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Oct 14 2016

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**VIA ELECTRONIC FILING**

Chief Clerk  
North Carolina Utilities Commission  
Dobbs Building  
430 North Salisbury Street  
Raleigh, North Carolina 27603

Re: Docket No. G-5, Sub 565

Dear Chief Clerk:

Enclosed on behalf of Public Service Company of North Carolina, Inc. is its Reply to Attorney General's Brief and Motion for Leave to File Reply Brief Out of Time for filing in the above-referenced proceeding.

If you have any questions regarding this filing, please do not hesitate to call me. Thank you for your assistance with this matter.

Very truly yours,

/s/Mary Lynne Grigg

MLG:kjg

Enclosure

**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 of North Carolina, Inc., for a General Increase in Its Rates and Charges	) ) ) )	REPLY TO ATTORNEY GENERAL'S BRIEF AND MOTION FOR LEAVE TO FILE REPLY BRIEF OUT OF TIME
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On October 10, 2016, the North Carolina Attorney General's Office ("Attorney General") filed a brief opposing portions of the Amended Stipulation entered into by Public Service Company of North Carolina, Inc. ("PSNC" or "Company") and the other parties to the above-captioned proceeding and filed with the Commission on August 30, 2016. The arguments in the Attorney General's Brief rely on selected pieces of evidence in the record and are not supported by the complete statements and conclusions of the witnesses. The Company contends and demonstrates herein that a complete reading of the transcript shows that the Attorney General's arguments are not supported by the evidence. Further, the Attorney General's Brief ignores other important aspects of the Amended Stipulation, which addressed all issues of the case. For these reasons, PSNC respectfully submits this Reply to Attorney General's Brief and moves for leave to file it out of time.<sup>1</sup>

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<sup>1</sup> Due to time constraints this reply does not attempt to address every argument in the Attorney General's Brief, but is intended to aid the Commission in its consideration of a number of points not supported by the complete statements of PSNC's witnesses and to highlight that the brief challenges only a small portion of the Amended Stipulation, which constitutes a comprehensive settlement of all issues in the case among all parties except the Attorney General.

### **Motion for Leave to Submit Reply**

Because this reply responds to certain matters raised in the Attorney General's Brief which could not be addressed prior to the October 10, 2016, deadline set by the Commission, PSNC submits that there is good cause for the Commission to accept the reply only four days after the date by which briefs and proposed orders were due. PSNC therefore moves that the Commission grant the Company leave to file the reply out of time.

### **Rate of Return**

With respect to the overall rate of return agreed to in the Amended Stipulation, the Attorney General's Brief asserts that the "overall rate of return – taking into account the ROE along with other factors proposed in this case – is actually higher at 7.53% than the overall rate of return the Commission fixed for Piedmont three years ago in Docket No. G-9, Sub 631 (which was 7.51%) although Piedmont's ROE was fixed at 10% in that case and *capital costs have trended downward.*" Attorney General's Brief at 2 (emphasis added). The brief's transcript cite (volume 5 at page 75) does not support the emphasized assertion. Rather, on this page of the transcript PSNC witness Addison testified on cross-examination that Piedmont's lower overall rate of return in Docket No. G-9, Sub 631, as compared to the stipulated rate of return in this case, may have been due to the lower percentage of equity in Piedmont's capital structure as compared to the stipulated equity in this case; he also testified that the 9.7% stipulated return on equity is higher than PSNC's embedded cost of long-term debt of approximately 5.5%.

Moreover, there is no evidence that capital costs have trended downward since Piedmont's rate case. To the contrary, PSNC witness Hevert's direct testimony indicates that capital costs have increased since Piedmont's rate case. Mr. Hevert testified that "since

December 2013, relative volatility has increased, suggesting greater increasing uncertainty in the natural gas utility industry”; “credit spreads have increased”; “[t]o the extent that credit spreads have increased, it is an observable measure of the capital markets’ increased risk aversion”; and “increased risk aversion clearly is associated with an increased Cost of Equity.” Tr. Vol. 5, p. 204, line 8 – p. 205, line 14.

