

**Docket No. 22-057-03**

**Utah Office of Consumer Services Witness**

**Daniel J. Lawton**

**Exhibits OCS 3.1S through OCS 3.2S**

**October 13, 2022**



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**SURREBUTTAL TESTIMONY OF  
DANIEL J. LAWTON**

1 **SECTION I: INTRODUCTION/BACKGROUND/SUMMARY**

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

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

5 **Q. ARE YOU THE SAME DANIEL LAWTON WHO FILED COST OF CAPITAL  
6 DIRECT TESTIMONY IN THIS PROCEEDING?**

7 A. Yes, I am.

8 **Q. ON WHOSE BEHALF ARE YOU FILING TESTIMONY IN THIS PROCEEDING?**

9 A. I have been retained to review the Dominion Energy Utah (“Company” or “DEU”) cost of  
10 capital request, and related financial issues, on behalf of the Utah Office of Consumer  
11 Services (“OCS”).

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

13 A. The purpose of my surrebuttal testimony is to respond to Company witness Nelson’s  
14 rebuttal testimony addressing overall cost of capital and return on equity requested by DEU  
15 in this case as well as Company witness Mendenhall’s rebuttal testimony addressing capital  
16 structure. In addition, I provide an update of my equity return employing updated market  
17 data on interest rates.

18 **Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR SURREBUTTAL  
19 TESTIMONY CONCLUSIONS.**

20 A. As a result of the update of my analysis for higher interest yields and my review of the  
21 rebuttal testimony of the DEU witnesses, the recommended 9.20% equity return and 51%

22 equity and 49.0% debt capital structure is still appropriate for setting just and reasonable  
23 rates in this proceeding.

24 Based on my update of cost of capital employing current market data on changed U.S.  
25 Treasury bond yields through September 2022, I conclude that a return on equity of 9.2%  
26 and an overall cost of capital of 6.652% employing DEU's proposed long-term debt cost  
27 with a 51% equity and 49% debt capital structure is consistent with current market capital  
28 cost requirements and is more than adequate for the Company to maintain its financial  
29 integrity and creditworthiness.

30 Second, a review of Company witness Nelson's rebuttal testimony in this proceeding has  
31 provided no evidence to support the DEU requested 10.30% cost of equity in light of  
32 current market capital costs. Ms. Nelson has failed to provide support for a cost of capital  
33 recommendation of 10.30% that is over 90-basis points higher than the 9.33% average  
34 authorized by regulatory authorities around the country during the first six-months of  
35 2022.<sup>1</sup>

36 Also, Ms. Nelson's rebuttal evidence fails to support the proposed equity level of 53.21%  
37 when comparable gas utilities and regulatory decisions around the country support at most  
38 a 51.0% equity level. Moreover, the additional rebuttal testimony of Mr. Mendenhall fails  
39 to support DEU's equity rich capital structure. I will address below these capital structure  
40 issues.

41

42 **SECTION II: OVERVIEW AND UPDATE OF COST OF CAPITAL**  
43 **RECOMMENDATION**

44

45 **Q. PLEASE SUMMARIZE YOUR PREVIOUS FINDINGS AND CONCLUSIONS**  
46 **RELATED TO DEU'S EQUITY RETURN IN THIS CASE.**

47 **A.** My analysis provided in my direct testimony of the Company's requested cost of equity

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<sup>1</sup> RRA Regulatory Focus, *Major energy rate case decisions in U.S. – January – June 2022*, S&P Global Market Intelligence, at 4.

capital in this proceeding is shown in the following table:

**Table 1**

**Cost of Equity Estimates From Direct Case<sup>2</sup>**

<b>MODEL</b>	<b>RANGE</b>	<b>MIDPOINT</b>
<b>DCF Model</b>	<b>8.73% - 9.24%</b>	<b>8.99%</b>
<b>Two-stage DCF</b>	<b>9.40% - 9.51%</b>	<b>9.46%</b>
<b>CAPM</b>	<b>8.18% - 8.39%</b>	<b>8.29%</b>
<b>ECAPM</b>	<b>8.50% - 8.65%</b>	<b>8.58%</b>
<b>Bond Risk Premium</b>	<b>9.70% - 9.73%</b>	<b>9.72%</b>
<b>Average All Models</b>	<b>8.90% - 9.10%</b>	<b>9.01%</b>

The 9.2% recommendation is based on the DCF and risk premium model results, and consideration of business and financial risks. When the 9.2% equity return recommendation is combined with my recommended capital structure and the Company's debt cost rate projected at December 31, 2023, it results in a recommended return on rate base investment as follows:

**Table 2**

**Recommended Capital Structure and Cost Rates for**

**Dominion Energy Utah<sup>3</sup>**

<b>DESCRIPTION</b>	<b><u>RATIO</u></b>	<b><u>COST</u></b>	<b><u>WEIGHTED COST</u></b>
<b>LONG-TERM DEBT</b>	49.00%	4.00%	1.960%
<b>COMMON</b>	51.00%	9.20%	4.692%
<b>TOTAL CAPITAL</b>	100.00%		6.652%

<sup>2</sup> Each cost of equity capital estimates is discussed in the testimony and is presented in the direct testimony in Exhibits (OCS-3.8), (OCS-3.9), (OCS-3.10), and (OCS-3.11).

<sup>3</sup> See Direct Testimony at Exhibit (OCS 3.12).

