

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND)	
TRANSPORTATION COMMISSION,)	
)	
Complainant,)	Dockets UE-121697 and UG-121705
)	<i>(Consolidated)</i>
v.)	
)	
PUGET SOUND ENERGY, INC.,)	Dockets UE-130137 and UG-130138
)	<i>(Consolidated)</i>
)	
Respondent.)	
_____)	

REBUTTAL TESTIMONY OF MICHAEL P. GORMAN
ON BEHALF OF
THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

DECEMBER 19, 2014

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

2 **A.** Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,
3 Chesterfield, MO 63017.

4 **Q. ARE YOU THE SAME MICHAEL P. GORMAN WHO FILED RESPONSE**
5 **TESTIMONY IN THE ORIGINAL ADMINISTRATIVE PROCEEDING AND**
6 **RESPONSE TESTIMONY ON DECEMBER 3, 2014 IN THESE DOCKETS?**

7 **A.** Yes.

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

9 **A.** I am appearing on behalf of the Industrial Customers of Northwest Utilities (“ICNU”).

10 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

11 **A.** I will provide a comment to Washington Utilities and Transportation Commission
12 Staff witness David Parcell’s estimated return on equity range for Puget Sound Energy
13 (“PSE” or “Company”) of 9.0% to 10.0%.

14 **Q. PLEASE SUMMARIZE YOUR FINDINGS AND RECOMMENDATIONS AS**
15 **OUTLINED BELOW.**

16 **A.** I based a fair and balanced interpretation of Mr. Parcell’s return on equity estimates
17 for PSE to support my finding that PSE’s current market cost of equity is in the range
18 of 9.0% to 9.6%. Mr. Parcell’s estimated range overstates a fair return on equity for
19 PSE. I state this based on the clear substantial findings in Mr. Parcell’s own studies.

20 Staff witness Thomas Schooley’s contention that PSE’s authorized return on
21 equity should not be adjusted if it is not earning its current authorized return on equity
22 is nonsensical and should be rejected. In setting the Expedited Rate Filing (“ERF”)
23 revenue requirement, it is appropriate for the Commission to consider significant
24 changes in PSE’s cost of service. One of those significant changes includes a decline

1 in PSE's cost of capital. That decline in its cost of capital, and lower authorized return
2 on equity should be used to set PSE's revenue requirement and retail rates.

3 **Response to Staff Witness David Parcell**

4 **Q. PLEASE DESCRIBE MR. PARCELL'S FINDINGS FOR PSE'S CURRENT**
5 **MARKET COST OF EQUITY.**

6 **A.** Mr. Parcell estimates PSE's current market cost of equity falls in the range of 9.0% to
7 10.0%. He bases this range on a Discounted Cash Flow ("DCF"), Capital Asset
8 Pricing Model ("CAPM"), and Comparable Earnings analysis. These results are
9 summarized at page 3 of his testimony. Mr. Parcell's results are shown below for ease
10 of reference.

<u>Methodology</u>	<u>Range</u>	<u>Midpoint</u>
Discounted Cash Flow	9.1% – 9.7%	9.4%
Capital Asset Pricing Model	6.5% - 6.8%	6.7%
Comparable Earnings	9.0% - 10.0%	9.5%

Source: Exhibit No.__(DCP-1T) at 3.

11 **Q. DO YOU BELIEVE THAT MR. PARCELL'S RANGE IS REASONABLE?**

12 **A.** No. I do not believe his return on equity studies support a high-end estimate of 10.0%
13 as he claims. As shown above in Table 1, which copies his results shown at page 3 of
14 his testimony, Mr. Parcell's DCF and CAPM produce high-end return on equity
15 estimates of 9.7% and approximately 6.8%, respectively. These are market-based

1 studies that measure the current return investors require in order to assume the
2 investment risk of PSE. They are the most commonly relied on methodologies to
3 estimate a utility's fair return on equity and support a finding of PSE's return on
4 equity of no higher than 9.7%. However, as discussed below, Mr. Parcell's high-end
5 DCF return of 9.7% should be interpreted as an extreme high-end based on his DCF
6 studies. A more balanced and reasonable high-end DCF based on Mr. Parcell's
7 studies is 9.5%.