### **Capital Structure**

With respect to the 52% equity portion of the capital structure agreed to in the Amended Stipulation, the Attorney General’s Brief on several occasions makes inferences that are not supported by the witnesses’ testimony. For example, the brief argues that the history of PSNC’s loans to the SCANA Money Pool from March 2010 through October 2014 “indicates 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.” Attorney General’s Brief at 7. The brief cites volume 5 of the transcript at page 117 to support this argument. *Id.* However, Mr. Addison’s testimony actually supports the conclusion that PSNC’s loans to the money pool coincide with issuances of long-term debt. Mr. Addison testified that “PSNC is going to be moving back into that period where they’re going to likely be a net borrower until the points that we go out and issue long-term debt.” Tr. Vol. 5, p. 117, lines 19-22. This is borne out by the reports the Company filed in Docket No. G-5, Sub 422, on financings it made in March 2010 and February 2011, and the reports of its money pool activities filed in Docket No. G-5, Sub 484, referenced in Commissioner Brown-Bland’s question to Mr. Addison. Tr. Vol. 5, p. 116, lines 13-23.

Next, the Attorney General's Brief, citing the cross-examination of PSNC witness Hevert at volume 5, page 244, of the transcript, recalculates the computation of short-term debt for the proxy companies in Mr. Hevert's supplemental testimony as yielding a 49.69% equity average "using the same eight periods as in Mr. Hevert's original testimony" and a 48.73% average "using the most recent eight periods." Attorney General's Brief at 8. The brief concludes that "Mr. Hevert's proxy company data indicates that an equity ratio of less than 50% is sufficient." *Id.* A complete review of this portion of the cross-examination does not support this conclusion, however and the Attorney General's reliance on the average misses the point. Mr. Hevert testified that, because short-term debt changes from day to day, the balances shown for each of the relevant periods are end-of-month and therefore not necessarily representative of the average balance during the course of the month. Tr. Vol. 5, p. 241, line 6 – p. 242, line 20. Accordingly, it is the range of results and not the average that is relevant to the analysis of the proxy group's capital structure. *Id.* at p. 248, lines 4-20. He concluded that the 52% equity contained in the Amended Stipulation is reasonable because it "certainly falls within the range." *Id.*

Finally with respect to capital structure, the Attorney General's Brief argues that "[t]he capital structure of a utility's parent holding company provides another proxy for assessing what is a reasonable capital structure ... and PSNC's parent SCANA maintains an equity ratio that has typically been less than 45% over the past five years." Attorney General's Brief at 8. The brief cites Attorney General-Hevert Cross Exhibit 1 and the transcript at page 207, volume 5, a statement in Mr. Hevert's direct testimony that it may be reasonable to look to the parent's capital structure or to develop a hypothetical capital structure in cases where the subject company does not issue its own securities. During

cross-examination on this point, Mr. Hevert testified why it was reasonable to use the capital structure of the operating company (PSNC) instead of looking to the parent company (SCANA) as a reference for PSNC's capital structure in this case. Tr. Vol. 5, p. 249, line 16 – p. 250, line 16; p. 251, lines 19-21. Mr. Hevert also testified on direct that if the Commission were to lower PSNC's common equity ratio it would have the effect of increasing the Company's overall cost of capital. Tr. Vol. 5, p. 212, line 11 – p. 213, line 18.

### **Return on Equity**

As with the overall rate of return and capital structure, the arguments in the Attorney General's Brief regarding return on equity are not supported by the evidence in this case. For example, the brief asserts that when Mr. Hevert performed his Constant Growth Discounted Cash Flow (DCF) analysis "he also calculates a 'Low ROE' from the *lowest* growth data; but, whereas his study produces a wide range of ROE results of 8.14% to 11.32%, his recommended ROE range draws from the high results, not the low results, which are ignored." Attorney General's Brief at 15 (emphasis in original). The brief cites to volume 6, page 22, and volume 5, page 147, of the transcript. *Id.* The assertion that Mr. Hevert considered only the high results is not supported by the record. As Mr. Hevert pointed out on cross-examination, he took into account both the high and low estimates of the growth data. Tr. Vol. 6, p. 21, line 24 – p. 22, line 11. Additionally, on its face the table referenced on page 147 of volume 5 shows that his recommended ROE range of 10.00% to 10.75% did not draw only from the high results, which ranged from 11.08% to 11.32%, but was within the overall range of high and low results.