61 In my opinion, these recommended return levels (9.20% equity return and 6.652% overall  
62 cost of capital) continue to be consistent with current market capital costs in the utility  
63 industry and consistent with just and reasonable rates for customers. My analyses of the  
64 Company's requested and Ms. Nelson's recommended 10.30% equity return and overall  
65 return request of 7.352% including analysis of the Company's rebuttal testimony, indicates  
66 that the Company's request is overstated and is not consistent with just and reasonable rates  
67 for customers given current market capital costs.

68 **Q. HAVE YOU UPDATED YOUR ANALYSIS IN THIS CASE?**

69 A. Yes. Since the August 26, 2022 filing of my direct testimony interest rate yields for 30-  
70 year U.S. Treasury bonds have increased from about 3.20% ((August 26, 2022) to about  
71 3.67% (October 4, 2022).<sup>4</sup> In light of these yield increases I have updated three models  
72 that are directly impacted by market yield changes. These three models are the Capital  
73 Asset Pricing Model (CAPM), the Empirical Capital Asset Pricing Model (ECAPM) and  
74 the equity – bond yield risk premium.

75 **CAPITAL ASSET PRICING MODEL ANALYSIS**

76 **Q. PLEASE EXPLAIN HOW YOU UPDATED AND CALCULATED THE EQUITY**  
77 **RETURN ESTIMATE EMPLOYING THE CAPM.**

78 A. Consistent with my direct testimony I employed the basic CAPM formula denoted as  
79 follows:

80 
$$R_f + \beta(R_m - R_f)$$

81 Where:

82  $R_f$ = risk free rate;

83  $\beta$  =beta;

84  $R_m$ = market return; and

85  $R_m - R_f$ = market risk premium or MRP

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<sup>4</sup> Federal Reserve website H-15 data.

86

87

This is the typical model structure employed by most financial analysts in estimating equity returns.<sup>5</sup>

88

89

**Q. WHAT RISK FREE ( $R_f$ ) VALUE DID YOU EMPLOY IN YOUR CAPM ESTIMATE?**

90

91

A. I employed the updated most recent three-month average of the 30-year U.S. Treasury bond yields. This three-month average is:

92

93

**Table 3<sup>6</sup>**

94

**30-Year U.S. Government Bond Yields**

July 2022	3.10%
August 2022	3.13%
September 2022	3.56%
<u>3-Month Average</u>	<u>3.26%</u>

95

The 3.26% updated average 30-year U.S. treasury yield is rounded up to 3.30% for this analysis.

96

97

**Q. WHAT VALUE DID YOU EMPLOY FOR BETA IN YOUR CAPM ANALYSIS?**

98

A. Consistent with my direct testimony, I employed a Value Line beta estimate for each company in the comparable group as shown in my direct testimony at Exhibit (OCS 3.5), column A and Exhibit (OCS 3.10) columns A and E. The mean and median beta values used were .83 and .80, respectively.

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<sup>5</sup> I provide additional model details for the CAPM in my Direct Testimony Technical Appendix in Exhibit (OCS 3.2).

<sup>6</sup> See Federal Reserve H-15 data at [www.federalreserve.gov](http://www.federalreserve.gov) (retrieved 10/4/22)



102

103 **Q. WHAT VALUE HAVE YOU EMPLOYED FOR THE MARKET RISK PREMIUM**  
 104 **(“MRP”)?**

105 A. The historical MRP is calculated the same as my direct testimony. To calculate the MRP,  
 106 I first looked at the long-term historical risk premiums for the period 1926-2021. The  
 107 following summarizes the historical MRP for the 1926-2021 period:

108

**Table 4**

109

**Market Risk Premium**

<u>Investment</u> <sup>7</sup>	<u>Arithmetic Mean Return</u>
Large Company Stocks	12.30%
Long Term Government Bonds	<u>6.00%</u>
Historical MRP	<u>6.30%</u>

110

111 Thus, the long-term historical MRP is 6.30% above the risk-free rate for long-term U.S.  
 112 Treasury Bonds.

113 I also estimated a more current MRP by measuring the difference between the  
 114 forecasted equity return for the comparable group as reported by Value Line for the period  
 115 2025-2027 of 9.44% and the updated 30-year U.S. Treasury yields of 3.30%.<sup>8</sup> This forward  
 116 estimate of MRP produces an MRP of 6.14% (9.44% - 3.30%). As I discussed in my direct  
 117 testimony (Exhibit OCS 3D at page 24) since 1981 capital costs have been declining as

<sup>7</sup> Kroll, *U.S. Capital Market Performance by Asset Class 1926-1921*, at page 58, Table 2.3 (2022 SBBI Yearbook).

<sup>8</sup> The 9.44% forecasted equity return by Value Line can be found in Exhibit (OCS 3.5) column “K” by averaging the mean and median result, also see Lawton work paper 1.

118 evidenced by the long-term decline in gas utility authorized equity returns and the decline  
119 in 30-year U.S. Treasury yields. The annual decline in equity costs is much slower, while  
120 debt costs have declined by larger margins annually. For the period 1981 through 2021 the  
121 average of the absolute value change in 30-year U.S. Treasury bond yields is about 58 basis  
122 points.<sup>9</sup> For authorized gas utility equity returns over the same time period, the average  
123 absolute value rate of change is about 26 basis points or less than half the rate of change in  
124 U.S. Treasury yields.<sup>10</sup> Thus, while it may be correct to conclude debt costs will increase  
125 over the short-term – equity cost increases should be of smaller magnitude.

