For all these reasons, MidAmerican's proposed capital structure should be rejected and my proposed capital structure should be adopted.

Q DOES THIS CONCLUDE YOUR REPLY TESTIMONY?

A Yes, it does.

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PUC DOCKET NO. 41474
SOAH DOCKET NO. 473-13-4655

APPLICATION OF SHARYLAND UTILITIES, L.P. TO ESTABLISH RETAIL DELIVERY RATES, APPROVE TARIFF FOR RETAIL DELIVERY SERVICE, AND ADJUST WHOLESALE TRANSMISSION RATE	**§**	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

Direct Testimony and Exhibits of

Michael P. Gorman

On behalf of

Texas Industrial Energy Consumers
and
Pioneer Natural Resources USA, Inc.

October 18, 2013

BRUBAKER & ASSOCIATES, INC.

Project 9821

ETI RFI 2-42
ATTACHMENT 3

PUC DOCKET NO. 41474
SOAH DOCKET NO. 473-13-4655

APPLICATION OF SHARYLAND UTILITIES, L.P. TO ESTABLISH RETAIL DELIVERY RATES, APPROVE TARIFF FOR RETAIL DELIVERY SERVICE, AND ADJUST WHOLESALE TRANSMISSION RATE	**§**	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

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APPLICATION OF SHARYLAND UTILITIES, L.P. TO ESTABLISH RETAIL DELIVERY RATES, APPROVE TARIFF FOR RETAIL DELIVERY SERVICE, AND ADJUST WHOLESALE TRANSMISSION RATE	**§**	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

Affidavit of Michael P. Gorman

State of Missouri)
) **SS**
County of Saint Louis)

Michael P. Gorman, being first duly sworn, on his oath states:

1. My name is Michael P. Gorman. I am a managing principal with Brubaker & Associates, Inc., 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017. We have been retained by Texas Industrial Energy Consumers and Pioneer Natural Resources USA, Inc. to testify in this proceeding on their behalf..

2. Attached hereto and made a part hereof for all purposes are my Direct Testimony, Exhibits, and Appendix A, all of which have been prepared in written form for introduction into evidence in Public Utility Commission of Texas Docket No. 41474.

3. I hereby swear and affirm that my answers contained in the testimony are true and correct.

Michael P. Gorman

Subscribed and sworn to before me this 17th day of October, 2013.

TAMMY S. KLOSSNER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Charles County
My Commission Expires: Mar. 14, 2015
Commission # 11024862

Notary Public

PUC DOCKET NO. 41474
SOAH DOCKET NO. 473-13-4655

APPLICATION OF SHARYLAND UTILITIES, L.P. TO ESTABLISH RETAIL DELIVERY RATES, APPROVE TARIFF FOR RETAIL DELIVERY SERVICE, AND ADJUST WHOLESALE TRANSMISSION RATE	§ § § § § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

Direct Testimony of Michael P. Gorman

INTRODUCTION

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael P. Gorman and my business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation and a managing principal with Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A These are set forth in Appendix A to my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of Texas Industrial Energy Consumers ("TIEC") and Pioneer Natural Resources USA, Inc. ("Pioneer"). TIEC members own and operate industrial facilities in the Sharyland Utilities, L.P. ("Sharyland" or "Company") service territory

and are large industrial consumers of electricity. Pioneer is a large producer of oil and gas resources within Sharyland's service territory.

Q WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

A My testimony will address Sharyland's overall rate of return including return on equity, capital structure and embedded debt cost.

SUMMARY

Q PLEASE SUMMARIZE YOUR RATE OF RETURN RECOMMENDATIONS.

A I recommend the Public Utility Commission of Texas (the "Commission" or "PUCT") award Sharyland a return on common equity of 9.35%, and an overall rate of return of 6.27% (Exhibit MPG-1).

I recommend adjustments to the Company's proposed capital structure. The Company proposes a 45% equity and 55% debt capital structure. However, the Company does not show that that capital structure mix reasonably reflects Sharyland's or its affiliate's, Sharyland Distribution and Transmission Services LLC ("SDTS"), actual capital structure supporting the investments in transmission and distribution assets. Based on my assessment of the actual capital structure at SDTS, excluding common equity supporting a goodwill asset, a capital structure appropriate for setting rates is 40% equity and 60% debt.