8 I do not believe that the Comparable Earnings methodology is reasonable and
9 produces reliable results. Setting aside my concerns about the accuracy of the
10 Comparable Earnings methodology, I believe that Mr. Parcell's Comparable Earnings
11 studies support a finding that PSE's current market cost of equity is in the range of
12 9.0% to 9.6%. Mr. Parcell's findings that the Comparable Earnings analysis supports
13 a high-end estimate for PSE's current cost of equity at 10% I believe is unsupported.

14 **Q. WHY DO YOU BELIEVE THAT MR. PARCELL'S HIGH-END DCF RETURN**
15 **OF 9.7% SHOULD BE INTERPRETED AS AN EXTREME HIGH-END**
16 **ESTIMATE BASED ON MR. PARCELL'S STUDIES?**

17 **A.** I base this conclusion on Mr. Parcell's Exhibit No.__(DCP-7), pages 4 and 5. As
18 shown on those pages, nearly all estimates produced by Mr. Parcell fall under 9.5%.
19 There are only two estimates that support an estimate above 9.5%. Those are based on
20 FirstCall EPS (earnings per share) growth estimates based on Mr. Parcell's proxy
21 group. As shown in that table, these DCF return estimates are based on mean and
22 median growth rate estimates of 5.3% and 5.4%, respectively. These are very high
23 estimates of sustainable long-term growth rates, which significantly exceed the
24 projected long-term Gross Domestic Product ("GDP") growth rate, and produce DCF
25 return estimates that are much higher than those produced from all other growth rate

1 sources identified by Mr. Parcell. As such, since Mr. Parcell excluded some of his
2 low-end estimates in recommending his DCF range, it would have been appropriate to
3 also exclude his highest estimates based on the numbers he produced on his Exhibit
4 No.__(DCP-7). For example, Mr. Parcell produced several DCF estimates of less
5 than 8%. Excluding his two highest estimates, Mr. Parcell's high-end of the range
6 would be 9.4% rather than 9.7%. This is more of a balanced interpretation of Mr.
7 Parcell's total DCF return estimates.

8 **Q. CAN YOU EXPLAIN WHY A COMPARABLE EARNINGS ANALYSIS DOES**
9 **NOT PRODUCE A RELIABLE ESTIMATE OF AN INVESTOR-REQUIRED**
10 **RETURN FOR MAKING AN INVESTMENT IN UTILITY STOCK?**

11 **A.** Yes. The Company's earned return on book equity can be higher or lower than the
12 market-required return based on whether or not the utility is producing strong or weak
13 earnings. If the Comparable Earnings analysis is used to estimate a fair return, then a
14 utility which is over-earning will continue to over-earn and a utility which is under-
15 earning will continue to under-earn. This methodology will not measure a rate of
16 return which entices investors to make economical investment decisions and
17 encourages them to invest in utility plant investments.

18 A market-based return on equity produces a return on equity that will provide a
19 utility investor the same compensation for investing in utility plant and equipment as
20 is available to the investor from making an alternative comparable risk investment. As
21 such, a market-based return on equity based on DCF or risk premium studies, will
22 produce fair compensation to the utility investor because it provides them with the
23 same risk-adjusted return for making investments in utility plant and equipment that
24 they can get by investing in other comparable risk companies. In contrast, an earned

1 return on equity may be too high or too low. There is simply no way to gauge whether
2 or not it represents a fair return.

3 For all these reasons, I believe the Comparable Earnings analysis simply
4 should not be given any weight in establishing a fair and balanced return on equity for
5 PSE in this proceeding.

6 **Q. PLEASE EXPLAIN WHY YOU BELIEVE MR. PARCELL'S COMPARABLE**
7 **EARNINGS ANALYSIS SUPPORTS A RETURN ON EQUITY RANGE OF**
8 **9.0% TO 9.6%.**

9 **A.** This is a reasonable range based on the evidence presented by Mr. Parcell. As shown
10 at page 25 of his testimony, he outlines his Comparable Earnings analysis studies.
11 The data from that table is copied below for ease of reference.