126 The result of this comparative analysis is that while debt cost may be increasing in the  
127 short-term any expected equity cost change is less than half the level of debt rate changes.  
128 Thus, as debt costs increase and equity costs increase at a slower rate the difference  
129 between the two will narrow. At least that has been the historical experience when debt  
130 cost was declining for the past 40 years.

131 Given the higher rates of inflation and tightening monetary policy increasing interest rates  
132 the expectation is that MRP's (difference in equity and bond returns) will be shrinking.  
133 This expectation of declining MRP with rising interest rates is supported by Ms. Nelson's  
134 testimony when she states: "... Market Risk Premium is inversely related to Government  
135 bond yields. That is, as interest rates fall, the Market Risk Premium increases."<sup>11</sup> Given  
136 the declining MRP expectation I have employed the average of the historical MRP of

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<sup>9</sup> See Exhibit (OCS-3.11)

<sup>10</sup> See Exhibit (OCS-3.11)

<sup>11</sup> Ms. Nelson Rebuttal Testimony at page 95, lines 1574 – 1578 describing findings from Harris and Marston Study see footnote 132.

137 6.30% and the forward MRP of 6.14% or 6.20%. This 6.20% MRP estimate is consistent  
138 with the expected ranges of MRP's of 5% - 8% found in a number of studies in the financial  
139 literature and is consistent with current financial markets expectations for MRP's.<sup>12</sup>

140 **Q. WHAT ARE THE RESULTS OF YOUR UPDATED CAPM ANALYSES FOR THE**  
141 **GAS COMPANY COMPARABLE GROUP?**

142 A. The results of the CAPM analyses can be found in my Exhibit (OCS-3.1S) at column D for  
143 the gas comparable group. The range (mean and median) of results indicate an equity return  
144 range of 8.26% to 8.47% with an 8.37% midpoint.

145 **Q. DID YOU UPDATE THE EMPIRICAL CAPM OR ECAPM RETURN ESTIMATE**  
146 **FOR THIS CASE?**

147 A. Yes. Like the CAPM analysis discussed above, I updated the ECAPM estimate of equity  
148 return for the changes in bond yields. The basic formula for the ECAPM for beta  
149 conversion is as follows:

$$150 \quad K = R_f + 0.25(R_m - R_f) + 0.75\beta(R_m - R_f)$$

151 **Q. WHAT ARE THE RESULTS OF YOUR UPDATED ECAPM ANALYSES FOR**  
152 **THE GAS COMPANY COMPARABLE GROUP?**

153 A. The results of the updated ECAPM analyses can be found in my Exhibit (OCS-3.1S) at  
154 column H. The range of ECAPM results (mean and median) are 8.57% to 8.73% with a  
155 midpoint of 8.65%.

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<sup>12</sup>Morin, Roger; New Regulatory Finance, Public Utility Reports, Inc. (2006) at page 163. See Chapter 5.

156

157 **Q. DESCRIBE YOUR UPDATES FOR THE BOND YIELD EQUITY RISK**  
158 **PREMIUM ANALYSIS.**

159 A. The updated bond yield equity risk premium analysis is presented in Exhibit (OCS-3.2S)  
160 and evaluates the risk/return differential between the authorized gas utility return on equity  
161 relative to 30-year U.S. Treasury bond yields for the period 1981 - 2021. The resulting  
162 risk premium is combined with the updated 30-year U.S. Treasury yields through  
163 September 30, 2022, the 30-year U.S. Treasury Bond recent 3-month average yield and the  
164 October 10, 2022, spot yield of 3.80% to determine the range of risk premium estimates of  
165 equity costs.

166 The resulting risk premium range of results for gas utilities is 9.79% to 10.08% with a  
167 midpoint of 9.93%.

168 **Q. PLEASE SUMMARIZE YOUR UPDATED COST OF EQUITY CAPITAL**  
169 **RESULTS FOR DEU.**

170 A. Table 5 below is a summary of the updated equity cost estimates for the comparable groups  
171 of companies employing the constant growth DCF, 2-Stage DCF, bond yield equity Risk  
172 Premium, CAPM, and ECAPM models. (Only the bond yield equity Risk Premium,  
173 CAPM, and ECAPM models are updated for the yield changes.)

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**Table 5****Updated Cost of Equity Estimates**<sup>13</sup>

<b>MODEL</b>	<b>RANGE</b>	<b>MIDPOINT</b>
<b>DCF Model</b>	<b>8.73% - 9.24%</b>	<b>8.99%</b>
<b>Two-stage DCF</b>	<b>9.40% - 9.51%</b>	<b>9.46%</b>
<b>CAPM</b>	<b>8.26% - 8.47%</b>	<b>8.37%</b>
<b>ECAPM</b>	<b>8.57% - 8.73%</b>	<b>8.65%</b>
<b>Equity Bond Risk Premium</b>	<b>9.79% - 10.06%</b>	<b>9.93%</b>
<b>Mean</b>	<b>8.95% - 9.20%</b>	<b>9.08%</b>
<b>Median</b>	<b>8.73% - 9.24%</b>	<b>8.99%</b>

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The updated analysis continues to support my recommended 9.20% equity return for DEU in this case. The two DCF models did not change, but do support a 9.20% equity return. Excluding the low estimate CAPM analysis and averaging the remaining four model midpoint results in a 9.25% estimate – well within the reasonable range of 9.00% to 9.50% range of estimates shown in Table 5.<sup>14</sup>

185

Based on my analyses I make the following conclusions and recommendations:

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188

(i) A return of 9.2% on shareholder equity is consistent with current market capital cost requirements, the updated model estimates, and is more than adequate for the Company to maintain its financial integrity and creditworthiness;

<sup>13</sup> Each cost of equity capital estimate is discussed in the testimony and is presented in Schedules (OCS-3.8), (OCS-3.9), (OCS- 3.1S), (OCS- 3.2S).