I recommend adjustments to Sharyland's proposed 6.73% embedded cost of debt. The Company's embedded cost of debt reflects only $163.5 million of approximately $440.3 million of actual SDTS debt. The actual weighted cost of debt at year-end 2012 for SDTS was 4.21%.

My recommended return on equity and my proposed capital structure will provide Sharyland with an opportunity to realize cash flow financial coverages and balance sheet strength that support an investment grade bond rating. Consequently, my recommended return on equity represents fair compensation for Sharyland's investment risk, and it will preserve the Company's financial integrity and credit standing.

I will also respond to Sharyland witness Mr. Robert B. Hevert's proposed return on equity of 10.75%. For the reasons discussed below, Mr. Hevert's recommended return on equity is excessive and should be rejected.

Q HOW DID YOU ESTIMATE SHARYLAND'S CURRENT MARKET COST OF EQUITY?

A I performed three versions of the Discounted Cash Flow ("DCF") model, Risk Premium study, and Capital Asset Pricing Model ("CAPM") to a proxy group of publicly traded companies that have investment risk similar to Sharyland. Based on these assessments, I estimate Sharyland's current market cost of equity to be 9.35%.

Electric Utility Industry Market Outlook

Q PLEASE DESCRIBE THE PURPOSE OF THIS SECTION OF YOUR TESTIMONY.

A I begin my estimate of a fair return on equity for Sharyland by reviewing the market's assessment of electric utility industry investment risk, credit standing, and stock price performance in general. I used this information to get a sense of the market's perception of the risk characteristics of electric utility investments in general, which is then used to produce a refined estimate of the market's return requirement for assuming investment risk similar to Sharyland's utility operations.

Based on the assessments described below, I find the credit rating outlook of the industry to be strong and supportive of the industry's financial integrity, and electric utilities' stocks have exhibited strong price performance over the last several years.

Further, the electric utility industry in general is in a large capital expenditure portion of its cycle, which is creating significant demands for external capital in order to support large capital improvement programs. Credit rating agencies and market participants have embraced the utilities' need for significant amounts of external capital by meeting the capital market demands of electric utilities at near historical low capital market costs. All of this supports my belief that Sharyland should have sufficient access to capital to support its major capital program, and relatively moderate capital costs are currently available and expected to be available for the next several years.

Based on this review of credit outlooks and stock price performance, I conclude that the market continues to embrace the electric utility industry as a safe-haven investment, and views utility equity and debt investments as low-risk securities.

Q PLEASE DESCRIBE ELECTRIC UTILITIES' CREDIT RATING OUTLOOK.

A Electric utilities' credit rating outlook has improved over the recent past and is stable. Standard & Poor's ("S&P") recently provided an assessment of the credit rating of U.S. electric utilities. S&P's commentary included the following:

> **Effect on ratings**
>
> Notwithstanding the slow economic recovery, credit quality in the domestic utility industry has continued a long shift to greater stability, and even modest improvement in some cases, especially as many companies re-emphasize their core competencies.

* * *

Industry Ratings Outlook

Good access to funding expected to continue

Liquidity is adequate for most utilities and investor appetite for utility debt remains healthy, with deals continuing to be oversubscribed at very attractive rates. The amount of medium- to long-term debt and hybrid securities issued through the three months ended March 31, 2013 was about $8.7 billion. Credit fundamentals indicate that most, if not all, utilities should continue to have ample access to funding sources and credit. The relative certainty of financial performance provided by the regulatory framework under which utilities operate, their effective monopoly position, long-lived assets, and the financing necessary to fund these assets are all factors that make the utility sector attractive to investors. These elements have also helped utilities more effectively manage their rate-relief needs and mitigate the effect of sizable rate increases on customers.[1]

Similarly, Fitch states:

Rating Outlook

Flat Growth Base Case: Fitch Ratings expects overall stable ratings for issuers within the U.S. Power and Gas Utility sector in 2013 despite modest deterioration in operating environment.

* * *

Stable Regulation but Authorized ROEs Trending Down

Fitch expects the downward pressure on authorized ROEs for regulated utilities to persist in tandem with falling interest rates in the economy. Lower ROEs are also associated with features increasingly common in tariff structures that minimize cash flow volatility. Many state regulators are awarding lower ROEs as an offset to awarding special tariff mechanisms such as revenue decoupling, forward test year, rate-adjustment trackers[,] etc.

