STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH
DOCKET NO. G-9, Sub 743

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of	)	
Application of Piedmont Natural Gas	)	BRIEF OF THE
Company, Inc., for an Adjustment of	)	ATTORNEY GENERAL'S OFFICE
Rates, Charges, and Tariffs Applicable	)	
To Service in North Carolina,	)	
Continuation of its IMR Mechanism,	)	
Adoption of an EDIT Rider, and Other	)	
Relief	)	

The North Carolina Attorney General's Office (the "AGO") respectfully submits this Brief in opposition to the application for a general rate increase filed by Piedmont Natural Gas Company, Inc. ("Piedmont" or the "Company") in the above-captioned docket.

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INTRODUCTION

Piedmont's request to increase rates for its North Carolina ratepayers is not just and reasonable, and the Commission should reject it. Under the law, Piedmont bears the burden of proof to show that the proposed increase is both just and reasonable to ratepayers.[1] Piedmont has failed to meet that burden.

In this Brief, the AGO focuses on two key problems with Piedmont's proposed rate increase.

First, the 9.7% rate of return on equity and 52% equity capital structure proposed in the Stipulation[2] are significantly higher than necessary to attract investors. The AGO's expert, Dr. Randall Woolridge, showed that an 8.7% rate of return on equity, under a 52% equity capital structure, is sufficient for Piedmont to successfully compete for investment capital under market conditions. No witness—other than Piedmont's expert—supports a rate of return at the level that would be set in the Stipulation, and Piedmont's expert came to that conclusion based on some factors that are upwardly-biased and others that are specifically prohibited under North Carolina precedent. By setting a 9.7% rather than 8.7% rate of return on equity, the Stipulation would unnecessarily charge ratepayers more than $ 23 million each year. *See infra* pp 4 - 33.

Second, Piedmont should promptly return to ratepayers the millions of dollars it has accumulated in excess deferred taxes. Piedmont holds at least $ 190

[1] N.C.G.S. §§ 62-75; 62-134(c).
[2] On August 13, 2019, Piedmont, the Public Staff, Carolina Utility Customers Association, Inc., and Carolina Industrial Group for Fair Utility Rates IV filed a settlement among those parties (the "Stipulation") that stipulated to a resolution of all matters, including the rate of return on common equity that Piedmont should be allowed an opportunity to earn. (Stipulation at 8)

million in excess deferred taxes, amassed from state corporate income tax rate cuts dating back to 2014 and a federal tax cut from 2017. Piedmont concedes that the benefit of these tax cuts should go to ratepayers, but Piedmont suggests a slow, phased return of these funds to ratepayers. Ratepayers have already waited for years to receive the benefit from these tax cuts. Piedmont suggests no logic that makes it reasonable for ratepayers to wait any longer. The Commission should require an immediate reduction in rates to reflect a return of the excess tax reserves as soon as possible, and in no more than two years. *See infra* pp 33 - 41.

ARGUMENT

I. PIEDMONT'S UNJUSTIFIABLY HIGH 9.7% RATE OF RETURN ON EQUITY AND 52% EQUITY CAPITAL STRUCTURE ADD OVER $ 23 MILLION ANNUALLY TO THE REVENUE REQUIREMENT.

The 9.7% rate of return on equity ("ROE") proposed under the Stipulation exceeds what is required under current economic conditions, adding over $23 million to Piedmont's annual revenue requirement.[3] Piedmont has the burden of proving that a 9.7% ROE is required.[4] Piedmont fails to meet this burden because it supports its proposal based on improper factors and upwardly-biased market analyses. The Commission should reject the Stipulation ROE and fix a rate that is as low as possible – not more than 8.7% – based on existing market conditions.

[3] The $23 million amount is calculated by comparing the cost of service using Piedmont's settlement proposal for a 9.7% ROE and 52% equity capital structure compared to an 8.75% ROE with 52% equity. (AGO-Powers Cross Exhibit 6; Off. Ex. Vol. 6 p 42)
[4] N.C.G.S. §§ 62-75; 62-134(c).

A. Piedmont's arguments are inconsistent with the standard for return on equity set by North Carolina statutes and caselaw.

1. The return on equity must be set at an amount that is fair to customers and investors, taking into account changing economic conditions.

Under North Carolina's statutory formula, the Commission must look to current market conditions when setting the rate of return, evaluating what is fair in light of the state of competition for capital. Section 62-133 specifies that the Commission shall fix the rate of return to produce a fair return for shareholders "considering *changing economic conditions*."[5] Under the statute, the rate of return should allow the utility to "compete in the market for capital funds" on reasonable terms.[6] The statute cautions that those terms must be fair not only to the utility's existing investors, but also to its customers.[7] In the words of our state's Supreme Court, the rate of return provision "advances the Legislature's twin goals of assuring sufficient shareholder investment in utilities while simultaneously maintaining the lowest possible cost to the using public for quality service."[8]

Piedmont's capital structure includes long term debt, short term debt, and common equity.[9] Determining the rate of return on debt is generally straightforward, but the return on common equity (ROE) is more difficult to determine.[10] The Commission's determination of the appropriate ROE is extremely

[5] N.C.G.S. § 62-133(b)(4) (emphasis added).
[6] *Id.*
[7] *Id.*
[8] *State ex rel. Utils. Comm'n v. Cooper*, 367 N.C. 430, 440, 758 S.E.2d 635, 641 (2014) ("*Cooper 2*") (internal quotation marks and citation omitted).
[9] Settlement Exhibit PKP-1, Lines 4-6; Off. Ex. Vol. 6 p 73.
[10] *Utilities Comm'n v. Public Staff*, 322 N.C. 689, 697-98, 370 S.E.2d 567, 572-73 (1988) ("*Public Staff*").

important, because it is the most expensive form of capital and the cost is paid by ratepayers.[11] As such, the statutory provisions relating to ROE "cannot be read in isolation as only protecting public utilities and their shareholders. Instead, it is clear that the Commission must take customer interests into account when making an ROE determination."[12]

The test laid down in N.C.G.S. § 62-133(b)(4) for determining a rate of return that is fair to investors and ratepayers is whether the rate is "sufficient to enable the utility to attract, on reasonable terms, capital necessary to enable it to render adequate service."[13] The determination must take into consideration changing economic conditions and other factors as they then exist.[14] Early United States Supreme Court cases established the guiding principles, which the General Assembly subsequently incorporated into the North Carolina ratemaking statute.[15] Dr. Woolridge testified that when he develops an opinion about a fair ROE for a regulated entity, he follows guiding principles, laid out by the United States Supreme Court that a fair ROE should be 1) comparable to the returns that investors expect on other investments of similar risk; 2) sufficient to assure confidence in the company's financial integrity, and 3) adequate in order to maintain and support the company's credit and to attract capital. (Tr. Vol. 5 p 180)

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[11] *Id.*

[12] *State ex rel. Utilities Comm'n v. Cooper*, 366 N.C. 484, 495, 739 S.E.2d 541, 548 (2013) ("*Cooper*").

[13] *Utilities Comm'n v. Duke Power Co.,* 285 N.C. 377, 393, 206 S.E.2d 269, 280 (1974) ("*Duke Power*").

[14] N.C.G.S. § 62-133 (a)(4); *State ex rel. Utilities Comm'n v. Public Staff*, 331 N.C. 215, 221, 415 S.E.2d 354, 359 (1992) ("*Public Staff 2*").

[15] *See Duke Power*, 285 N.C. at 388, 393, 206 S.E.2d at 276-77, 280; *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virgini*a, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

2. Piedmont urges the Commission to consider improper factors that are contrary to holdings of the North Carolina Supreme Court.

