STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

DOCKET NO. G-5, Sub 565

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of	)	
Application of Public Service Company	)	ATTORNEY GENERAL'S
of North Carolina, Inc., for a General	)	RESPONSE TO PSNC'S
Increase in Its Rates and Charges	)	REPLY BRIEF

The North Carolina Attorney General's Office (the "AGO") respectfully submits this Response to the Reply Brief filed by Public Service Company of North Carolina, Inc. ("PSNC") on 14 October 2016. Contrary to PSNC's contentions, the AGO's arguments are supported by appropriate and substantial evidence in the case that the proposed rate of return is excessive and will impose an unreasonable burden on the region served by PSNC. Likewise, there is appropriate and substantial evidence that the proposed Integrity Management Tracker ("IMT") rate adjustment mechanism should be rejected because PSNC has not shown that there is a need for yet another rate adjustment mechanism, and any benefit it offers is outweighed by multiple disadvantages for consumers. The AGO's arguments present important considerations that must be weighed by the Commission alongside other evidence in the case. The following points respond to particular points raised by PSNC in the order that they appear in PSNC's Reply.

1. <u>The Overall Rate of Return</u>.

PSNC complains that there is not support in the record for the AGO's argument that the proposed overall rate of return in this case is actually *higher* than the overall rate of return the Commission fixed in the Piedmont general rate case in 2013 even though the 9.7% rate of return on equity ("ROE") proposed in this case is lower than the 10% ROE in Piedmont's case. PSNC Reply at 2. The AGO cited page 75 of transcript Volume 5 in support of the point (AGO Brief at 2), but the full cite should have included pages 73-75 of Transcript Volume 5. On page 74, PSNC witness Addison agreed, subject to check, that the overall rate of return in the Piedmont case was 7.51%, and he agreed on page 73 that the overall rate of return in this case is 7.53%.[1] The point of this comparison is that the 9.7% ROE in this case *appears* to move the rate of return gradually lower toward the cost of capital reflected in financial market data, but that appearance is deceptive because it ignores the offsetting effect of the higher 52% equity ratio proposed in the stipulated capital structure. AGO Brief at 2. On page 75 of Volume 5, the cross examination on this point continued and turned to questions about the much higher cost of equity relative to the cost of debt, and the costly effect of a high equity ratio on the Company's revenue requirement.

The AGO also noted that capital costs have trended downward since the Piedmont case (AGO's Brief at 2), and PSNC contends that there is no evidence in the record to support that point. PSNC Reply at 2. To be clear, the AGO does not argue that Piedmont's ROE or its overall rate of return fixed in 2013 should be a starting point for estimating the appropriate rate of return for PSNC in 2016.[2] Rather, the point of the comparison to Piedmont was to illustrate the significance

[1] PSNC does not refute the numbers.

[2] As discussed in the AGO's Brief at 25 and cases referenced there, it is not appropriate for the Commission to rely on past ROE determinations authorized for other utilities without evidence tying those determinations to the facts of this case.

of the higher equity ratio in the capital structure in this case, since even with a 9.7% ROE, the overall cost of capital for customers is *higher* than it was for Piedmont's customers using a 10% ROE. AGO Brief at 2.

Nonetheless, the AGO does not agree with PSNC's contention that there is no evidence that capital costs have trended downward since 2013. PSNC's agreement to a 9.7% ROE, despite Mr. Hevert's estimate that a 10.6% ROE is still needed, suggests that the cost of capital has declined. Further, Mr. Hevert's Constant Growth DCF study shows that the trend is downward for ROE results produced from the most recent stock market data (i.e. 30 days ending February 12, 2016) compared to the data over a longer time frame (i.e. 180 days ending February 12, 2016). <u>See</u> Exhibit RBH-1. (T5 p 147, T6 pp 28- 29)