* * *

Strong Liquidity Conditions to Prevail

Fitch expects the power and gas utility sectors to continue to enjoy strong capital market access. Low interest rates due to accommodative monetary policies by the Fed continue to bring down

[1] *Standard & Poor's RatingsDirect*: "Industry Report Card: Stable-To-Modestly Improved Industry Outlook Supports Ratings For U.S. Regulated Electric, Gas, And Water Utilities," April 19, 2013 at 3-4 and 6-7, emphasis added.

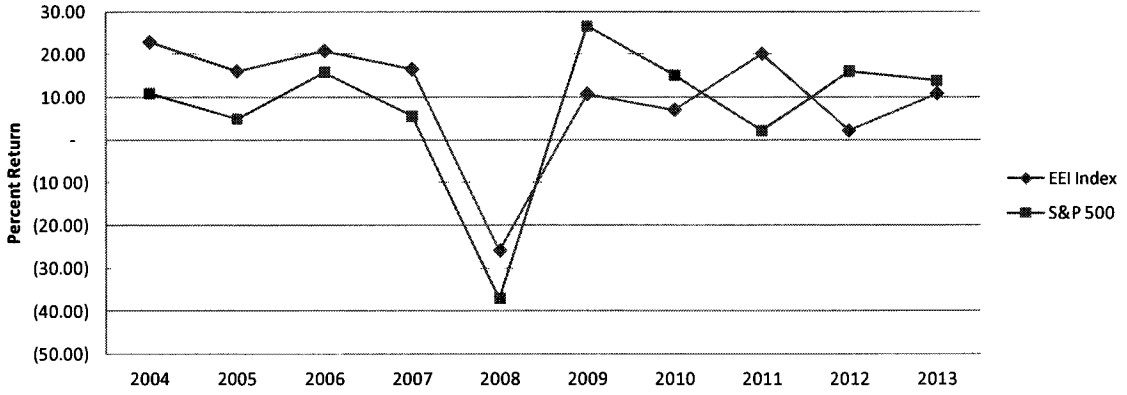
the cost of debt for companies, which represents a significant expense item for the capital-intensive utility sector. Since 2006, interest expense has declined almost 150 bps for the typical utility holding company as financing costs for new debt issuance is at historic lows and these companies have unprecedented access to the capital and bank markets.[2]

Q PLEASE DESCRIBE ELECTRIC UTILITY STOCK PRICE PERFORMANCE OVER THE LAST SEVERAL YEARS.

A As shown in the graph below, the EEI has recorded electric utility stock price performance compared to the market. The EEI data shows that its Electric Utility Index has outperformed the market in downturns and trailed the market during recovery. This supports my conclusion that utility stock investments are regarded by market participants as a moderate to low-risk investment.

FIGURE 1

Index Comparison



Source: EEI Q2 2013 Stock Performance Financial Update, at Page 1.

EEI describes electric utility stock price/valuation as sustainable:

Share Valuations Give Mixed Messages

Industry balance sheets are sound, dividends appear to be generally safe and supported by healthy business

[2] *FitchRatings*: "2013 Outlook: Utilities, Power, and Gas," December 7, 2012 at 1, 6-7 and 10, emphasis added.

fundamentals, and the industry's regulated focus offers long-term stability in an uncertain economy. Utility investors get dividend growth potential in addition to favorable tax treatment relative to bonds, an attractive mix for investors willing to assume the share price risk.

Utility stock price trends in the immediate future will probably mirror those of the past few years. Utilities will likely do better than the broad market if economic growth stalls, interest rates fall and the fears that stalk markets return – whether in the form of instability in Europe, slowdown in China, or eruption of geopolitical risks in emerging markets such as Brazil, Turkey or in the Middle East. Conversely, if all is quiet on the risk front and confidence in economic growth strengthens, interest rates will likely continue to rise. Whether that means utility shares fall remains to be seen, but they will probably lag the performance of other sectors when bullish sentiments dominate markets.[3]

Q WHAT ARE THE IMPORTANT TAKEAWAY POINTS FROM THIS ASSESSMENT OF ELECTRIC UTILITY INDUSTRY CREDIT AND INVESTMENT RISK OUTLOOKS?

A Credit rating agencies consider the electric utility industry to be stable and believe investors will continue to provide an abundance of capital to support utilities' large capital programs and at moderate capital costs. All of this supports the continued belief that electric utility investments are generally regarded as safe-haven or low-risk investments, and the market embraces low-risk investments – like utility investments. The demand for low-risk investments will provide funding for electric utilities in general.