Next, the Attorney General's Brief argues that "[t]he other feature of Mr. Hevert's DCF study that skews his results upward is his over-reliance on sources of data that reflect five-year projections of annual growth in earnings per share – Zack's, First Call, and Value Line – without consideration of other factors available to investors for measuring growth." Attorney General's Brief at 15. The brief cites to Exhibit RBH-1 and volume 6, pages 21 and 22, of the transcript. However, Mr. Hevert explained on cross-examination why it was appropriate to use earnings growth and not the other factors. Tr. Vol. 6, p. 25, line 3 – p. 27, line 8; *see also* Tr. Vol. 6, p. 144, n. 12 (academic support for Mr. Hevert's use of analyst growth forecasts rather than the historical data advocated by the Attorney General). He testified that, for example, it was better to use earnings growth than dividends "simply because ... the dividends are derived from earnings. You cannot pay dividends unless you have earnings." Tr. Vol. 6, p. 25, lines 1-5. He further testified that he did not give historical earnings growth any weight, in part, "because a lot of analysts will already look at historical earnings growth and they would be reflected in the earnings projected." *Id.* at p. 26, lines 16-20. His testimony specifically refutes the argument in the Attorney General's Brief that "[j]ust looking at projected earnings growth does not appropriately capture the long term growth data for Laclede that investors would consider." Attorney General's Brief at pp. 16-17.

Similarly, in its argument concerning Mr. Hevert's Multi-Stage DCF analysis the Attorney General's Brief contends that the "results are skewed by his reliance on a high long-term growth rate of 5.31% for the GDP growth in the last stage of his model" in that he did not use "a forward-looking GDP growth rate that is published for investors or used by other authorities, and instead calculated the rate himself." Attorney General's Brief at

18. The brief cites the transcript at page 151 of volume 5 and pages 32 through 34 of volume 6. Mr. Hevert explained during cross-examination on this issue why these allegations are not correct. Tr. Vol. 6, p. 33, line 16 – p. 34, line 17. He concluded that his computation was “[n]ot necessarily” lower than the rates published by the Social Security Administration and by the Energy Information Administration if scenarios other than their reference cases were considered. *Id.* He concluded that his estimate was “well within the range” of the high and low cost scenarios that they provide. *Id.*

Finally, with respect to the Capital Asset Pricing Model (CAPM), the Attorney General’s Brief argues that “Mr. Hevert’s CAPM results are skewed in an upward direction by his reliance on a high estimate that Mr. Hevert performed himself of the market premium for the overall stock market relative to the risk free rate” in that his estimate “is not a source that is relied on by investors, and is too high for these purposes and not reliable.” Attorney General’s Brief at 24. This argument is based on the Attorney General’s desire to “substitute the risk premium provided in a ‘Client Alert’ issued by Duff & Phelps, an investor service that publishes data regarding the market risk premium ....” Attorney General’s Brief at 22. As with the other issues, Mr. Hevert’s testimony during cross-examination on this point contradicts the Attorney General’s argument. Tr. Vol. 6, p. 39, line 9 – p. 43, line 6. He testified that the Duff & Phelps estimated risk premium of 5% to 5.5% is not their CAPM approach but only one component of their “building block approach” under which other risk factors would be layered on to this component to calculate the cost of equity. *Id.* at p. 40, line 9 – p. 41, line 13. He also testified that using just this 5 to 5.5% risk premium would produce a cost of equity of only 7.49%, which would result in significant negative market consequences. *Id.* at p. 41, line 13 – p. 43, line



6. Indeed, the Attorney General’s Brief concedes that “data published by Duff & Phelps ... may not be appropriate to determine a point-estimate for the cost of equity capital in this proceeding ....” Attorney General’s Brief at pp. 23-24.

### **Integrity Management Tracker**

In opposing the Integrity Management Tracker (IMT) agreed to in the Amended Stipulation, the Attorney General’s argument is based, in part, on the assertion that the IMT is not needed to maintain the financial integrity of the Company. Attorney General’s Brief at 26-28. The brief supports this assertion with quotes from a confidential credit report and the testimony of PSNC witness Addison found on page 63 of volume 5 of the transcript, which the brief properly characterizes as stating “that the use of a tracker mechanism for cost recovery will not reduce investor perceptions of risk ....” *Id.* at 27. However, the brief improperly uses this testimony to support a different proposition – “that it [the IMT] is not *needed* to address investor uncertainties about the risks associated with the investments.” *Id.* at 26 (emphasis in original). This is not a reasonable conclusion. That the investment community would not view PSNC as less risky with the IMT does not mean that it would not view PSNC as riskier without the IMT, especially if the Commission were to refuse an integrity management recovery mechanism supported in a near-unanimous stipulation. In fact, it is reasonable reach the opposite conclusion based on the evidence in this case – that such an action would negatively impact the Company’s financial standing because of the perceived regulatory environment in which PSNC is denied a recovery mechanism when its peers have all been granted them. *See* Tr. Vol. 5, p. 62, line 22 – p. 63, line 2 (“[T]he Commission is viewed as reasonable and investors are aware of the previous approval of similar mechanisms for other utilities.”); *see also id.* at p. 178, lines