Our appellate courts have concluded that some factors are *not* appropriate considerations for the Commission when it determines a utility's rate of return. Piedmont urges the Commission to rely on these improper factors.

a. Gradualism

First, Piedmont suggests that only gradual changes to the ROE should be authorized in order to moderate the impact of change on investors. That position is not consistent with holdings of our Supreme Court. "The Commission's concern about an 'extreme fluctuation' between the rate of return allowed in [the utility's] last general rate case and that allowed here, termed 'gradualism' by Chairman Wells, … is an improper consideration in determining rate of return… It appears like 'down-market' factors, to arise from the Commission's inappropriate desire 'to protect investors from swings in market prices."[16]

Furthermore, Piedmont errs when it presumes that the ROE from Piedmont's last rate case should be the starting point when evaluating where to fix the ROE in the case now under review. N.C.G.S. § 62-133(e) expressly provides that "the fixing of a rate of return shall not bar the fixing of a different rate of return in a subsequent proceeding." "Previous findings are not *… res judicata*, even as to what was a fair rate of return on common equity capital as of the dates of those former orders, and such findings do not prevent the Commission from finding a lower return on common equity capital fair in the present case, even though the

[16] *Public Staff*, 322 N.C. at 699, 370 S.E.2d at 573; *see also Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643.

tide of inflation has continued to rise."[17] Likewise, the Commission is not bound by a prior ROE. The Supreme Court ruled, "[I]f the Commission is now of the opinion that in the earlier case it fixed too high a rate of return, it is not thereby precluded from finding a lower rate of return to be fair in the present case."[18]

Ignoring these principles, Piedmont suggested during cross examination that Dr. Woolridge's 8.7% ROE recommendation is flawed because it would reduce return too much from the 10.0% ROE fixed in Piedmont's last rate case. (Tr. Vol. 5 pp 302-05) Piedmont prepared a chart of ROEs authorized by this Commission in cases decided over the past decade to demonstrate that changes in authorized returns have been gradual*. See* Tr. Vol. 4 pp 117-18; Exhibit JLS-4; Off. Ex. Vol. 4 p 25. In essence, Piedmont suggests that the Commission should overlook market conditions if they would cause a substantial reduction in ROE. But it is not the job of the Commission to protect investors from swings in market prices or to make changes in ROE gradual.[19] Nor is it fair to customers.[20]

b. <u>Other utilities' and regulators' authorized returns</u>

Another improper consideration that Piedmont promoted in support of a high ROE determination is evidence about the ROEs approved by regulators in other utility rate cases. Our Supreme Court has concluded that the ROE authorized by regulatory commissions in other cases is not a proper factor to rely on when

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[17] *Duke Power,* 285 N.C. at 395, 206 S.E.2d at 281.
[18] *Id.*
[19] *Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643 (holding that a "gradual" change that protects investors from market swings is improper" and "has nothing to do with the company's existing cost of equity").
[20] *Id.* (holding that the rate of return must be fair to customers as well as investors under *current* economic conditions).

determining rates of return.[21] The reason is simple: there is nothing to show that the returns for the other utilities are comparable to the utility being evaluated.[22] "Fundamentally, the Commission's reliance on past ROE determinations authorized for other utilities, without evidence tying those determinations to the facts of the case *sub judice,* prevent[s] the Commission from fairly considering current economic conditions."[23]

Contrary to the Supreme Court's decisions, Piedmont encourages the Commission to rely heavily on the results reached for other utilities by other regulators in other cases. Indeed, Mr. Hevert's chief complaint with the results produced by Dr. Woolridge's ROE studies is that he "has given considerable weight to the Constant Growth Discounted Cash Flow method, even though his results fall well below returns recently authorized for other natural gas utilities." (Tr. Vol. 4 pp 242, 248) During cross examination, Piedmont's lawyer questioned Dr. Woolridge's analyses because his market-based recommendation is lower than returns that have been authorized by some regulators. (Tr. Vol. 5 pp 310-11, 314-22)

Regulators' decisions on other utilities are even incorporated by Mr. Hevert as a key factor for his Bond Yield Plus Risk Premium model. (Tr. Vol. 4 p 218) In that study he compares long-term (30 year) bond yields to regulators' *authorized* rates of return. Some of the rates of return in his study were authorized as long ago as 1980, and he uses this data in lieu of market data about current market

[21] *Public Staff 2,* 331 N.C. at 224, 415 S.E.2d at 360-61; *see also Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643.
[22] *Id.*
[23] *Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643.

conditions. (Exhibit RBH-R-6 p 2; Off. Ex. Vol. 4 p 130) As such, Mr. Hevert's Bond Yield Risk Premium analysis measures not "the market for capital funds"—the test under N.C.G.S. § 62-133(b)(4)—but instead the behavior of *regulatory commissions* over time. (Tr. Vol. 5 p 267)[24]

In addition to violating the requirement that this Commission must base its ROE determination on current market conditions, this analysis is inappropriate for use in setting North Carolina rates, because it reflects the effect of policies of other states that are not market-based. For example, "gradualism," which is a forbidden consideration under North Carolina ratemaking law, is an accepted factor in Virginia and Maryland, affecting the ROEs authorized in those states.[25] (Tr. Vol. 4 p 331; Tr. Vol. 5 pp 324-25)

c. <u>Existence of a partial settlement</u>

Piedmont urges the approval of a 9.7% ROE because it has been accepted by some parties as one piece of a general resolution of the case. The Commission may consider the Stipulation, but it would be improper and unfair to authorize an excessive ROE settled upon by some parties in exchange for concessions by Piedmont as to other unspecified elements of the case. The North Carolina statute that addresses how rates are fixed describes a formula to follow, and expressly requires the Commission to *fix* the rate of return. N.C.G.S. § 62-133(b)(4). As such,

[24] His analysis is also erroneous because it relies on projected bond yields, as well as current yields, driving the results up. (Tr. Vol. 5 p 266)

[25] *Public Staff*, 322 N.C. at 699, 370 S.E.2d at 573; *Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643. Gradualism is not only alien to North Carolina law, but contrary to North Carolina's foundational principle that rates should be fixed "as low as may be reasonably consistent" with Constitutional due process. *See Duke Power*, 285 N.C. at 388, 206. S.E.2d at 276 (stating this principle).

when the Commission considers proposals put forth as part of a non-unanimous stipulation, it must "make its own independent conclusion supported by substantial evidence on the record that the proposal is just and reasonable to all parties in light of all the evidence presented."[26] In its determination of a fair ROE, in particular, the Commission should consider and analyze a stipulated ROE "along with all the evidence regarding proper rate of return" and adduce "its own independent conclusion as to the proper rate of return on equity."[27]

Witness Hinton, testifying for the Public Staff, stated that he and Mr. Hevert disagree about the appropriate ROE, but that they accept a 9.7% ROE as part of a global settlement of the case. (Tr. Vol. 6 p 174) Mr. Hinton testified that "[s]ettlements, as well as the individual components of the settlements, are often achieved by the respective parties' agreements to accept otherwise unacceptable individual aspects of individual issues in order to focus on other issues." (Tr. Vol. 6 p 172) He continued to recommend an ROE of 9.13% and agreed to the higher ROE only in exchange for unspecified settlement terms. (Tr. Vol. 6 p 174)

Mr. Hevert's testimony in support of the stipulation was similar. He stated that he continued to believe that "10.00 percent to 11.00 percent represents an appropriate and defensible range of the Company's Cost of Equity." (Tr. Vol. 4 p 306) However, because he "recognize[d] the benefits" of the stipulation, he testified that "the Stipulated ROE is a reasonable resolution of a complex, and frequently

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[26] *State ex rel. Utilities Comm'n v. Carolina Utility Customers Association*, 348 N.C. 452, 466, 500 S.E.2d 693, 703 (1998) ("*CUCA*") (reversing Commission order fixing ROE because it was adopted from the partial stipulation without Commission consideration and analysis of all the evidence regarding proper rate of return and without an independent conclusion adduced from the evidence.)
[27] *Id.* at 466-67, 500 S.E.2d at 703.

contentious issue." (*Id*.) Mr. O'Donnell, who testified on behalf of the Carolina Utility Customers Association and recommended a 9% ROE (Tr. Vol. 6 p 56), did not change his recommendation. Thus, as in *CUCA*[28], there is no evidence supporting the ROE in the Stipulation other than the stipulation itself and conclusory testimony from the utility expert as to its reasonableness.

This evidence relating to a partial settlement does not relieve the Commission of the requirement that it must fix a fair ROE by making an independent evaluation.