<sup>14</sup> The 9.0% bottom of the reasonable range is identified by the mid-point of the mean and median of all five models in Table 5. The top of the reasonable range is calculated by removing the low (8.37%) and high (9.93%) model midpoint estimates in Table 5, the remaining top end of the range is 9.46% or about 9.50%.

189 (ii) The Company's cash flows and liquidity at an overall rate of return on rate base  
190 investment of 6.652% is more than adequate to meet cash operating and construction  
191 requirements;

192 (iii) The Company's overall cost of capital, employing the Company's proposed capital  
193 structure and cost rates for debt and my recommended equity return of 9.2%, to be earned  
194 on rate base investment should be set at 6.652% for setting just and reasonable rates for  
195 customers in this proceeding;

196 (iv) The Company's proposed 10.30% return for equity shareholders is an overstatement  
197 of the required return on equity to hold and attract equity capital;

198 (v) The Company's proposed 7.352% overall return on investment is overstated and should  
199 not be adopted as representative of the Company's cost of capital requirements; and

200 (vi) DEU's rebuttal analysis fails to support a cost of equity substantially above the current  
201 market cost of equity and is over 90-basis points above the current 9.33% average  
202 authorized gas utility returns around the country for the first half of 2022.<sup>15</sup>

203 **SECTION III: RESPONSE TO MS. NELSON'S REBUTTAL ANALYSIS**

204  
205 **Q. AT PAGE 85, LINES 1403-1405 OF HER REBUTTAL TESTIMONY, MS.**  
206 **NELSON CLAIMS THAT YOU RELIED EXCLUSIVELY ON THE DCF**  
207 **RESULTS AND GAVE NO WEIGHT TO OTHER FINANCIAL MODELS – IS**  
208 **THAT CORRECT?**

209 **A.** No, Ms. Nelson is not correct. My direct testimony at page 4, lines 53 – 56, states:

210 Based on the model results, I am recommending a 9.20% return  
211 on equity in this case. When the low end CAPM results are  
212 excluded the four remaining models (two DCF and risk premium

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<sup>15</sup> See [spglobal.com/marketintelligence](https://spglobal.com/marketintelligence), RRA Regulatory Focus; Major Rate Case Decisions in the U.S. January – June 2022 at page 4.

213 and ECAPM) average 9.2%. The 9.20% recommendation is also  
214 consistent with the two DCF results which average 9.20%.

215 I believe my statement above is quite clear as to the model results and the recommended  
216 equity return in this case. I do not understand Ms. Nelson's assertion that I only relied on  
217 my DCF model results.

218 **Q. WHAT OTHER ISSUES DO YOU ADDRESS IN THIS SECTION OF YOUR**  
219 **TESTIMONY?**

220 A. In this part of my testimony, I address several other comments and arguments made by Ms.  
221 Nelson in her rebuttal testimony that are specific to my recommendations in this case.  
222 These issues include:

- 223 • the estimated growth rate (sustainable growth rate) for the constant growth DCF  
224 analysis (Nelson rebuttal at page 87, line 1430);
- 225 • the Two-Stage DCF cash flows at year end versus mid-year convention (Nelson  
226 rebuttal at page 87, lines 1431 - 1432);
- 227 • the inputs to the CAPM and ECAPM (Nelson rebuttal at 92-93);
- 228 • the calculation of the current market risk premium MRP (Nelson rebuttal at 98);
- 229 • Ms. Nelson's failed calculation of the MRP for her CAPM analysis (Ms. Nelson  
230 rebuttal page 99); and
- 231 • capital structure issues (Ms. Nelson rebuttal pages 24 – 35).

232 **Q. MS. NELSON'S REBUTTAL TESTIMONY AT PAGE 87, LINES 1430,**  
233 **REFERRING TO MY DCF ANALYSES STATES "I DISAGREE WITH HIS**  
234 **USE OF SUSTAINABLE GROWTH RATES." DO YOU AGREE WITH MS.**  
235 **NELSON'S CRITICISMS?**

236 A. No. I do not agree. Ms. Nelson analysis is incomplete and the facts discussed below

237 support my argument to use sustainable growth rates in my DCF analyses. First, in my  
238 analysis I employed analyst's earnings per share forecasts from Value Line, Zacks, and  
239 Yahoo Finance. Also, I used and considered sustainable growth estimates employing  
240 Value Line forecasted data for the calculations in the constant growth DCF analysis.  
241 This Value Line forecasted data is the same data source as the forecasted earnings per  
242 share about which Ms. Nelson has no complaint. Despite Ms. Nelson's contentions,  
243 both EPS estimates and sustainable growth forecasts are commonly employed growth  
244 rate estimates for DCF analyses. Moreover, in my experience, regulatory authorities  
245 around the country employ numerous growth estimate methods when setting equity  
246 returns and establishing rates.