5-7 (“[A]ll of the proxy companies employ infrastructure recovery mechanisms similar to that proposed by the Company.”). In any event, the applicable statute does not require a showing that the tracker is necessary to maintain the utility’s financial integrity and the Commission has not previously required such a showing. *See In the Matter of Application of Piedmont Natural Gas Company, Inc. for a General Increase in its Rates and Charges*, Order Approving Partial Rate Increase and Allowing Integrity Management Rider, Docket No. G-9, Sub 631 (December 17, 2013) at 39 (discussing the public interest requirement of the statute).

### **Other Considerations Related to the Amended Stipulation**

The Attorney General’s Brief focuses primarily on issues related to the agreed upon rate of return reflected in the Amended Stipulation, inappropriately singling out isolated pieces of this comprehensive settlement agreement and ignoring the give-and-take that characterizes settlement negotiations. The Commission has recognized that “a settlement necessarily involves give-and-take by the parties, and that the negotiated revenue impact will likely be somewhere between the positions of the Stipulating Parties absent the settlement.” *In the Matter of Application of Duke Energy Carolinas, LLC, for Adjustment of Rates and Charges Applicable to Electric Utility Service in North Carolina*, Order Granting General Rate Increase at 64, Docket No. E-7, Sub 1026 (September 24, 2013). The North Carolina Supreme Court has also acknowledged the value of settlement agreements as allowing for the negotiation between parties to resolve disputes. *See, e.g., State ex rel. Utilities Comm’n v. Carolina Utility Customers Association*, 348 N.C. 452, 466, 500 S.E. 2d 693, 703 (1998) (stating that the Court “recognizes the crucial role that informal disposition plays in quickly and efficiently resolving many contested proceedings

and encourages all parties to seek such resolution through open, honest and equitable negotiation.”). By its very nature, settlement is the product of comprehensive give-and-take negotiations during which each party makes concessions on some issues in exchange for favorable results on other issues.

As a result of the settlement negotiations that transpired in this case, the adjustments that were agreed upon by the Stipulating Parties, including adjustments to the rate of return on equity and capital structure, resulted in a significant decline in the Company’s requested revenue requirement increase, from approximately \$41.6 million in the Application to approximately \$19 million in the Amended Stipulation. By isolating specific aspects of the Amended Stipulation for critique, the Attorney General ignores all of the other positive elements of this comprehensive settlement and, as a result, the interplay between those elements and the agreed upon rate of return, which taken together has resulted in a substantial decrease to the revenue requirement requested in this case.

### **Conclusion**

As demonstrated above, the transcript of evidence in this case does not support the arguments in the Attorney General’s Brief, which challenges only a portion of the comprehensive settlement embodied in the Amended Stipulation entered into by all of the other parties to this proceeding. The overall rate of return, capital structure, and rate of return on equity agreed to in the Amended Stipulation are amply supported by the evidence as being reasonable and appropriate for use in this case. The IMT agreed to in the Amended Stipulation is demonstrated by the evidence in this case to be in the public interest, and the Attorney General’s Brief does not show otherwise. Based on this, PSNC submits that the

Amended Stipulation is fair and reasonable, in the public interest, and supported fully by the record and should be approved in its entirety.

Respectfully submitted this 14th day of October, 2016.

/s/Mary Lynne Grigg

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## CERTIFICATE OF SERVICE

I certify that a copy of the foregoing Reply to Attorney General's Brief and Motion for Leave to File Reply Brief Out of Time has been served on all parties of record or their attorneys, or both, by United States mail, first class or better; by hand delivery; or by means of facsimile or electronic delivery upon agreement of the receiving party.

This the 14<sup>th</sup> day of October, 2016.

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