B. <u>The AGO's expert, Dr. Randall Woolridge, demonstrated that an 8.7% rate of return on equity is supported by market data and analysis showing what investors require under current economic conditions.</u>

Taking into account all of the evidence in the record, the cost of equity is 8.7%, and that is the rate of return on equity the Commission should fix in this case if it accepts the 52% equity capital structure proposed in the Nonunanimous Settlement. That determination is supported by the testimony of Randall Woolridge, the expert witness presented by the Attorney General's Office.[29] (Tr. Vol. 5 p 181)

Dr. Woolridge explained how market forces demonstrate that an 8.7% ROE will continue to provide a sufficient return for the company to compete for capital in current markets.[30] (Tr. Vol. 5 p 237-38)

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[28] *Id*.

[29] Dr. Woolridge is a Professor of Finance and the Goldman, Sacks & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at Pennsylvania State University, and has prepared testimony and provided consulting service for over 25 years on rate of return in regulatory cases. (Tr. Vol. 5 pp 172, 278)

[30] Dr. Woolridge testified that a higher rate of return – 9.0% -- would be appropriate if Piedmont had a capital structure with 50% equity, which is a slightly riskier capital structure

Dr. Woolridge estimated Piedmont's cost of equity capital by applying two well-established models: the Discounted Cash Flow ("DCF") model, and the Capital Asset Pricing Model ("CAPM"). (Tr. Vol. 5 p 206) He relied primarily on the DCF model and gave the CAPM results less weight because risk premium studies (of which the CAPM is one form) provide a less reliable indication of the cost of equity for public utilities. (Tr. Vol. 5 p 206)

1. Dr. Woolridge's Discounted Cash Flow (DCF) model supports his 8.7% ROE opinion.

A constant growth DCF analysis measures the cost of common equity based on the sum of the dividend yield plus the expected rate of growth of dividends for comparable companies.[31] (Tr. Vol. 5 p 207) The DCF approach is the best measure of the equity cost rates for public utilities because of the investment valuation process and because of the relative stability of utilities. (Tr. Vol. 5 p 206) The DCF method is commonly relied on by cost of capital witnesses and is used in some form by virtually all investment firms as a technique for valuation. (Tr. Vol. 5 p 208; Tr. Vol. 6 pp 34-35)

Dr. Woolridge analyzed a proxy group of eight publicly-traded natural gas companies with risk profiles similar to Piedmont's, which were the same as Mr. Hevert's proxy group. (Tr. Vol. 5 pp 189-90; Exh. JRW-2; Off. Ex. Vol. 5 p 196) Applying the DCF method, Dr. Woolridge calculated the dividend yields for the

than one with a heavier share of equity as compared to debt. (Tr. Vol. 5 pp 181, 194) He demonstrated that the proxy group of gas distribution companies had on average 48.5% equity (Exhibit JRW-2; Off. Ex. Vol. 5 p 196), less than Dr. Woolridge's recommendation and far less than the Stipulation capital structure of 52% equity.

[31] *See State ex rel. Utilities Com. v. Public Staff,* 323 N.C. 481, 488, 374 S.E.2d 361, 365 (1988).

proxy group and, from the 30-day, 90-day, and 180-day average stock prices, he selected 2.6%, which is the high end of the range of median results. (Tr. Vol. 5 p 211)[32] He applied an adjustment for growth over the coming year, and that resulted in an adjusted yield of 2.678%. (Tr. Vol. 5 p 212)

To estimate the rate of growth of dividends for the proxy group, Dr. Woolridge reviewed multiple measures of the long-term dividend growth expected by investors including historical and projected growth rate estimates for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS"). (Tr. Vol. 5 pp 212-14) He described strengths and weaknesses of the different measures. For instance, while he considered analysts' earnings per share projections, he did not exclusively rely on them because of their well-documented tendency to be "overly optimistic and upwardly-biased." (Tr. Vol. 5 pp 214-18) Dr. Woolridge summarized his analysis of the historical and prospective growth rates, which ranged from 5.0% to 6.3%. (Tr. Vol. 5 pp 213-21) From these results, he selected 6.0% as the appropriate growth rate for the DCF study, which is at the high end of the range of projected growth rates. (Tr. Vol. 5 pp 220-21)

Dr. Woolridge's equity cost rate calculated using his DCF analysis is the sum of the 2.678% adjusted yield plus the long-term growth rate of 6%, which comes to 8.70%. This result *does not* reflect the low end of the range of data for either the dividend yield or the growth factor. Instead, when it is examined in detail, the components of Dr. Woolridge's DCF study use reliable sources of data, and

[32] Dr. Woolridge's dividend yield was slightly higher than most of the dividend yields used in Mr. Hevert's updated DCF results. *See* Exhibit RBH-R-1; Off. Ex. Vol. 4 pp 109-11.

the factors selected both for the dividend yield and the growth rate fall somewhat higher than the midpoint of the range of the data. (Tr. Vol. 5 pp 211, 220-21)

2. <u>Dr. Woolridge employed the Capital Asset Pricing Model (CAPM) as a check.</u>

Dr. Woolridge also employed the Capital Asset Pricing Model (CAPM) as a check. The capital asset pricing model is a risk premium analysis that posits that the cost of equity is equal to the sum of the interest on a risk-free investment plus an appropriate risk premium. (Tr. Vol. 5 p 222) He gave his CAPM results less weight than his DCF analysis, because he believes that risk premium studies provide a less reliable indication of equity cost rates for public utilities. (Tr. Vol. 5 p 206)

Dr. Woolridge explained that the yield on long-term Treasury bonds is usually used as the appropriate risk-free rate in a CAPM analysis. (Tr. Vol. 5 p 223) He testified in his prefiled testimony that the yield on thirty year Treasury bonds had been in the 2.5% to 4.0% range over the last several years, and that the current yield is at the lower end of that range. (Tr. Vol. 5 p 224)[33] He used the higher end of the range, 4.0%. (*Id*.)

In order to factor in the risk level of the particular equity investment being assessed, the overall market risk premium must be multiplied by an appropriate number that measures the investment's risk, known as the "beta." (Tr. Vol. 5 p 225) Dr. Woolridge derived the risk coefficient from published analysis of the betas of the companies in his proxy group. (*Id*.) The median beta coefficient was 0.65. (*Id*.)

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[33] He observed in his summary at the evidentiary hearing that Treasury bonds hit a low yield of about 2% in July 2019. (Tr. Vol. 5 p 281)

A beta value less than 1.0 signifies that the investment is less risky than the market as a whole, which is true of the regulated gas industry. (*Id*.; Exhibit JRW-6; Off. Ex. Vol. 5 p 205)

Dr. Woolridge testified that the market risk premium, which is the expected return on the overall market, is "very difficult to measure and is one of the great mysteries in finance." (Tr. Vol. 5 p 226) Dr. Woolridge described the types of studies that are available to investors, including historical evaluations, studies using expected results, and surveys of financial professionals. (Tr. Vol. 5 pp 226-230; Exhibit JRW-9 pp 4-8; Off. Ex. Vol. 5 pp 217-21) He explained that he eliminated studies conducted prior to 2010, which had a median market risk premium of 4.87%. (Tr. Vol. 5 p 230) The range of all of the studies and surveys he reviewed was 1.87% to 6.26%. (*Id*.; Exhibit JRW-9 p 5; Off. Ex. Vol. 5 p 218) He described six studies in more detail: the December 2018 *CFO Magazine* and Duke University survey of approximately 200 CFOs; Pablo Fernandez's 2019 survey of 4,000 academics, financial analysts, and companies; nine years of the monthly market risk premium analysis of NYU Professor and valuation expert Aswath Damodaren; the analysis of investment advisory firm Duff & Phelps; six years of KPMG's market risk premium analysis; and the current U.S. market risk premium from market-risk-premia, a website that provides market information for thirty-six countries. (Tr. Vol. 5 pp 231-34)

Dr. Woolridge testified that his review of the studies and surveys, giving most weight to the ones he found to be most relevant and timely, suggested that the appropriate market risk premium in the U.S. is in the range between 4.0% and

6.0%. (Tr. Vol. 5 p 234) He noted that this was "a conservatively high estimate of the market risk premium considering the many studies and surveys of the market risk premium." (*Id.*)

Dr. Woolridge's CAPM analysis resulted in an ROE of 7.6%, which is the sum of the 4.0% risk-free rate plus the risk premium of 3.6% (produced from a 0.65 beta adjustment to the market risk premium of 5.5%). (Tr. Vol. 5 pp 234-35)

Thus, his range of appropriate equity costs for Piedmont was 7.60% to 8.70%, assuming Piedmont was allowed a 52% common equity structure. (Tr. Vol. 5 p 236) Since, as noted, Dr. Woolridge does not find the CAPM method to be reliable, his ultimate opinion was at the upper end of the range, 8.7%. (*Id.*)

3. The results of Dr. Wooldridge's ROE analysis is consistent with current economic conditions.

Dr. Woolridge provided numerous reasons that current economic conditions demonstrate that his cost of equity recommendation was appropriate.