247 Ms. Nelson at page 88, line 1441 cites one study (2003 Arnott and Asness) that  
248 dismisses the sustainable growth rate because "the underlying premise of the  
249 sustainable growth model does not hold," concluding that earnings growth is  
250 associated with high dividend payouts.<sup>16</sup> Ms. Nelson's conclusion is not correct. For  
251 example, if a firm pays out all earnings as dividends and puts nothing back into the  
252 firm there can be no growth, The conceptual premise for the sustainable growth  
253 method "is that future growth in dividends for existing equity can only occur if a  
254 portion of the overall return to investors is reinvested into the firm instead of being  
255 distributed as dividends."<sup>17</sup>

256 There is no one best growth estimate and the use of multiple approaches expands and  
257 enhances the analysis. For these reasons Ms. Nelson's criticisms of the sustainable  
258 growth method on this issue are without merit.

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<sup>16</sup> Ms. Nelson Rebuttal Testimony at page 88, line 1441 – 1448.

<sup>17</sup> Morin, Roger; New Regulatory Finance, Public Utility Reports, Inc. (2006) at page 303.



261 **Q. AT PAGE 88, LINES 1449 THROUGH 1472 OF MS. NELSON’S REBUTTAL SHE**  
262 **DISCUSSES A CONCERN REGARDING THE CALCULATION OF CASH**  
263 **FLOWS IN YOUR TWO-STAGE DCF ANALYSIS – DO YOU HAVE A**  
264 **COMMENT?**

265 A. Yes, first, Ms. Nelson’s concerns on the Two-Stage DCF calculation is misplaced. Ms.  
266 Nelson’s concern addresses the payment and timing of future cash flows employment of a  
267 mid-year rather than end-of-year convention. Ms. Nelson points to my calculation of the  
268 constant growth DCF where I increased the cash flow (current annualized 2022 dividend  
269 payment) by one-half the growth rate for the constant growth DCF analysis.<sup>18</sup>

270 A review of my direct testimony at Exhibit (OCS 3.9) for the Two-Stage DCF calculation  
271 shows that I did not increase the 2022 actual dividend by one-half the growth rate, but  
272 instead employed the forward 2023 dividend payment for the calculation.<sup>19</sup> Instead of  
273 increasing 2022 for one-half year, I employed a full year looking forward (2023) and no  
274 further adjustment is necessary.

275 **Q. MS. NELSON HAS SEVERAL COMMENTS REGARDING YOUR CAPM AND**  
276 **ECAPM INTEREST RATE AND MODEL INPUTS – DO YOU HAVE A**  
277 **RESPONSE?**

278 A. Yes. First, Ms. Nelson agrees that the use of the models such as ECAPM are reasonable  
279 and appropriate methods to estimate DEU’s cost of equity.<sup>20</sup> Ms. Nelson also agrees that  
280 the 30-year U.S. Treasury yield and the Value Line beta estimates should be employed.<sup>21</sup>  
281 But, Ms. Nelson disagrees on the use of current rather than forecasted 30-year U.S.  
282 Treasury yields for the risk-free rate and has several criticisms regarding the calculation of  
283 the market risk premium (“MRP”). I address these issues below.

284 First, as to 30-year U.S. Treasury yields, I have employed both the recent 3-month average  
285 and spot estimates for the risk-free rate in the CAPM and ECAPM analyses. Moreover, I

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<sup>18</sup> Ms. Nelson Rebuttal Testimony at page 89, line 1457 – 1459.

<sup>19</sup> See Daniel Lawton Direct Testimony Exhibit (OCS 3.9) at Column A.

<sup>20</sup> Ms. Nelson Rebuttal Testimony at page 91, line 1493.

<sup>21</sup> Ms. Nelson Rebuttal Testimony at page 91, line 1493 – 1494.

286 have updated the 3-month average and spot yield as part of my updated analysis in this  
287 testimony. While it is true that cost of capital estimates entail a forward-looking analysis,  
288 Ms. Nelson provides no evidence that reliance on` forecasted yields are somehow superior  
289 to current actual data in conducting a cost of capital analysis.

290 Second, Ms. Nelson raises a concern related to employing the total bond return in  
291 calculating the historical market risk premium.<sup>22</sup> The historical MRP calculation is the  
292 stock market return less the risk free or bond return over some historical time period. While  
293 bond returns consist of i) income return, ii) capital gains or losses, and iii) reinvestment  
294 return, Ms. Nelson asserts only the income or coupon returns of 4.87% (rather than the  
295 total bond return of 6.0%) is the risk-free rate, therefore only the income portion of the  
296 bond return should be considered.<sup>23</sup> Under Ms. Nelson's approach the MRP should be  
297 7.46% rather than my calculated 6.30% (12.3% - 6.0%) or about 116-basis points higher.<sup>24</sup>

298 Ms. Nelson's criticism misses a key point. This is a historical analysis of MRP and the  
299 historical bond returns include returns (capital gains and reinvestment income) beyond the  
300 income component. To ignore the reality of the additional bond income would tend to bias  
301 the model results. All analysts should make every attempt to avoid a biased analysis for a  
302 predetermined equity return result, therefore Ms. Nelson's criticism on this matter should  
303 be given no weight.

304 Third, Ms. Nelson attempts to critique my forward looking MRP calculation.<sup>25</sup> In the  
305 forward analysis I estimate the 2025 – 2027 equity return for the comparable utility group  
306 based on Value Line forecasted data.<sup>26</sup> This produces a proxy for the market equity return  
307 based on the comparable utility group. Given the goal in this case is to determine DEU's  
308 cost of equity based on a comparable group analysis – employing the comparable group as  
309 a proxy for market return is a reasonable assumption. To calculate the market risk premium,  
310 I subtract the current 30-year U.S. treasury yield of 3.30% (as updated) from the 9.44%

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<sup>22</sup> Ms. Nelson Rebuttal Testimony at page 92, line 1516 – 1517.