<u>Description</u>	<u>Proxy Group</u>	<u>Gorman Group</u>	<u>Morin Group</u>
Historic Return on Equity			
Mean	8.3% - 9.1%	9.4% - 9.8%	10.0% - 10.3%
Median	8.8% - 9.2%	9.5% - 9.9%	9.8% - 10.2%
Historic Market-to-Book			
Mean	124% - 152%	130% - 148%	142% - 155%
Median	121% - 143%	129% - 141%	139% - 151%
Prospective Return on Equity			
Mean	8.7% - 9.6%	9.1% - 9.9%	9.9% - 10.4%
Median	9.0%	9.0% - 9.8%	9.5% - 10.0%

Source: Exhibit No.____(DCP-1T) at 25.

12 As shown under the Proxy Group column, Mr. Parcell's methodology, his
13 Comparable Earnings analysis for his proxy group indicates a return on equity of 8.7%

1 to 9.6%. Further, use of my April 2013 proxy group indicates a fair return on equity
2 in the range of 9.1% to 9.9%. Use of PSE witness Dr. Morin's proxy group is slightly
3 higher at 9.9% to 10.4%. The simple average of these mean results from the three
4 different proxy groups indicates a fair return on equity in the range of 9.2% to 10.0%.
5 The median estimated range from this analysis falls fairly squarely in the range of
6 9.0% to 9.9%.

7 The midpoints of the mean and median proxy group prospective return on
8 equity estimates are approximately 9.2% and 9.0% for Mr. Parcell's proxy group,
9 9.5% and 9.4% for the Gorman proxy group, and 10.3% and 9.8% for the Morin proxy
10 group. Further, examination of Mr. Parcell's Exhibit No.__(DCP-10), page 1,
11 indicates that a Comparable Earnings analysis would support a 9.0% return for his
12 proxy group for 2013, 2014 and the three- to five-year projection. The study also
13 shows that a 9.0% return is appropriate for 2013 and 2014 under the Gorman proxy
14 group, with an increase to 9.8% in the three- to five-year projections. Only
15 Dr. Morin's proxy group supports a return on equity in the high to mid nines in 2013
16 and 2014 and the three- to five-year projections. A majority of the Comparable
17 Earnings projections made by the companies in these proxy groups falls below 9.5%.
18 Considering Mr. Parcell's total Comparable Earnings analysis, a majority of these
19 estimates support a return on equity finding of 9.5% or less for PSE.

20 **Response to Thomas Schooley**

21 **Q. DO YOU HAVE ANY COMMENTS ON STAFF WITNESS THOMAS**
22 **SCHOOLEY'S TESTIMONY?**

23 **A.** Yes. At page 4 of Mr. Schooley's testimony, he states that data through 2014 shows
24 that PSE continues to earn less than its authorized rate of return of 7.77%. However,

1 he notes it is getting closer. He concludes that because PSE is not achieving its
2 authorized return of 7.77%, it is unnecessary to reduce its authorized return.

3 **Q. PLEASE COMMENT.**

4 **A.** Mr. Schooley's argument is simply without merit. In setting rates, the Company
5 should be provided with an opportunity to earn a fair and reasonable return on equity.
6 That return on equity should be based on an earned return on equity that is equivalent
7 to what investors could earn in other enterprises of corresponding risk. Setting rates
8 does not provide the Company with a guarantee to earn its authorized return on equity.

9 Mr. Schooley's belief that if the Company fails to earn its authorized return on
10 equity then a higher rate of return is appropriate, is simply not based on fair
11 compensation and appropriate rate-setting standards. Mr. Schooley is simply
12 observing that the Company management must more aggressively manage its cost of
13 service in order to achieve its objective of earning its authorized rate of return. To the
14 extent management is coming up short, it must work harder or control risks more
15 effectively. If the risks are beyond management's control, then it is free to file for a
16 change in rates if it believes that rate change is justified. The Company's failure to
17 earn its authorized return on equity is not a basis to provide it with a rate of return that
18 exceeds its current cost of common equity.

19 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

20 **A.** Yes, it does.

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