First, Dr. Woolridge noted that natural gas utilities are very low risk investments, and further, that they have many adjustment mechanisms that shield investors from market risks.[34] (Tr. Vol. 5 pp 237, 304) In fact, he noted that the "betas," *i.e.*, measures of risk, have been declining in recent years, indicating that the risk of the industry had declined. (Tr. Vol. 5 p 237) The credit ratings issued by S&P and Moody's for Piedmont are in line with the ratings for others in the proxy group, indicating that Piedmont's risk is similar to the average. (*Id.*)

[34] By statute, Piedmont's gas costs may be adjusted periodically and are trued up annually, *see* N.C.G.S. § 62-133.4, and other adjustment mechanisms apply significant periodic rate adjustments, including Piedmont's Integrity Management Rider (IMR) and its Margin Decoupling Tracker. (Tr. Vol. 6 pp 155-56)

Second, long-term bond yields for utilities are still historically low and are likely to remain low given low inflationary expectations and slow global economic growth. (*Id.*)

Third, Dr. Woolridge testified that even though authorized ROEs for natural gas distribution companies have mostly declined between 2012 and 2019, the authorized rates have lagged behind the market cost. (Tr. Vol. 5 p 238)

Fourth, Dr. Woolridge reported the results of a study by Moody's which found that the downward trend in rates of return authorized by regulators has not weakened the credit profiles of utilities. Instead, the companies are still strong in credit agency ratings, and they have continued to be able to raise $50 billion per year in capital. (Tr. Vol. 5 pp 239; 304-05) Testimony in this case demonstrated that this is true for Piedmont in particular. On May 24, 2019, Piedmont completed a historic $600 million long-term debt offering, its single largest. (Tr. Vol. 4 p 115) In June 2018, Duke Energy Corporation infused 300 million of equity capital into Piedmont, and it added another $150 million in June 2019. (Tr. Vol. 4 p 117)

Fifth, Dr. Woolridge explained that capital market conditions support a lower ROE: interest rates are at a historic low, and utility stock prices are at a historic high. (Tr. Vol. 5 p 307)

Sixth, Dr. Woolridge showed that his proposed return on equity – 8.7% – is not out of line with the actual earned returns on equity earned by gas distribution companies in his proxy group. (Tr. Vol. 5 pp 203, 305; Exhibit JRW-5; Off. Ex. Vol. 5 p 204) While the actual returns on equity earned by companies in the proxy group bumped up in 2018, the returns have been in the range of 8% to 9% over the past three years. (Tr. Vol. 5 p 305) During that time, the price-to-book ratios for the proxy group were over 2, which demonstrates investors' willingness to pay far more for the stock than the book value of the assets, and which means that these 8% to 9% returns were "more than enough to meet investor return requirements." (*Id*.)

Seventh, Dr. Woolridge analyzed ten years of over market-to-book ratios for the proxy group, and demonstrated that they have increased from 1.25 to 2.0. This demonstrates, Dr. Woolridge explained, that returns on equity have been greater than the cost of capital, which means returns on equity have been more than necessary to meet investors' required returns, and that "customers have been paying more than necessary to support an appropriate profit level for regulated utilities." (Tr. Vol. 5 p 203; Exhibit JRW-5 p 3; Off. Ex. Vol. 5 p 204)

In sum, under existing market conditions and based on the behavior of actual market participants, Dr. Woolridge demonstrated that a return of 8.7% is sufficient for investors. (*Id.*) Alternatively, the evidence would also support approval of a capital structure that uses 50% equity, and Dr. Woolridge recommends allowing a 9.0% ROE if the Commission uses 50% equity given the somewhat higher risk to investors. (Tr. Vol. 5 p 181)

C. The return on equity recommended by Dr. Woolridge is supported by other expert witnesses.

1. Dr. Woolridge's testimony is consistent with the testimony of the witnesses presented by the Public Staff and CUCA.

Dr. Woolridge's recommendation is corroborated by the testimonies of Robert Hinton,[35] the expert witness presented by the Public Staff, and Kevin O'Donnell,[36] the expert witness presented by the Carolina Utility Customers Association.[37] The table on the next page summarizes the recommendations and results produced by the economic models of the parties' experts.

[35] Mr. Hinton is the Director of the Economic Research Division of the Public Staff, has a B.S. and a Master of Economics degree, and has over 30 years of experience as an analyst and expert witness on the Public Staff. (Tr. Vol. 6 p 164)

[36] Mr. O'Donnell is President of Noval Energy Consultants, Inc., has degrees in civil engineering and an MBA, and has over 25 years of experience as a consultant on utilities issues and a financial analyst. (Tr. Vol. 6 p 12)

[37] Additionally, Nicholas Phillips, Jr., commented on Piedmont's requested ROE but did not provide estimates based on market studies.(Tr. Vol. 5 p 75) As will be discussed in Part I.D *infra*, the evidence presented by Piedmont witness Hevert to support a significantly higher return on equity should be given little or no weight because it relies on models that use upwardly biased factors and analyses and recommendations that are erroneous.

			SUMMARY OF ROE RECOMMENDATIONS												
		Range		ROE	Discounted Cash Flow				CAPM		Expected Earnings		Bond Yield Risk Prem.		Note
Witness	Party	Low	High	Recommendation	Low	High	[mid]	Low	High	[mid]	Low	High	Low	High	
Mr. Hevert	Piedmont	10.00%	11.00%	10.60%	7.54%	13.80%	10.67%	9.62%	12.96%	11.29%	10.02%	10.18%	9.87%	10.01%	1
Dr. Woolridge	AGO	7.60%	8.70%	8.70%		8.70%	8.70%		7.60%	7.60%	Comparal	Earnings	Approved	ROE	2
Mr. O'Donnell	CUCA			9.00%	7.60%	9.60%	8.60%	5.50%	7.50%	6.50%	9.00%	10.00%	Regression Analysis		3
Mr. Hinton	Public Staff			9.13%	8.10%	9.10%	8.60%	7.79%	9.10%	8.45%	9.00%	9.85%		9.64%	4

Note 1	See Hevert at 3, Rebuttal RBH-R-1, RBH-R-5, RBH-R-6, RBH-R-7.
Note 2	See Woolridge at 2, 50, 64.
Note 3	See O"Donnell testimony at 3, 45.
Note 4	See Hinton testimony at 5, 31, 37, Exh JRH-5, JRH-6.

AGO-Hevert Cross Ex. 1; Off. Ex. Vol. 4 p 197.

(text continues on next page)

It is plain from the summary that the experts for the AGO, Public Staff, and CUCA concluded that an ROE significantly lower than the 9.7% Stipulation ROE is sufficient under current market conditions. Their recommendations were much lower than Piedmont's expert. All of them relied on the Discounted Cash Flow ("DCF") method.[38] The midpoint of the results for the DCF studies was 8.6% for both Mr. Hinton and Mr. O'Donnell, while Dr. Woolridge's DCF result was just slightly higher at 8.7%. On the other hand, Piedmont's witness relied on very high results produced in other studies.[39]

Fixing an ROE of 8.7% or less for Piedmont is supported by Dr. Woolridge's analyses, and the reliability of his recommendation is well-supported by the economic analyses described in his testimony as well as the testimonies of witnesses Hinton and O'Donnell.