<sup>23</sup> Ms. Nelson Rebuttal Testimony at page 93, line 1529 – 1547. For the 4.87% coupon return see Kroll 2022 SBBI Yearbook at page 199 (Exhibit 10.9).

<sup>24</sup> Ms. Nelson Rebuttal Testimony at page 93, line 1546 – 1547.

<sup>25</sup> Ms. Nelson Rebuttal Testimony at page 96, line 1601 – page 98, line 1647.

<sup>26</sup> See Direct Testimony Daniel Lawton Exhibit OCS 3D at page 51, line 933 – 939, also see Exhibit (OCS 3.5).

311 market return proxy to arrive at 6.14% MRP (9.44% - 3.30%). This analysis is no different  
312 from any calculation of market risk premium other than in this case employing the  
313 comparable group as a proxy for the relevant market. Such an approach provides an  
314 additional data point for evaluating the equity return estimates. Again, Ms. Nelson's  
315 criticism is without merit.

316 **Q. AT PAGE 99 OF MS. NELSON'S REBUTTAL SHE DENIES HER MARKET RISK**  
317 **PREMIUM ANALYSIS VIOLATES BASIC UNDERLYING DCF ASSUMPTIONS**  
318 **– DO YOU HAVE ANY COMMENTS?**

319 A. Yes, I have several comments. The basic issue is that Ms. Nelson's attempt to calculate an  
320 expected market return by applying a constant growth DCF to all the companies (dividend-  
321 paying and non-dividend-paying) in the S&P 500 is not correct. Her analysis is not correct  
322 because many of the S&P 500 companies are growth stocks that do not pay dividends. If  
323 Ms. Nelson wanted to employ the S&P 500 for her analysis, she should have analyzed only  
324 dividend paying companies in her work.

325 To see why the use of only dividend paying companies is important in the constant growth  
326 DCF analysis one need only look at Ms. Nelson's direct testimony. First, at page 19, lines  
327 352 – 356 Ms. Nelson sets forth four basic assumptions underlying the DCF model. These  
328 assumptions are i) constant growth in earnings and **dividends**, (emphasis added) ii) stable  
329 **dividend** payout ratio, (emphasis added) iii) constant price/earnings multiple, and iv)  
330 discount rate (k or ROE) greater than the growth rate. A review of Ms. Nelson's analysis  
331 in her direct testimony at DEU Exhibit 2.04 pages 1 - 6, column 4, shows over 90 of the  
332 500 companies report "zero" dividends. This fact alone is inconsistent with the underlying  
333 assumptions discussed above. Further, in Ms. Nelson's direct testimony at page 15, lines  
334 270 – 272, in her discussion of the criteria for selecting her proxy group, she states:

335 Because certain models assume that earnings and dividends grow over time,  
336 **I excluded companies that do not consistently pay quarterly cash**  
337 **dividends, or have cut their dividend in the last two years.** (emphasis  
338 added)

339 By attempting to model non-dividend paying companies with the DCF model, Ms. Nelson  
340 failed to follow her own basic assumptions or her own testimony when conducting her  
341 analyses shown in her Exhibit 2.04.

342 Ms. Nelson’s rebuttal testimony compounds this error when she states “reviewing my DEU  
343 Exhibit 2.04 (for both the Bloomberg analysis and the Value Line analysis) shows that for  
344 every company in the S&P 500, “the growth rate in Column [5] is less than the DCF in  
345 Column [6].”<sup>27</sup>(emphasis added) Ms. Nelson’s statement is **NOT** correct. A review of DEU  
346 Exhibit 2.04 page 1 of 12 starting with the company Adobe Inc. (ADBE), shows that  
347 column 6 (“DCF Result”) is not greater than column 5 (“Long-Term Growth Est.”) – they  
348 are both 16.45% - they are equal. If one proceeds through this Exhibit DEU 2.04, one will  
349 find over 90 instances where Ms. Nelson’s statement that “the growth rate in Column [5]  
350 is less than the DCF in Column [6]” is **NOT** correct. Ms. Nelson’s own Exhibit DEU 2.04  
351 contradicts her rebuttal claims that after “reviewing my DEU Exhibit 2.04 (for both the  
352 Bloomberg analysis and the Value Line analysis) shows that for every company in the S&P  
353 500, the growth rate in Column [5] is less than the DCF in Column [6]” this statement is  
354 not correct and claims to the contrary are just not credible.

355 **Q. DO YOU HAVE ANY COMMENTS REGARDING MS. NELSON’S CRITICISMS**  
356 **OF YOUR CAPITAL STRUCTURE RECOMMENDATION FOR DEU?**

357 A. Yes, I have several comments. First, at page 27, line 438 regarding my basis for  
358 recommending changes to DEU’s capital structure Ms. Nelson states: “Mr. Lawton has not  
359 satisfied that burden.” At the outset, the Company, not the parties has the burden in this  
360 proceeding and attempts at burden shifting are not appropriate. But it is important to look  
361 at the true burden on the ratepayers of the Company’s proposed capital structure with

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<sup>27</sup> Ms. Nelson Rebuttal Testimony at page 99, lines 1652 – 1655.