[3] *EEI Q2 2013 Financial Update* "Stock Performance," at 6.

RATE OF RETURN

Sharyland Investment Risk

Q PLEASE DESCRIBE THE MARKET'S ASSESSMENT OF THE INVESTMENT RISK OF SHARYLAND.

A. Sharyland is a Texas-based transmission and distribution ("T&D") electric company. Sharyland witness Ralph G. Goodlet, Jr. describes the corporate structure of Sharyland at pages 4 and 5 of his direct testimony. There, he states that Sharyland Utilities acquired control of Cap Rock Energy Corporation ("Cap Rock") which operated four separate divisions in 2010. He states that Sharyland Utilities has five retail divisions including four former Cap Rock divisions which he referred to as "Sharyland" and as the subject of the Application in this proceeding, and a fifth division referred to as "Sharyland McAllen." The five divisions make up the entire utility called Sharyland Utilities. Sharyland Utilities is owned by Hunter L. Hunt and members of his family. It is organized as a limited partnership.

Mr. Goodlet also states that in 2008, the Commission approved a restructuring for Sharyland Utilities to allow for broader alternatives for obtaining equity for significant capital expenditures. This included the use of a Master Limited Partnership ("MLP") or a Real Estate Investment Trust ("REIT") to facilitate investments. Sharyland Utilities transferred its T&D assets to Sharyland Distribution and Transmission Services LLC ("SDTS"). Under the arrangement approved by the Commission, Sharyland Utilities leases the assets from SDTS.

In response to TIEC-SU-5-3, the Company states that neither Sharyland Utilities or SDTS have a credit rating from either S&P, Moody's or Fitch.

Q CAN YOU DESCRIBE THE INVESTMENT CHARACTERISTICS OF A TEXAS TRANSMISSION AND DISTRIBUTION UTILITY ("TDU")?

A Yes. To assess its investment risk, I considered T&D companies operating in Texas. There are six T&D companies listed on the PUCT website that operate in the Electric Reliability Council of Texas ("ERCOT") region of the state.[4] These are AEP Texas Central Company ("AEP TCC"), AEP Texas North Company ("AEP TNC"), Texas-New Mexico Power Company ("TNMP"), CenterPoint Energy Houston Electric ("CenterPoint"), Oncor Electric Delivery Company ("Oncor"), and Sharyland. As shown on my Exhibit MPG-2, these TDUs have continually exhibited investment grade bond ratings with stable credit outlooks.

American Electric Power is the parent company of AEP TCC and AEP TNC. In assessing American Electric Power ("AEP") subsidiaries' credit standing, which S&P rates as a "BBB" with stable outlooks, S&P stated the following:

> **Business Risk: Excellent**
>
> Our assessment of AEPTC's business risk profile as "excellent" incorporates the strengths of a wires-only utility with no supply obligations that only transmits and distributes electricity in southern and central Texas. It participates in the AEP West Power Pool, sharing the revenues and costs of pool sales to utilities and power marketers, and also sells directly at wholesale to utilities, municipalities, rural electric cooperatives, and retail electric providers. Operations are integrated with the AEP West system.
>
> The excellent business risk profile of parent AEP reflects its status as a large public utility holding company that owns regulated electric utility subsidiaries operating in 11 states in the Midwest and Southwest. These subsidiaries consist of low-risk transmission and distribution wires-only businesses in Texas; . . . .[5]

[4] http://www.puc.texas.gov/industry/electric/rates/TDR.aspx – Transmission and Distribution Rates for Investor Owned Utilities.

[5] Standard & Poor's RatingsDirect: "AEP Texas Central Co.," June 12, 2013, emphasis added.

Similarly, S&P assigns TNMP and Oncor an "Excellent" business risk profile and "Stable" investment grade credit ratings of "BBB" and "BBB+", respectively.[6]

Recently, S&P put CenterPoint on CreditWatch with potential for further upgrade. S&P assigns this company a credit rating of "BBB+." CenterPoint benefits from low operating risk, an effective management of regulatory risk, and steady predictable cash flows. Specifically, S&P states:

> **Business Risk: Excellent**
>
> Standard & Poor's ratings on CEHE reflect the credit profile of its parent, CenterPoint.
>
> CEHE has an excellent business risk profile that reflects operations under a generally constructive regulatory environment, lack of commodity exposure, and a service territory with attractive demographics and historically consistent customer growth.[7]

Q WHAT CONCLUSIONS DID YOU REACH BASED ON YOUR REVIEW OF THE ELECTRIC UTILITY INDUSTRY IN GENERAL?