2. <u>Discounted cash flow studies by the Public Staff and CUCA witnesses support an 8.7% ROE.</u>

The reliability of the 8.7% DCF result produced by Dr. Woolridge is supported by the DCF studies that were performed by Mr. Hinton and Mr. O'Donnell, with similar results. Mr. Hinton's DCF analysis produced an equity cost range of 8.1% to 9.1% (Tr. Vol. 6 p 147), and the midpoint of his range is 8.6%. Mr. O'Donnell's DCF analysis produced an equity cost range of 7.6% to 9.6% (Tr. Vol. 6 p 45), which again has a midpoint of 8.6%. Both recommended a somewhat

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[38] Mr. Hinton relied on both the DCF method and his Regression Analysis of bonds and authorized returns. (Tr. Vol. 6 pp 141, 147) Other models performed by Mr. Hinton and Mr. O'Donnell were used as a check. (Tr. Vol. 6 pp 50, 141, 150-51)

[39] The table shows the midpoint or "mid" results where a "high" and "low" result was produced by the expert to illustrate how the results compared among the experts, but Mr. Hevert pointed out that he did not show a midpoint of his analyses and does not agree that it is appropriate to rely on the midpoint of the results. (Tr. Vol. 4 p 316)

higher ROE: Mr. Hinton recommended 9.13%, and Mr. O'Donnell recommended 9.0%. (Tr. Vol. 6 pp 120)

3. As a matter of law, the Commission should not rely on other models presented by the Public Staff and CUCA witnesses.

Other studies that were presented in testimonies from Mr. Hinton and Mr. O'Donnell should not be given significant weight in the determination by the Commission because they were not relied on by the witnesses themselves other than as a check. Our Supreme Court has held that, where an expert presents a model but uses it only as a check on other analyses that he considers more reliable, then the results for the model that was used as a check are insufficient evidence to support the Commission's ROE determination.[40]

Dr. Woolridge, Mr. Hinton, and Mr. O'Donnell all performed CAPM studies and presented the results. However, although the results of their CAPM studies were lower than their DCF studies, they did not give the results much weight and only used them as a check, because they considered the CAPM approach less reliable. (Tr. Vol. 5 p 206; Tr. Vol. 6 pp 50, 153)

Similarly, Mr. O'Donnell and Mr. Hinton presented studies based on the Comparable Earnings approach but used the approach only as a check, and accordingly, the results are not sufficient evidence to be given significant weight in the Commission's determination. (Tr. Vol. 6 pp 34, 150-51) Mr. O'Donnell explained his concerns about the CAPM and the Comparable Earnings approaches relative to the DCF:

[40] *Public Staff 2*, 331 N.C. at 225, 415 S.E.2d at 361 (concluding that it was improper to rely on the result of Dr. Olson's risk premium study to support the authorized ROE because he testified that he used it only as a check.).

> The DCF is a pure investor-driven model that incorporates current investor expectations based on daily and ongoing market prices. When a situation develops in a company that affects its earnings and/or perceived risk level, the price of the stock adjusts immediately. Since the stock price is a major component in the DCF model, the change in risk level and/or earnings expectations is captured in the investor return requirement with either an upward or downward movement to account for the change in the company.
>
> The comparable earnings model is based on earned returns from book equity, not market equity. There is no direct and immediate stockholder input into the comparable earnings model and, as a fault, that model lacks a clear and unmistaken link to stockholder expectations.
>
> The CAPM suffers, to a degree, from the same problem as the comparable earnings model in that there is not a direct and immediate link from stock market prices to the CAPM result. The beta in the CAPM can reflect changes in the ROE, but the delay can, sometimes, make the CAPM results meaningless.

(Tr. Vol. 6 p 34) Mr. Hinton described a similar concern. (Tr. Vol. 6 pp 150-53)

The Commission should not give any weight to Mr. Hinton's regression analysis of bond yields, because it relies improperly on authorized returns. (Tr. Vol. 6 p 149) For reasons discussed in Part B, the returns authorized in other cases are not a proper consideration for determining existing economic conditions and investor behavior.

In sum, evidence shows that the existing cost of equity for Piedmont is 8.7%, and that is what should be fixed as the ROE in the case.

D. Piedmont failed to meet its burden to support a 9.7% ROE rate.

Piedmont has the burden of proof to support a 9.7% ROE.[41] Piedmont has failed to meet that burden. The Commission should give little or no weight to the

[41] N.C.G.S. §§ 62-75; 62-134(c).

evidence provided by Piedmont's expert Hevert.[42] Mr. Hevert's analyses contain errors that create systemic upward bias, and they rely on methods and data inputs that inflate his cost of equity recommendations. Mr. Hevert's high initial 10.6% ROE recommendation would be reduced under the Stipulation, but even the Stipulation's 9.7% ROE exceeds a market-based rate by a substantial amount and is not supported by any analysis.

Mr. Hevert presented the results of multiple models to estimate Piedmont's cost of equity (Tr. Vol. 4 p 155), but stated that his (lower) DCF model results should be viewed with caution and more weight should be given to his (higher) Risk Premium-based methods. (*Id*.) Therefore, he gave more weight to CAPM and his Bond Yield Risk Premium. The fourth method that he used – an Expected Earnings approach - was presented as a check to assess the reasonableness of the DCF and Risk Premium-based methods. (*Id.*)

1. <u>Mr. Hevert's Capital Asset Pricing Model analysis is flawed.</u>

The results Mr. Hevert produces in his updated Capital Asset Pricing Model range from a low of 9.62% to a high of 12.96%. (Exhibit RBH-R-5; Off. Ex. Vol. 4 p 128) There are two main flaws that cause his results to be so high.

As noted above in Part I.B, two significant inputs for a CAPM analysis are the risk-free rate and the market risk premium. The CAPM estimates the cost of common equity based on the sum of the interest-free bond rate plus the risk premium associated with equity investments comparable to the subject company.

[42] Mr. Hevert is a Partner of ScottMadden, Inc., has degrees in Business and Economics and an MBA, and has 30+ years of experience working in regulated industries including time served as a financial officer and in other capacities. (Tr. Vol. 4 p 148)

(Tr. Vol. 5 p 222) Mr. Hevert uses unreliable and upwardly-biased methods for deriving both of these inputs. First, to estimate the risk-free rate, he has included projected Treasury yields in addition to current yields for 30 year Treasuries. The projected yields distort Mr. Hevert's results because they are abnormally high relative to current yields. (Tr. Vol. 5 p 247) Mr. Hevert's use of projected yields as inputs in the study increases the risk free factor from between 21 and 101 basis points. (Exhibit RBH-5; Off. Ex. Vol. 4 p 128; showing current 30 year Treasury yield of 3.04% and projected yields of 3.25% and 4.05%) Dr. Woolridge criticized the use of projected yields because such projections are unreliable. (Tr. Vol. 5 p 248) In this case, they added over 100 basis points to the high end of the study results.

Second, with respect to the market risk premium, Mr. Hevert was the only witness who eschewed published studies in favor of performing his own analysis. As with Dr. Woolridge, *see* Part I.B *supra*, Mr. O'Donnell reviewed a number of published market risk premiums and determined that the appropriate range was 4.00% - 6.00%; Mr. O'Donnell found an ROE of between 5.50% and 7.50%. (Tr. Vol. 6 pp 52-55) Mr. Hinton used a market premium analysis from Duff & Phelps, and the results of his CAPM analysis suggested an ROE of 7.79%. (Tr. Vol. 6 p 153) All three rejected the CAPM analysis in favor of their higher DCF analysis. (Tr. Vol. 5 p 206; Tr. Vol. 6 pp 56, 153)

In order to calculate the market risk premium factor, Mr. Hevert produced his own study using a DCF analysis to forecast the expected rate of return on equities in the market, generally. (Tr. Vol. 5 pp 249-50) His initial market risk premiums were 10.65 (using Bloomberg inputs) and 13.77% (using Value Line inputs), and his updated market risk premium figures were 12.25% and 12.15%, using those inputs, respectively. (Exh. RBH-5 & Exhibit RBH-R-5; Off. Ex. Vol. 4 pp 83, 128) Thus, Mr. Hevert's market risk premiums were more than double the range Dr. Woolridge found in his review of published studies and surveys. Mr. Hevert's analysis means that he is forecasting long-term growth in the U.S. stock market of -13.68% to 16.81%. (Tr. Vol. 5 p 249, Tr. Vol. 6 p 64) As all three of the other ROE experts explained, these levels of predicted growth are extremely high. (Tr. Vol. 5 pp 249-50; Tr. Vol. 6 pp 64, 161) Mr. Hevert's market risk premium analysis uses highly unrealistic assumptions about future economic and earnings growth, and these assumptions generate an unrealistically high estimate of market risk premiums. (Tr. Vol. 5 p 248; Tr. Vol. 6 pp 61-64, 161-62) Dr. Woolridge explains that – realistically - earnings in the S&P 500 cannot grow at rates in excess of 10% per year, as indicated in Mr. Hevert's study, while gross domestic product is projected to grow at a rate of 4.5%. (Tr. Vol. 5 pp 258-64, 283)