362 53.21% equity versus my proposed 51% equity ratio. This burden is an additional \$6.3  
363 million in annual revenue requirements.<sup>28</sup> So, if the Company's capital structure is adopted  
364 shareholders will gain millions annually in additional profits at the expense of \$6.3 million  
365 in higher revenue requirements to DEU's customers.

366 The key issue is why higher equity ratios were previously allowed and how we got  
367 to this point. As I stated in my direct testimony the 55% equity ratio was Commission  
368 authorized in Docket No. 19-057-02, although the equity ratio is somewhat high by  
369 historical standards. The higher authorized equity ratio was an adjustment to offset cash  
370 flow decreases created by the implementation of the Tax Cuts and Jobs Act of 2017  
371 (TCJA) specifically the reduced utility cash flows resulting from lower deferred taxes. (The  
372 corporate income tax rate was reduced from the prior statutory rate of 35% down to 21% a  
373 40% reduction – this reduced annual deferred tax payments and cash flows to the utility).

374 Now, after nearly 5-years under the TCJA the DEU rate base investment level is  
375 larger because accumulated deferred taxes (a rate base offset) are lower than they would  
376 have been under the old 35% tax rate. With the higher rate base earnings level – cash flows  
377 and returns will continue to grow over time. The end result is that the higher equity ratio  
378 requested in this case is no longer required to enhance cash flows and financial metrics.

379 Given that an equity enhanced capitalization is no longer necessary, in an effort to  
380 establish a reasonable capital structure one can look to the equity levels of the comparable  
381 group as well as authorized equity levels in the gas utility industry. As I outlined in my  
382 direct testimony a review of the equity levels of the comparable group as well as authorized  
383 equity levels in the gas utility industry support a 51% equity capitalization.<sup>29</sup>

384

385 **Q. AT PAGE 25 OF MS. NELSON'S REBUTTAL TESTIMONY SHE ASSERTS**  
386 **THAT YOUR CAPITAL STRUCTURE COMPARISONS AND ANALYSIS**  
387 **INCORRECTLY FOCUSES ON THE HOLDING COMPANY LEVEL AND THE**  
388 **PROPER "APPLES-TO-APPLES" COMPARISON IS TO THE UTILITY**  
389 **SUBSIDIARY CAPITAL STRUCTURE. DO YOU AGREE?**

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<sup>28</sup> Mr. Mendenhall Rebuttal Testimony at page 12, lines 299-300.

<sup>29</sup> See Daniel Lawton Direct Testimony Exhibit (OCS 3D) page 56, lines 1022 – 1024, and Table 16, also see Exhibit (OCS 3.5) at columns D and E.

390 A. No, I do not agree with Ms. Nelson. First, while I considered comparable group company  
391 capital structures my conclusion and 51% equity ratio recommendation did not rely entirely  
392 on the comparable group comparison, which showed a 48% forecasted equity ratio. As can  
393 be seen in my direct testimony Exhibit (OCS 3.5) the average 2025 – 2027 forecasted  
394 comparable group equity ratio is 48%. Again, I relied more on the current authorized equity  
395 ratios as presented in my direct testimony at page 56 Table 16.

396 Second, the whole point of the comparable group analysis is to develop a  
397 “publically traded” comparable risk or peer group with market data so financial models can  
398 be developed and equity costs estimated.<sup>30</sup> All of this market data for every comparable  
399 company is at the consolidated holding company level. The gas utility subsidiaries like  
400 DEU in Utah are not separately traded in the market.

401 Included in the public market data for each company at the consolidated holding  
402 company level are stock prices, dividends, and business risk measures – and financial risk  
403 metrics based on capital structure. All of this information is available to the investor when  
404 making rational investment decisions as to whether to invest in each company and at what  
405 price.

406 Ms. Nelson suggests we should not consider this consolidated holding company  
407 market data that rational investors consider in their decisions, but instead focus on  
408 subsidiary capital equity levels. I must disagree with Ms. Nelson. The comparable group  
409 equity return estimates are based on the consolidated holding company market data – the  
410 associated capital structure which impacts the equity return estimate must also be on the  
411 consolidated holding company market data. Only then will you have an “**APPLES-TO-**  
412 **APPLES**” comparison.

413

414 **Q. AT PAGE 33 OF MS. NELSON’S REBUTTAL TESTIMONY SHE STATES THAT**  
415 **SOME OF THE RRA’S EQUITY RATIOS INCLUDE JURISDICTIONS THAT**  
416 **INCLUDE NON-INVESTOR SUPPLIED CAPITAL IN THE RATEMAKING**  
417 **CAPITAL STRUCTURE. DO YOU HAVE A COMMENT?**

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<sup>30</sup> Ms. Nelson, and all other equity return analysts employed comparable group approached for estimating cost of equity in this case.

418 A. Yes. Ms. Nelson is correct that some jurisdictions – specifically Arkansas, Florida,  
 419 Indiana, and Michigan do include short-term debt and/or non-investor supplied capital in  
 420 the ratemaking capital structure. Table 6 below shows by jurisdiction the authorized equity  
 421 level for gas utility cases from January through August 2022 and the questioned  
 422 jurisdictions that may include non-investor funds in capital structure are not included. The  
 423 result is that the average equity ratio is about 50% - which is less than the 51% equity ratio  
 424 I recommend in this case. The bottom line is that Ms. Nelson’s criticism on this issue makes  
 425 no difference. Accepting and using Ms. Nelson’s data from Exhibit DEU 2.18R at page 3  
 426 – supports a 51% equity ratio.