Furthermore, Mr. Hevert's explanation of the downward trend in his DCF study provides insight about the recent value investors place on utilities stocks compared to their value in 2014 and historically. Mr. Hevert testified that his DCF results – and the fact that the ROE results trended downward - were affected by the fact that stock prices went up for utilities in late 2015 and early 2016, reducing the dividend yield for stockholders. (T6 p 29) In other words, equity investors were willing to pay more for utility stocks in late 2015 and 2016 even though that lowered the yield they would receive, and this tended to produce a lower cost of capital under the Constant Growth DCF approach. Mr. Hevert argued that the higher stock price-to-earnings ratios that were experienced by utilities in late 2015 and early 2016 (i.e., the higher "P/E" ratio) is not sustainable and caused him to look at other measures than the Constant Growth DCF study to measure the cost of capital. (T6 p 29, T5 p 141-142) Nonetheless, his testimony that investors were willing to pay higher prices for utility stocks in late 2015 and early 2016, and thus receive lower yields on dividends, tends to show that investors were willing to accept a lower return on their investment, at least in the near term. Furthermore, Mr. Hevert testified that the price of utility stocks relative to earnings was high in 2014 relative to its historical average going back to the 1990s, (T6 pp 11-12)("utilities are being valued quite highly now relative to their historical average") and that "the current values are higher now than they were in 2014." (T6 p 12) This evidence that utility stocks carried higher values relative to earnings in late 2015 and 2016 compared to 2014, and that the higher stock values tend to have a downward effect on yields, indicate a trend that continued between 2014 and 2016.

Moreover, the evidence that investors have placed higher values on gas utility stocks since 2014 tends to run contrary to Mr. Hevert's assessment that investors have shown increasing uncertainty about the natural gas industry and that investors' risk aversion has been reflected in an increased cost of capital since 2013. See PSNC Reply Brief at 3 (T5 pp 204-205).

2. Capital Structure.

PSNC also argues that the AGO's Brief draws inferences not supported by witness testimony, and gives as an example contentions that relate to PSNC witness Addison's response to questions about loans from PSNC to the SCANA Money Pool from March 2010 through October 2014. PSNC Reply at 3. The AGO argued that PSNC's actual reported equity ratio does not reflect the appropriate ratemaking equity, and gave as an example the fact that PSNC was able to make substantial loans from March 2010 through October 2014 to the Money Pool. AGO Brief at 6-7. The Money Pool is maintained by SCANA so that the affiliates and parent can "take advantage of each others' cash flow or investment abilities at different points in time." (T5 p 117) The AGO posited that the high level of loans PSNC made during the period relative to the amounts it borrowed from the Pool indicate that PSNC's rates were generating more cash than the Company needed, and it was loaning that cash to SCANA and its other subsidiaries through the Money Pool. AGO Brief at 7. PSNC claims that Mr. Addison's testimony shows that PSNC's loans to the Money Pool coincided with issuances of long-term debt by PSNC (see Reply Brief at 3), but that does not appear to be consistent with his testimony.[3] In fact, Mr. Addison testified that, during "the historical period" from 2010 to 2014, PSNC did not have as many capital investments to make as it will prospectively, "so we've not had to issue a great deal of long-term debt, anything like that, not been into the commercial paper markets a lot in the past."[4] (T5 p 117)

Next, PSNC disagrees with the AGO's contention that the average equity ratio for PSNC expert Hevert's proxy group supports the argument that an equity ratio of 50% or less is sufficient. PSNC Reply at 4. Notably, PSNC does not disagree that the average equity ratio for the group is 49.75%, according to

[3] PSNC appears to refer to reports it has filed in a different docket but that were not admitted into the evidence in this case. See PSNC Reply Brief at 3.
[4] As to PSNC's argument that, due to increased investments in ratebase, it is moving back to a period when it is likely to be a net borrower from the Money Pool until points when it issues long term debt (PSNC Reply at 3), the AGO addressed this in the confidential section of the AGO Brief, and will not repeat that discussion here. See the AGO's Brief at 9-10.

Supplemental Exhibit No. RBH-2 using equity ratio data for ten periods, or that the average equity ratio using eight periods is less than that. Instead PSNC contends that it is appropriate to consider the range of results, not the average, and argues that 52% falls within the range. Id. The average equity ratio for proxy group companies for the ten quarterly periods ranges from 43.75% to 54.06% (see Supplemental Exhibit RBH-2), so once again Mr. Hevert's position supports a point that is high in the range.

PSNC also disagrees that the significantly lower equity ratio of SCANA and SCANA's debt rating should be considered in the Commission's evaluation in this case. Reply Brief at 4-5. The significance of financial market information about SCANA is explained in the AGO's Brief, and includes confidential information, and the details will not be restated here. See AGO Brief at 8-9.

3. Return on Equity

PSNC makes four complaints about the AGO's arguments that the proposed ROE of 9.7% is excessive.