The criticism of Mr. Hevert's methodology is by no means limited to Intervenors' experts. The same concerns about Mr. Hevert's CAPM methodology are reflected in this Commission's finding in the Final Order in the most recent Duke Energy Progress rate case. The Commission explained that due to Mr. Hevert's reliance on projected Treasury bond yields for the risk-free rate his results were "an outlier and upwardly biased."[43] Further, the Commission found the following with respect to his market risk premium calculations:

[43] Order Accepting Settlement, Deciding Contested Issues and Granting Partial Rate Increase, issued 23 February 2018 in Docket No. E-2, Sub 1142 at 85.

> Witness Hevert's risk premium component of his CAPM uses a constant growth DCF for the S&P 500 companies, using analyst-projected earnings per share forecasts as the growth component. Witness Hevert's DCF dividend growth component, based solely on analysts' earnings per share growth projections without consideration of any historical results, is upwardly biased and unreliable.[44]

Mr. Hevert's DCF analysis that he incorporates into his CAPM model suffers from the exact same problem: it uses only analysts' projected earnings growth estimates with no historical results. (Tr. Vol. 4 p 216)

The Virginia Corporation Commission found the same flaws in Mr. Hevert's CAPM analysis presented to establish the cost of capital in a Virginia Electric and Power Company case;

> [T]the Company's Capital Asset Pricing Model ("CAPM") analysis is …flawed. For example, the Company's highest ROE estimates result from the use of a 2019 projected 30-year Treasury bond yield of 4.2% and a 2021 projected 30-year Treasury bond yield of 4.4%. The Commission has explicitly rejected the use of such projected interest rates in prior cases, stating that inclusion of these projected rates inflates the results of the utility's risk premium analysis. In addition, the Company exclusively used earnings per share as the measure of long-term growth to develop the market risk premium component of its CAPM analysis, which results in an overstatement of the cost of equity.

AGO Hevert Cross Exhibit 2, Final Order dated 29 November 2017 at 5; Off. Ex. Vol. 4 p 202.

In sum, Mr. Hevert's CAPM analysis is flawed and unreliable and should not be given any weight in the determination of the cost of equity capital for Piedmont.

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[44] *Id.*

2. <u>The other approaches used by Mr. Hevert are problematic.</u>

Mr. Hevert's other studies also should not be given weight by the Commission, as they rely on upwardly-biased data or on factors forbidden by the Supreme Court.

Mr. Hevert's other risk premium analysis – the Bond Yield Risk Premium – has two flaws. (Tr. Vol. 5 pp 266-268) First, his use of projected interest rates causes the results of the study to be higher and is reason to question the results for reasons discussed in connection with the CAPM study. (*Id.*) Second, his use of regulators' *authorized* returns in lieu of basing his analysis on current market data is not permissible in fixing ROEs in North Carolina.[45] Thus, as was discussed in Part I.B, his study relies on improper factors.

Mr. Hevert's DCF model should not be given weight in the determination of the cost of equity capital because 1) Mr. Hevert himself indicated skepticism about the reliability of the DCF method, (Tr. Vol. 4 p 155), and 2) his analysis is flawed because he has relied on projected earnings per share data without exercising judgment about the limitations of that data. (Tr. Vol. 5 pp 242-46, 282) As Dr. Woolridge explained, earnings per share growth rates projected by Wall Street analysts are overly optimistic and upwardly biased. (*Id.*) Dr. Woolridge demonstrated that there are issues with the Value Line growth rates that were used that result in high values for eight of nine of the companies, including an outlier growth rate of 25.5% for one of the companies in the proxy group. (Tr. Vol. 5 pp 244-45, 282) The same problem this Commission found with regard to Mr. Hevert's

[45] *See* Part B; *Public Staff 2,* 331 N.C.at 224, 415 S.E.2d at 360-61; *see also Cooper 2,* 367 N.C. at 443, 758 S.E.2d at 643.

use of a DCF study to estimate the risk premium used in a CAPM model in the Duke Progress rate case applies to the DCF analysis employed here: "Witness Hevert's DCF dividend growth component, based solely on analysts' earnings per share growth projections without consideration of any historical results, is upwardly biased and unreliable."[46]

Finally, Mr. Hevert's Expected Earnings approach should be given little weight because 1) it was relied on by him as a check on other methods; and 2) the method does not evaluate investor behavior. The Expected Earnings approach reflects the actual earnings on book value of investment for each of the companies in the proxy group as a basis for estimating the cost of capital. (Tr. Vol. 4 p 221) The analysis does not include a component to measure investor return requirements, however, and so does not reflect changes in expectation affected by existing economic conditions such as increases or decreases in interest rates. (Tr. Vol. 5 p 269) Investors do not purchase stock at book value, so the market information about stock prices is not considered. (Tr. Vol. 5 p 270) Further, the approach is similar to the Comparable Earnings method, and suffers from problems described earlier in the quote from Mr. O'Donnell's testimony when he explained why he did not rely on that approach. (*See* Tr. Vol. 6 p 34)

In short, Mr. Hevert's cost of equity analyses are upwardly-biased and erroneous and should not be given weight in the Commission's determination.

[46] Order Accepting Settlement, Deciding Contested Issues and Granting Partial Rate Increase, issued 23 February 2018 in Docket No. E-2, Sub 1142 at 85.

E. Public input has raised concerns about the rate increase.

In setting the rate of return, consumer interests are not a mere afterthought; accordingly, the North Carolina Supreme Court has held that the Commission must make findings of fact about the impact of changing economic conditions upon consumers when it considers what rate of return to establish pursuant to N.C.G.S. § 62-133(b)(4).[47]

Although the unemployment rate in North Carolina overall has fallen since the peak in 2009-2010, the rate in Piedmont's service territory remains somewhat higher than the national unemployment rate. (Tr. Vol. 5 p 276) At the same time, the median household income has grown slower in North Carolina than the national average and is more than 10% below norm. (*Id.*) The residential gas rates are more than 15% higher than the national average. (*Id.*)

Cost is an important factor to consider in determining a reasonable ROE because even small increases or decreases in the ROE make a large difference in the utility's revenue requirement, particularly when the cost of income taxes is taken into account. Here, over $23 million would be shaved from Piedmont's annual revenue requirement if the Commission were to establish an 8.7% ROE instead of the 9.7% ROE proposed in the Stipulation. (AGO-Powers Cross Ex. 6; Off. Ex. Vol. 6 p 42) This $ 23 million will be charged to Piedmont's customers.

Customers testified about the impact of the proposed rate increase at public hearings held in High Point, Charlotte and Wilmington, (Tr. Vol. 1 – Tr. Vol. 3) and identified the following key concerns:

[47] *State ex rel. Utilities Comm'n v. Cooper*, 367 N.C. 644, 650, 766 S.E.2d 827, 830 (2014).