427  
 428 **TABLE 6**  
 429 **2022 AUTHORIZED EQUITY RETURNS AND EQUITY RATIOS**  
 430

<b>STATE/JURISDICTION</b>	<b>UTILITY</b>	<b>ROE</b>	<b>EQUITY RATIO</b>
KENTUCKY	DELTA NATURAL GAS	9.25%	NA
NORTH CAROLINA	PIEDMONT NATURAL GAS	9.60%	51.60%
NEW YORK	NIAGRA MOHAWK POWER	9.00%	48.00%
NORTH CAROLINA	PUBLIC SERVICE CO. OF NC	9.60%	51.60%
NEVADA	SOUTHWEST GAS	9.40%	50.00%
NEVADA	NORTH CAROLINA	9.40%	50.00%
NEW YORK	ORANGE & ROCKLAND	9.20%	48.00%
KENTUCKY	ATMOS ENERGY	9.23%	54.50%
NEW YORK	COMING NATURAL GAS	9.25%	48.00%
MICHIGAN	CONSUMERS ENERGY	9.90%	NA
NEW HAMPSHIRE	NORTHERN UTILITIES INC.	9.30%	52.00%
INDIANA	NORTHERN IND. PUB SERV	9.85%	49.47%
OREGON	AVISTA CORP	9.40%	50.00%
NEW JERSEY	ELIZABETHTOWN GAS	9.60%	52.00%
MINNESOTA	CENTERPOINT ENERGY	9.39%	51.00%
WASHINGTON	CASCADE NATURAL GAS	9.40%	47.00%
MEAN (excludes MI & IN)		9.36%	50.28%
MEDIAN (excl. MI & IN)		9.40%	50.00%

SOURCE:

EXHIBIT DEU 2.18R , PAGE 3 OF 4, 2022 RATE DECISIONS

431

432

433 **Q. AT PAGES 30 – 31 OF MS. NELSON’S REBUTTAL TESTIMONY SHE POINTS**  
434 **OUT THAT WINTER STORM URI COSTS IMPACTED THE CAPITAL**  
435 **STRUCTURES OF BOTH “ONE GAS INC.” AND “ATMOS” – DO YOU HAVE**  
436 **COMMENTS?**

437 A. Yes, I have several comments. First, Winter Storm Uri did cause both Atmos and ONE  
438 Gas, Inc. to take on added debt to deal with the spike in natural gas costs that occurred  
439 during Winter Storm Uri in February 2021. Following legislative action in various  
440 jurisdictions both Atmos and ONE Gas have since securitized significant amounts of the  
441 winter storm related debt. But accepting Ms. Nelson’s argument and removing both Atmos  
442 and ONE Gas, Inc. from the comparable group capital structure analysis in Exhibit OCS  
443 3.5, the resulting comparable capital structure declines to about 45% equity. This  
444 demonstrates again my recommended 51% equity ratio is conservative.

445 **SECTION IV: RESPONSE TO MR. MENDENHALL’S REBUTTAL ANALYSIS**

446 **Q. MR. MENDENHALL ALSO CLAIMS THAT DEU’S CURRENT EQUITY RATIO**  
447 **IS REASONABLE. DO YOU HAVE A RESPONSE?**

448 A. Yes, Mr. Mendenhall in his Rebuttal testimony at page 12, lines 301 -305, states that since  
449 2019 “the Company has been working to reduce the equity portion of its capital structure.”  
450 He goes on to state the Company has reduced the equity level from 60.04% to the current  
451 53.21% in this case.<sup>31</sup> What Mr. Mendenhall doesn’t say is that while the Company is  
452 “working” to reduce the equity level, allowing the current 53.21% equity ratio for setting  
453 rates in this case means that shareholders would be earning higher profits and customers  
454 would be paying higher rates to support those profits.

455 My recommendation is to set the equity ratio at 51.0% and save consumers about \$6.3  
456 million in annual revenue requirements and the Company will be incentivized to work  
457 harder and reduce the equity ratio to 51.0%. Then the Company’s equity ratio, while still  
458 higher than the peer group average, would certainly be more in line with authorized equity

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<sup>31</sup> Mr. Mendenhall Rebuttal Testimony at page 12, lines 303-304.



459 ratios around the country.

460 **Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.**

461 A. I have updated my analysis to reflect increasing interest rates. The range of results indicate  
462 an equity cost of 9.0% to 9.50%. My original recommendation of 9.20% is still within the  
463 9.0% - 9.5% reasonable range. Certainly, as the Commission sifts through the evidence in  
464 this proceeding there is room within this range to move above or below the 9.20%  
465 recommendation. As to a capital structure decision, in the last case this Commission  
466 responded to the Company's cash flow needs and equity enhancements. Those equity  
467 enhancement needs are no longer necessary. While the Company asserts it has been  
468 working to lower the equity levels – the Commission should approve a lower equity level  
469 in DEU's capital structure of 51% in this case.

470 After reviewing all of Ms. Nelson's arguments her equity return calculations are overstated  
471 and do not represent market capital cost or current authorized equity returns. Ms. Nelson's  
472 updated analysis suffers the same infirmities that were contained in her direct testimony. I  
473 previously addressed problems with Ms. Nelson's analysis in Section XI of my direct  
474 testimony and will not repeat those arguments here.

475

476 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

477 A. Yes.