First, PSNC disagrees with the AGO's argument that Mr. Hevert's DCF study is skewed by his reliance on the most extreme data and contends that the argument is not supported by the evidence. See PSNC Reply at 5. However, Mr. Hevert did agree that the "mean high" estimate in his Constant Growth DCF study reflects the highest result based on the multiple growth data sources he used, and the "mean low" estimate reflects the lowest result. (T6 p 21 line 22 – p 22 line 20) The AGO's Brief points out that - although the DCF study shows the lowest as well as the mean and highest results - Mr. Hevert's recommended

ROE range draws from the high results and ignores the low results. AGO Brief at 15. Indeed, his 10.6% ROE recommendation is higher than the midpoint between the mean results and the highest results, as is shown on the following table:

SUMMARY OF CONSTANT GROWTH DCF RESULTS

Column	1 Midpoint of Columns 2 and 3	2 Mean Low	3 Mean	4 Mean High	5 Midpoint of Columns 3 and 4
30-Day Average	8.75	8.14	9.36	11.08	10.22
90-Day Average	8.85	8.24	9.46	11.18	10.32
180-Day Average	9.00	8.38	9.61	11.32	10.47
Mean	8.87	8.25	9.48	11.19	10.34

See Table 2 on T5 p 147.

Columns 2, 3, and 4 in the table show Mr. Hevert's DCF results from his Table 2. Column 1 reflects the average of the "mean low" and "mean" results (i.e., columns 2 and 3). Column 5 reflects the average of the "mean" and "mean high" results (i.e., columns 3 and 4). Column 5 indicates that Mr. Hevert's 10.6% ROE recommendation falls above the midpoint between his "mean" result and his "mean high" result in his Constant Growth DCF study. Thus, it is not unfair to say that Mr. Hevert drew from the high results and ignored the low results.

Second, PSNC disagrees with the AGO's argument that Mr. Hevert's DCF study is also skewed by his over-reliance on five-year projections of annual growth in earnings-per-share without consideration of other factors available to investors for measuring growth. PSNC Reply at 6. It is fair to point out, however, that other measures of growth are available to investors, and that relying on just the one factor may have distorted Mr. Hevert's results. This was illustrated by the Value Line information available to investors provided as an attachment to the AGO's Brief, as well as the box showing the growth data for Laclede Group. See AGO's Brief at 16.

Third, PSNC disagrees with the AGO's argument that Mr. Hevert's multi-stage DCF results are skewed by his reliance on a high long-term growth rate of 5.31% for the GDP growth rate in the last stage of his model. PSNC Reply at 6-7. However, Mr. Hevert did acknowledge that, in recent testimony he filed in Missouri, he referenced a rate used by the Energy Information Administration and a rate used by the Social Security Administration, both of which are substantially lower. T6 pp 33-34. The Energy Information Administration rate for GDP was 4.24% and the rate for the Social Security Administration was 4.35%, either of which would make a sizeable difference in the multi-state DCF result. (T6 p 34) He testified that the Social Security Administration uses 4.35% as their "reference" or "base" case but also produce what they refer to as a "high and a low cost scenario," and stated that his estimate of 5.31% is "higher than their base case, but is well within the range of the estimates that they provide." Id. He also suggested that the Energy Information Administration GDP rate is their "reference" case. Id. Once again, witness Hevert draws from the higher data for measuring growth.

Fourth, PSNC disagrees with the AGO's argument that Mr. Hevert's Capital Asset Pricing Model (CAPM) is skewed in an upward direction by his reliance on a high estimate of the market premium investors require. PSNC Reply at 7-8. PSNC does not disagree with the AGO's assertions that Mr.

Hevert's risk premium is not based on any published source and reflects his estimate derived using his own DCF study, and PSNC does not disagree that Mr. Hevert's derived risk premium plugged into his CAPM study indicates that investors expect to earn a return on equity of between 12.78% and 14.01% in the overall stock market. See PSNC Reply at 7-8; AGO's Brief at 22.