A As outlined above, the Texas TDUs are viewed by the market participants as a low-risk investment alternative. All T&D companies operating in the Texas service area have excellent business risk scores from S&P, stable credit outlooks, and benefit from supportive regulation.

Sharyland's Proposed Capital Structure

Q WHAT IS SHARYLAND'S PROPOSED CAPITAL STRUCTURE?

A Sharyland's proposed capital structure is supported by Sharyland witness Mr. Robert Hevert and is shown in Table 1 below.

---

[6]Standard & Poor's RatingsDirect: "Summary: Texas-New Mexico Power Co.," October 15, 2013 and "Oncor Electric Delivery Co. LLC," May 10, 2013.

[7]Standard & Poor's RatingsDirect on the Global Credit Portal: "Trans-Allegheny Interstate Line Co.," March 16, 2012 at 2, emphasis added.

TABLE 1

Sharyland's Proposed Capital Structure

Description	Weight
Common Equity	45%
Long-Term Debt	55%
Total Regulatory Capital Structure	100%

Source: Hevert Direct Testimony at 33.

Q IS SHARYLAND'S PROPOSED CAPITAL STRUCTURE REASONABLE?

A No. I propose a capital structure based on SDTS's actual capital structure adjusted to remove the common equity supporting a goodwill asset. As shown on my Exhibit MPG-1, page 2, removing a goodwill asset from SDTS's year-end capital structure produces a capital structure composed of 39.2% common equity, and 60.8% long-term debt. I propose SDTS's capital structure used for ratemaking purposes because it owns Sharyland's T&D assets, and leases them back to Sharyland. On Sharyland's financial statements as attached to Sharyland witness Mr. David White's testimony, under the Sharyland Utilities, L.P. audited financial reports, it shows a negative balance for participants' equity, and a goodwill balance of $1.1 million, as supporting its assets. The largest financial obligation of Sharyland Utilities, L.P. is its long-term financing obligation. This appears to be the lease structure it has with its affiliate SDTS for the T&D assets.

Q WHY IS IT APPROPRIATE TO ADJUST SDTS'S COMMON EQUITY BALANCE TO REMOVE COMMON EQUITY SUPPORTING THE GOODWILL ASSET?

A This is appropriate for several reasons. First, Sharyland has agreed that goodwill assets should not be included in developing its cost of service in this proceeding. Sharyland witness Mr. White in his direct testimony (Bates page 284) specifically stated that the Company agreed not to recover merger-related expenses in rates, and it did not include a goodwill asset resulting in its rate base.

However, the Company did not remove the common equity supporting the $83.4 million goodwill asset from the ratemaking capital structure. As a result, the Company has included costs associated with acquisition or merger-related expenses because it did not remove the common equity capital supporting the goodwill asset to form its capital structure.

Including costs associated with the restructuring of Sharyland is in direct contradiction to the commitment Sharyland made to the Commission as stated at Bates pages 36 and 37 of Mr. Goodlet's direct testimony. There, he states that Sharyland committed to the Commission that it would not seek to recover the costs of the transaction to acquire Cap Rock in its rates.

Q WAS THE GOODWILL ASSET RECORDED AS A RESULT OF MERGER AND ACQUISITION ACTIVITY?

A Yes. The Company has not broken out how the specific acquisitions under which it has recorded a goodwill asset, but the Company did say the following:

> (i) Goodwill
>
> Goodwill represents the excess of costs of an acquired business over the fair value of the assets acquired, less liabilities assumed. Goodwill is not amortized and is tested for impairment annually or more frequently if events or changes in circumstances arise. As of December 31, 2012 and 2011, approximately $83.4 million,

respectively, was recorded in goodwill in the Company's consolidated balance sheets.[8]

As such, the goodwill asset was related to acquisitions undertaken by Sharyland.

Q WHY IS IT APPROPRIATE TO REDUCE COMMON EQUITY BY REMOVING THE GOODWILL EFFECT FROM THE CAPITAL STRUCTURE OF THE COMPANY?