- Customers are against the proposed rate increase. (Tr. Vol. 1 pp 13-14; Tr. Vol. 3 pp 13-15)
- Low income, senior citizens or disabled individuals who live on a fixed income will have even more difficulty paying their bills if there is an increase in the utility rates. These customers will increasingly have to rely on payment plan arrangements in order to pay their utility bills and keep their utility service active. (Tr. Vol. 1 pp 16-20, 42-43, 45-50; Tr. Vol. 2 pp 32-33, 35, 41-43, 56, 77, 82-83)
- Some consumers are forced to choose between paying for utilities and meeting other needs such as purchasing essentials like food or medications. (Tr. Vol. 1 pp 43, 45-50; Tr. Vol. 2 pp 78, 82-83).
- Many are concerned about the climate and are against the rate increase if it is used to expanding the current fossil fuel infrastructure rather than invest in renewable energy sources. (Tr. Vol. 1 pp 21-22, 30-31, 33-34, 36-39; Tr. Vol. 2 pp 17-19, 21-23, 24-25, 27-29, 35-36, 39, 42, 48-57, 72-74; Tr. Vol. 3 pp 18-19, 20-23, 24, 31-32, 34-35)
- Proposed fossil fuel infrastructure projects are in low income areas that are at risk and will be disadvantaged when pollution or accidents occur. (Tr. Vol. 1 p 32; Tr. Vol. 2 pp 32-33, 56, 63-64; Tr. Vol. 3 pp 35-36)
- Some believe the rate increase and requested return on equity increase are unfair and unjustly place a burden on the consumers. (Tr. Vol. 2 pp 24-29, 86-87; Tr. Vol. 3 pp 18-19)

- Many think the rate increase serves to increase profits, benefit shareholders, and pay large executive salaries. (Tr. Vol. 1 pp 17, 41, 54-55; Tr. Vol. 2 pp 25, 39, 41, 44, 66-69, 73; Tr. Vol. 3 p 22).

The budgetary concerns of these customers are equally as valid as the desire of Piedmont's shareholders to reap more return on their investment.

The legislature intended for the Commission to set the rate of return as low as "may be reasonably consistent" with Constitutional requirements.[48] Here, Mr. Hevert's opinion patently fails to meet this standard. His result is an outlier among the four experts who provided ROE opinions and is demonstrably unreliable and upwardly-biased. Likewise, the ROE in the Partial Stipulation is well above the ROE opinions of Dr. Woolridge, Mr. O'Donnell, and Mr. Hinton, and should also be rejected. There is no credible and legally-valid expert opinion supporting the Stipulation ROE of 9.75% ROE. Therefore, for the reasons stated in Dr. Woolridge's testimony, the Commission should set the ROE at 8.7%.

II. PIEDMONT SHOULD PROMPTLY RETURN TO RATEPAYERS $155 MILLION IT IS HOLDING IN EXCESS DEFERRED TAX COLLECTIONS.

Reductions in federal and state corporate income tax rates over the last six years have lowered operating expenses for utilities.[49] As a result, Piedmont has accrued a large sum in federal deferred taxes that it no longer needs to meet its future tax liabilities. The Attorney General supports rate adjustments that promptly return the benefits of these tax changes to ratepayers.

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[48] *See Utilities Comm. v. Power Co.,* 285 N.C. 377, 388, 206 S.E.2d 269, 276 (1974).

[49] The Commission previously ruled that this general rate case would determine how Piedmont would reflect the federal tax rate changes in new utility rates. *See Order Addressing the Impacts of the Federal Tax Cuts and Jobs Act on Public Utilities* in Docket No. M-100, Sub 148, issued 5 October 2018, at 69.

A. Piedmont's Federal Excess Deferred Income Taxes Are Should Be Returned to Ratepayers Within Two Years.

Piedmont has large balances of federal excess deferred income taxes ("EDIT") because the Tax Cuts and Jobs Act of 2017 (the "Tax Act") changed both the federal tax income rate and the treatment of depreciation expenses. EDIT represents monies Piedmont previously collected in rates to meet future tax liabilities that Piedmont will no longer owe.

1. Piedmont has a large balance of federal excess deferred taxes which should be returned within two years at the most.

At the end of 2018, Piedmont had a total of $378 million of federal EDIT on its books. (Tr. Vol. 5 p 103) The great majority of this amount — $279 million — is "protected" EDIT for which the Tax Act dictates the flow back to ratepayers. (*Id.*; Tr. Vol. 6 p 198) Protected EDIT is associated with changes in depreciation deductions for property, and the federal tax code prescribes its return over a time period that mimics the life of the underlying assets. (Tr. Vol. 5 p 103) Piedmont will return the protected EDIT over approximately 50 years. (Tr. Vol. 5 p 131; Perry Tr. Vol. 6 p 198; Stipulation at 15) The Attorney General does not contest this approach.

In contrast, this Commission has sole discretion to determine how quickly Piedmont returns the *unprotected* EDIT to ratepayers. (Tr. Vol. 6 p 201; *see also* Tr. Vol. 5 p 149) Piedmont's unprotected EDIT totals approximately $99 million. (Tr. Vol. 5 p 104)

Under the Stipulation, all of the federal unprotected EDIT would be amortized and returned to customers on a levelized basis through a rider over five years. (Stipulation at 15)

2. Piedmont should return all excess deferred income taxes within two years of the order in this case.

The Attorney General urges the Commission to return the unprotected EDIT to ratepayers over no more than two years. The parties do not dispute that the ratepayers are entitled to these monies. Piedmont witness Barkley testified, "Instead of having an obligation to pay this money to the IRS in the future, the Company now has an obligation to pay it to customers." (Tr. Vol. 5 pp 102-03) Public Staff witness Perry stated, "These funds rightfully belong to the ratepayers and should be returned to them as soon as reasonably possible." (Tr. Vol. 6 p 201) However, the Stipulation would return state and federal EDIT to ratepayers many years later than the fastest reasonably possible time.

3. Piedmont's proposal—five years—would give Piedmont more time than any other utility to return unprotected federal EDIT.

Initially, Piedmont wanted to divide the approximately $99 million of unprotected EDIT into two "buckets": $74 million related to Piedmont's investment in property, plant, and equipment, and approximately $25 million that was not. (Tr. Vol. 5 p 104) Piedmont proposed to return the $74 million bucket to ratepayers over twenty years, and the second $25 million over five years. (Tr. Vol. 5 pp 104-05)

The Public Staff disagreed with Piedmont's treatment of the unprotected EDIT. Public Staff witness Perry testified as follows:

> I do not agree with the Company's characterization of its unprotected federal EDIT as "unprotected, PP&E related" and "unprotected, non PP&E related." The IRS tax normalization rules are very clear—EDIT is either protected, or it is not. The EDIT that the Company designates as "unprotected, PP&E related" is clearly still unprotected under IRS rules, a fact conceded by the Company.

(Tr. Vol. 6 p 200) Witness Perry testified that Piedmont's position on the unprotected EDIT was "not supported by any accounting or ratemaking principle." (*Id.*)

The Public Staff recommended return of the federal unprotected EDIT over five years, consistent with its position in the recent Duke Energy Carolinas rate case. (Tr. Vol. 6 pp 191, 259) In that rate case, which was filed before the Tax Act passed, the Commission did not reach the EDIT flow-back issue.

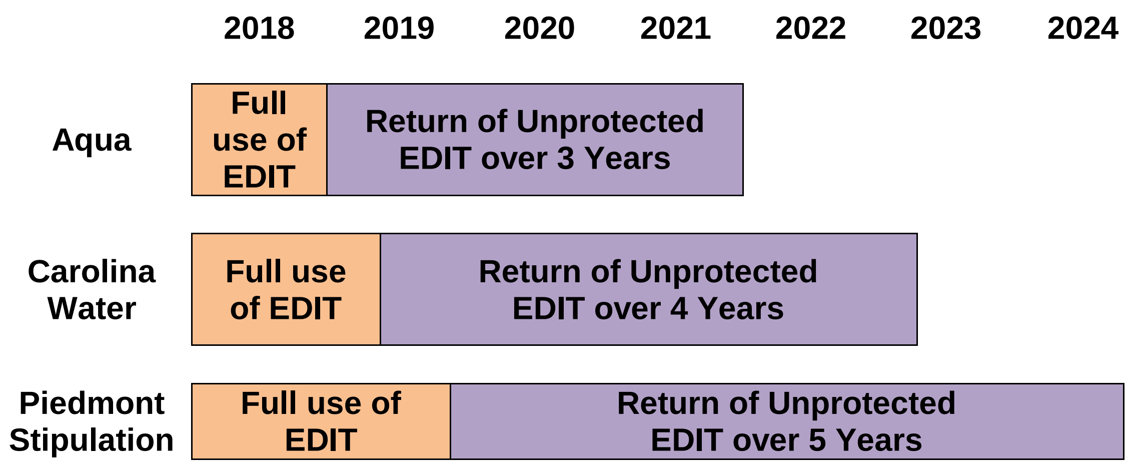
No other utility has been granted five years to flow back the EDIT. If the Commission adopts the positions reflected in the Stipulation, Piedmont will be an outlier regarding EDIT, both in the length of the flow-back period and in the overall time the company will have to use ratepayers' money. In the last general rate case of Aqua, the Commission ordered the utility to return the unprotected EDIT to ratepayers in a rider to rates over three years.[50] (Tr. Vol. 5 pp 135-36; AGO Barkley Cross Exhibit 1 p 22; Off. Ex. Vol. 5 p 254) When the Commission entered the Order, the new lower federal tax rates had been in place nearly a year, giving Aqua four years of access to the funds and time to plan for their replacement. (*Id.*)

