS GROWTH ESTIMATE?

A. Yes. This "Industry Earnings" growth estimate shown in his QGC Exhibit 2.1R at page 2 of 2, cobbles together forecasted growth in rate base for Questar Gas with targeted net income growth for AGL Resources with average annual earnings per share growth for South Jersey Industries and WGL Holdings Inc. targeted 2016 earnings growth. This computation is not the expected long run growth in earnings per share, but rather a basket of different growth measures that do not fit together. Growth estimates in rate base do not necessarily translate into expected earnings growth any more than a targeted net income growth or short term earnings projections will translate into long term investor expectations of earnings growth. When evaluating a DCF model

[7] Id
[8] David Curtis Rebuttal Testimony at QGC Exhibit 2.1R, page 2 of 2, column (i), line 2.

one seeks to evaluate long-term earnings growth expectations of investors. It is doubtful that any investor let alone the typical investor would consider Mr. Curtis' "Industry Growth" estimate reasonable or reliable.

Q. AT PAGE 13 LINES 298-309 OF HIS REBUTTAL TESTIMONY MR. CURTIS CONTINUES TO CLAIM A SIZE PREMIUM ADJUSTMENT FOR THE CAPITAL ASSET PRICING MODEL CALCULATION. PLEASE COMMENT?

A. I previously addressed this issue at page 39 of my direct testimony. Mr. Curtis fails to distinguish the difference between a regulated monopoly with a service territory and no competition from the situation of a small or midsize competitive market firm. The analysis I cited in my direct testimony is based on that very distinction.[9]

Q. HAS MR. CURTIS PROVIDED ANY REBUTTAL ARGUMENT THAT WOULD CAUSE YOU TO CHANGE YOUR RECOMMENDATIONS IN THIS MATTER?

A. No. Mr. Curtis has presented no evidence to support a 10.35% equity return. Moreover, the current market data and recent equity return decisions by regulators for gas utilities support a 9.3% equity return in this case.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes.

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[9] Wong, Arnie. "Utility Stocks and Size Effect: An Empirical Analysis, " Journal of Midwest Finance Association (1993)