A Goodwill is not an asset used to provide utility service. Rather, goodwill is an accounting asset that is created by purchase accounting transactions related to acquisitions. As noted in the quote above by Sharyland's financial disclosures, goodwill represents the difference between the fair value price paid for the asset and its original book value. When the Company records a goodwill asset, it also increases the amount of common equity capital to keep its balance sheet in balance.

Moreover, goodwill is an asset that has no economic value. Indeed, goodwill is subject to an impairment test annually to establish whether or not the Company can continue to record it on its balance sheet. If the impairment test fails, the Company must record impairment charges that reduce its goodwill asset and also reduce the amount of common equity.

Since goodwill is a paper asset that does not produce cash flows, a utility cannot and does not issue debt to fund a goodwill asset. Debt can only be issued to fund utility plant and equipment for which the utility sells utility services, generates revenues and produces cash flows adequate to service the utility debt service. Goodwill does not produce cash flows and cannot support utility debt service.

[8]Direct Testimony of Sharyland witness David White, Bates page 333.

Q ARE GOODWILL OR ASSET ACQUISITION ADJUSTMENTS TYPICALLY INCLUDED IN A UTILITY'S COST OF SERVICE?

A No. Just as Sharyland has recognized in this case, goodwill assets or acquisition adjustments typically are not included in a utility's cost of service. Importantly, in other jurisdictions, when a goodwill asset of any size is recorded on a utility's books and records, an adjustment is also made to the capital in developing a ratemaking capital structure.

Explicit adjustments to the common equity supporting a goodwill asset are required by the Illinois formula rate principles in the Energy Infrastructure Modernization Act ("EIMA").[9] The EIMA formula rate requires an adjustment to common equity to remove the capital supporting any goodwill asset recorded on the utility's balance sheet.

The general objective with removing goodwill assets and the common equity supporting goodwill assets from the utility's cost of service is to exclude the cost associated with major acquisitions and mergers from developing the utility's cost of service. As such, goodwill should be excluded from a utility's rate base, and the common equity supporting the goodwill asset should be excluded from the utility's ratemaking capital structure. These costs are simply not related to the provision of utility service and should not be considered in developing a utility's cost of service.

Q WHAT CAPITAL STRUCTURE DO YOU PROPOSE BE USED TO SET SHARYLAND UTILITIES' OVERALL RATE OF RETURN?

A I recommend the Commission use a capital structure composed of 60% debt and 40% common equity. This capital structure is based on SDTS's actual 2012 capital

[9]Illinois Public Act 098-0015, (220 ILCS 5/4-301) (from Ch. 111 2/3, par. 4-301), Sec. 4-301.

structure, adjusted to remove the common equity supporting the goodwill asset also recorded on SDTS's 2012 balance sheet.

This adjusted capital structure is developed on my Exhibit MPG-1, page 2 of 2. With this adjustment, the actual capital structure supporting Sharyland's transmission and distribution assets, is composed of 39.2% common equity and 60.8% long-term debt. I rounded the Company's actual capital structure to 40%/60% equity/debt to form my recommended capital structure in this case.

Q WHAT EMBEDDED COST OF DEBT IS SHARYLAND PROPOSING TO USE TO ESTIMATE ITS OVERALL RATE OF RETURN?

A Sharyland witness Robert Hevert proposes an embedded cost of debt of 6.73%. He bases that recommendation on two senior notes issues in 2010 and 2009 at interest rates of 6.47% and 7.25%, respectively. This is shown on his Exhibit RBH-13.

Q IS MR. HEVERT'S ESTIMATED EMBEDDED COST OF DEBT REASONABLE?

A No. Mr. Hevert calculated the embedded cost of debt based on only two senior note issuances amounting to $163.5 million. However, SDTS has $440.3 million of debt recorded on its balance sheet that is used to support its T&D operations, acquisition of Cap Rock Holdings Corporation ("CRHC")[10] and for general construction purposes. As shown on my Exhibit MPG-3, the embedded debt cost for SDTS is 4.21%.

Q DID MR. HEVERT OR ANY OTHER SHARYLAND WITNESS EXPLAIN WHY THEY LIMITED THE EMBEDDED DEBT COST TO ONLY TWO BOND ISSUES?

A No, and the embedded debt cost proposed by Mr. Hevert is based on the most expensive senior notes issued by SDTS. With that understanding and no explanation

[10]White Direct at Bates 333.

of why the other outstanding debt was excluded I find Mr. Hevert's proposed embedded debt cost recommendation to not be reasonable.