In the general rate case brought by Carolina Water Service, the Commission ordered the utility to return the unprotected EDIT to ratepayers through a levelized rider to rates over four years.[51] (Tr. Vol. 5 pp 136-37; AGO Barkley Cross Exhibit 2 p 12; Off. Ex. Vol. 5 p 474) Because the Commission entered the order in

[50] Order Approving Partial Settlement Agreement and Settlement, Granting Partial Rate Increase, and Requiring Customer Notice (Dec. 18, 2018), Docket W-218 Sub 497.
[51] Order Approving Joint Partial Settlement Agreement and Settlement, Granting Partial Rate Increase, and Requiring Customer Notice (Feb. 21, 2019), Docket W-354, Sub 360.

February 2019, Carolina Water Service had the use of the excess deferred taxes for over five years.

In contrast, if the Commission accepts the proposed treatment of unprotected EDIT in the Stipulation, Piedmont will have the use of the excess deferred taxes for nearly seven years after the new tax law came into effect. (Tr. Vol. 5 p 142) This disparity between the Stipulation and the recent Aqua and Carolina Water Service orders can be seen clearly in one of the AGO's exhibits, as shown below:



(AGO Barkley Cross-Examination Exhibit 3, Off. Ex. Vol. 5 p 609)

4. <u>The best interest of ratepayers requires that Piedmont return the federal unprotected EDIT within two years.</u>

Piedmont argued that it was in ratepayers' interest for Piedmont to take 20 years to return all the unprotected EDIT on its books. It suggested, "Inasmuch as credit quality drives access to affordable capital, it is also important, and in the best interest of customers, to prevent weakening of the Company's cash flow and credit quality." (Tr. Vol. 5 p 99)

The Public Staff did not agree that Piedmont's concerns about credit quality should govern the length of the EDIT return period. Witness Perry testified that "the Public Staff does not agree that the Commission should allow those concerns [regarding cash flow and credit metrics] to determine its actions in this case, given the lack of specific evidence of likely harm to the ratepayers presented by the Company. . . ." (Tr. Vol. 6 p 202)

Piedmont did not support its assertion about cash flow and credit quality with evidence, and as noted above, Piedmont is having great success accessing the capital markets, receiving equity investments from its parent corporation and successfully issuing its largest ever long-term debt offering. (Tr. Vol. 4 pp 115, 117)

Piedmont witness Barkley acknowledged that Piedmont is a sophisticated company that had considerable time to plan to return excess funds to ratepayers. (Tr. Vol. 5 p 150) Moreover, in passing the Tax Act, Congress already protected utilities from the cash flow consequences of the lower tax rates and loss of full "bonus deprecation." The Tax Act protects approximately 75 percent of the federal EDIT such that Piedmont will return it to ratepayers over 50 years.

Piedmont's statement about ratepayers' best interests ignores that ratepayers will have other uses for that money—uses that they choose instead of a forced investment in Piedmont. Further, the longer Piedmont holds the tax-related funds, the less likely it becomes that they will be returned to the same ratepayers who paid for them in rates.

5. Smoothing rates is not a sufficient reason to prevent ratepayers from receiving a prompt return of deferred taxes.

The Public Staff cites concerns about having natural gas bills go up abruptly in the future; as a result, it suggests that excess deferred taxes should be returned over longer than the shortest reasonably possible time. Witness Perry testified that a jump in rates would be "very upsetting to customers." (Tr. Vol. 6 p 261) Increasing rate stability is the sole justification the Public Staff offers for its proposal to return unprotected EDIT over five years. (Tr. Vol 6 p 202)[52]

However, if the Commission concludes customers need information for budgeting purposes or to reduce confusion, the Commission could order Piedmont to give customers information about the temporary nature of the tax flowback. The Commission has ordered similar customer notices for many utilities in Docket No. M-100, Sub 138, *Implementation of House Bill 998-An Act to Simplify NC Tax Structure & to Reduce Individual & Business Tax Rates*.

This matter falls within the Commission's discretion. Piedmont acknowledges that "the Commission has the discretion to flow back all of the unprotected EDIT over any time period it deems appropriate." (Tr. Vol. 6 p 200; *see also* Tr. Vol. 5 p 149) The Attorney General urges the Commission to exercise its discretion to require Piedmont to return EDIT to ratepayers within two years of the order in this case.

[52] The Public Staff based its position in this case on supplemental testimony it provided in the most recent Duke Energy Carolinas rate case. The Public Staff's initial recommendation in the DEC case had been for the excess deferred taxes to be returned to ratepayers over two years. (Tr. Vol. 6 p 259) In revising the Public Staff's position in the DEC matter, Public Staff witness Boswell testified that it was as a result of the utility's concerns about the impact on its cash flow. (*Id*.) In the present case, no record evidence shows that the Public Staff has concerns about Piedmont's cash flow.

B. There Are No Reasons to Return the State Excess Deferred Income Taxes Over a Longer Period of Time Than Two Years.

Piedmont also has EDIT balances resulting from the multiple reductions in the North Carolina state corporate tax rate over the last several years. The North Carolina corporate income tax rate stepped down from 6.9% at the time of Piedmont's last rate case in 2013 to 2.5% effective January 1, 2019. (Tr. Vol. 5 p 150) The balance of Piedmont's state EDIT is $56,190,417. (Tr. Vol. 5 p 106) In the Stipulation, the parties have agreed that Piedmont will return these funds to be returned to ratepayers over three years. (Stipulation at 15.) The Attorney General believes the Commission should return these state EDIT funds to ratepayers within two years from the date of the order in this matter.

Piedmont originally proposed to return the state EDIT to customers over five years. (Tr. Vol. 5 p 106.) The Public Staff recommended a two-year flow back. (Tr. Vol. 6 p 204) In the Stipulation, Public Staff and Piedmont agreed to have Piedmont return these funds to ratepayers over three years. (Stipulation at 15)

As with the federal unprotected EDIT, no party has advanced a prudent reason or evidence-based justification for such a lengthy period for Piedmont to hold the state EDIT. The state EDIT funds have been accumulating since 2014, when state corporate income taxes fell. Ratepayers should not wait three more years for a full return of these funds. After five years, the disconnect between the customers whose rate payments contributed to the deferred tax balances and the ratepayers who will receive a credit for the excess funds is even greater than with respect to the federal EDIT. Moreover, Piedmont has had even more time to replace the state EDIT as a source of capital than it has with the federal EDIT.

Finally, a three-year flowback period is inconsistent with two recent dockets in which the Commission approved flow-back over one-year and two-year periods. (Tr. Vol. 6 p205, citing the orders in Public Service Company of North Carolina, Inc., Docket No. G-5, Sub 565 (one-year return period), and Dominion Energy North Carolina, Docket No. E-22, Sub 532 (two-year return period)).

The Commission should return the state EDIT to ratepayers over no more than two years.

CONCLUSION

For the reasons stated above, the Commission should set Piedmont's Return on Common Equity at 8.7%. Additionally, the Commission should direct Piedmont to return excess deferred taxes over a period of time not to exceed two years.

Respectfully submitted this the 25th day of September, 2019.

JOSHUA H. STEIN
ATTORNEY GENERAL

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CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing BRIEF OF THE ATTORNEY GENERAL'S has been served upon the parties of record in this proceeding by email or by depositing a copy of the same in the United States Mail, postage prepaid, this the 25th day of September 2019.

__/s/______________________
Jennifer T. Harrod
Special Deputy Attorney General