Rather, PSNC contends that the "Client Alert" issued by Duff & Phelps, which estimates an equity risk premium (called an "ERP") of 5.5% (increased from 5%) is not published to be used in a CAPM. PSNC Reply at 7. PSNC contends, instead, that the Duff & Phelps equity risk premium is a component of a "building block approach" that involves multiple risk factors to calculate the cost of equity. See PSNC Reply Brief at 7. However, PSNC's contention is contradicted by the Client Alert summary that was introduced as Attorney General-Hevert Cross Exhibit 5 (attached). It states,

> The ERP is a key input used to calculate the cost of equity capital within the context of the Capital Asset Pricing Model (CAPM) and other models.

Id. When the 5.5% equity risk premium from Duff & Phelps is used in place of the risk premium derived by Mr. Hevert, and the higher risk free rate of 4% from Duff & Phelps is used – keeping other risk factors the same - the CAPM produces a cost of capital estimate of 7.49% or 8.16%, depending on the beta coefficient, which is substantially lower than the estimate produced from Mr. Hevert's "derived" equity risk premium. See Attorney General-Hevert Cross Exhibit 6. (T6 pp 42-44) The Commission may find that 7.49% or 8.16% is not appropriate in this proceeding, and indeed, the Commission has not typically relied on the CAPM model. Nonetheless, the record supports the arguments in the AGO's Brief, and demonstrates that data published for investor clients of Duff & Phelps to measure the equity risk premium for the CAPM model produces an estimate of the cost of capital that is 500 basis points or more below the results produced by Mr. Hevert's derived equity risk premium.

4. Integrity Management Tracker.

With respect to the AGO's arguments that the proposed IMT is not in the public interest, PSNC complains that the AGO's Brief improperly uses testimony from PSNC witness Addison. PSNC Reply at 8. PSNC agrees that the AGO's Brief properly characterizes Mr. Addison's testimony as asserting "that the use of a tracker mechanism for cost recovery will not reduce investor perceptions of risk," but claims that the statement is improperly used by the AGO to support the contention that the tracker mechanism "is not needed to address investor uncertainties about the risks associated with the investments." Id. The distinction drawn by PSNC is not easy to follow and there is nothing improper about the AGO's argument. Indeed, the Company's statement that such a mechanism is not needed to reduce investor perceptions of risk is a pertinent consideration to the Commission's determination, particularly in light of multiple disadvantages the IMT poses for consumers; i.e., that it will allow frequent additional rate increases, based on expedited review, without regard to offsetting cost factors, and without meaningful public input.

In sum, the AGO's arguments that the proposed rate of return is excessive and will impose an unreasonable burden on the region served by PSNC are supported by appropriate and substantial evidence in the case. Likewise, there is appropriate and substantial evidence that the proposed IMT rate adjustment mechanism should be rejected as contrary to the public interest, because PSNC has not shown that there is a need for yet another rate adjustment mechanism, and any benefit it offers is outweighed by multiple disadvantages for consumers. These are important considerations that the Commission must weigh alongside other evidence in the case.

Respectfully submitted, this the 19th day of October, 2016.

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CERTIFICATE OF SERVICE

The undersigned certifies that she has served a copy of the foregoing ATTORNEY GENERAL'S RESPONSE TO PSNC'S REPLY BRIEF upon the parties of record in this proceeding and their attorneys by electronic mail.

This the 19 th day of October, 2016.

/s/ Margaret A. Force
Margaret A. Force
Assistant Attorney General

Attorney General- Hevert
Cross Exhibit 5

I/A

DUFF & PHELPS

Valuation and Corporate Finance Advisors

Duff & Phelps Increases Recommended U.S. Equity Risk Premium fro 5.0% to 5.5%

Duff & Phelps regularly reviews fluctuations in global economic and financial market conditions that warrant periodic reassessments of the recommended Equity Risk Premium (ERP). Based upon current market conditions, Duff & Phelps recommends an increase in the U.S. ERP to 5.5% when developing discount rates as of **January 31, 2016** and thereafter (ur further guidance is issued). The prior Duff & Phelps recommended U.S. ERP was 5.0%, established as of February 28, 2013. Both of these ERP estimates were measured relative to a normalized yield of 4.0% on 20-year U.S. Treasury bonds. Click he read the report.

Note that for valuations performed as of **December 31, 2015**, the Duff & Phelps U.S. ERP recommendation remained at 5.0% matched with a normalized risk-free rate of 4.0%.

The ERP is a key input used to calculate the cost of equity capital within the context of the Capital Asset Pricing Model (CAPI and other models. The ERP is used as a building block when estimating a company's discount rate and is an essential ingred of any business valuation.