RETURN ON EQUITY

Q PLEASE DESCRIBE WHAT IS MEANT BY A "UTILITY'S COST OF COMMON EQUITY."

A A utility's cost of common equity is the return investors require on an investment in the utility. Investors expect to achieve their return requirement from receiving dividends and stock price appreciation.

Q PLEASE DESCRIBE THE FRAMEWORK FOR DETERMINING A REGULATED UTILITY'S COST OF COMMON EQUITY.

A In general, determining a fair cost of common equity for a regulated utility has been framed by two hallmark decisions of the U.S. Supreme Court: Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Va., 262 U.S. 679 (1923) and Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

These decisions identify the general standards to be considered in establishing the cost of common equity for a public utility. Those general standards provide that the authorized return should: (1) be sufficient to maintain financial integrity; (2) attract capital under reasonable terms; and (3) be commensurate with returns investors could earn by investing in other enterprises of comparable risk.

Q PLEASE DESCRIBE THE METHODS YOU HAVE USED TO ESTIMATE SHARYLAND'S COST OF COMMON EQUITY.

A I have used several models based on financial theory to estimate Sharyland's cost of common equity. These models are: (1) a constant growth DCF model using consensus analysts' growth rate projections; (2) a constant growth DCF using sustainable growth rate estimates; (3) a multi-stage growth DCF model; (4) a Risk Premium model; and (5) a CAPM model. I have applied these models to a group of publicly traded utilities that I have determined share investment risk similar to Sharyland's.

Risk Proxy Group

Q HOW DID YOU SELECT A UTILITY PROXY GROUP SIMILAR IN INVESTMENT RISK TO SHARYLAND TO ESTIMATE ITS CURRENT MARKET COST OF EQUITY?

A I relied on the same proxy group used by Sharyland's witness Mr. Hevert to estimate Sharyland's return on equity.

Discounted Cash Flow Model

Q PLEASE DESCRIBE THE DCF MODEL.

A The DCF model posits that a stock price is valued by summing the present value of expected future cash flows discounted at the investor's required rate of return or cost of capital. This model is expressed mathematically as follows:

$$P_0 = \frac{D_1}{(1+K)^1} + \frac{D_2}{(1+K)^2} \ldots \frac{D_\infty}{(1+K)^\infty} \quad \text{where} \qquad \text{(Equation 1)}$$

P_0 = Current stock price

D = Dividends in periods 1 - ∞

K = Investor's required return

This model can be rearranged in order to estimate the discount rate or investor-required return, "K." If it is reasonable to assume that earnings and dividends will grow at a constant rate, then Equation 1 can be rearranged as follows:

$K = D_1/P_0 + G$ (Equation 2)

K = Investor's required return

D_1 = Dividend in first year

P_0 = Current stock price

G = Expected constant dividend growth rate

Equation 2 is referred to as the annual "constant growth" DCF model.

Q PLEASE DESCRIBE THE INPUTS TO YOUR CONSTANT GROWTH DCF MODEL.

A As shown in Equation 2 above, the DCF model requires a current stock price, expected dividend, and expected growth rate in dividends.

Q WHAT STOCK PRICE HAVE YOU RELIED ON IN YOUR CONSTANT GROWTH DCF MODEL?

A I relied on the average of the weekly high and low stock prices of the utilities in the proxy group over a 13-week period ending on September 20, 2013. An average stock price is less susceptible to market price variations than a spot price. Therefore, an average stock price is less susceptible to aberrant market price movements, which may not be reflective of the stock's long-term value.

A 13-week average stock price reflects a period that is still short enough to contain data that reasonably reflect current market expectations, but the period is not so short as to be susceptible to market price variations that may not reflect the stock's

long-term value. In my judgment, a 13-week average stock price is a reasonable balance between the need to reflect current market expectations and the need to capture sufficient data to smooth out aberrant market movements.

Q WHAT DIVIDEND DID YOU USE IN YOUR CONSTANT GROWTH DCF MODEL?

A I used the most recently paid quarterly dividend, as reported in *Value Line*.[11] This dividend was annualized (multiplied by 4) and adjusted for next year's growth to produce the D_1 factor for use in Equation 2 above.

Q WHAT DIVIDEND GROWTH RATES HAVE YOU USED IN YOUR CONSTANT GROWTH DCF MODEL?

A There are several methods that can be used to estimate the expected growth in dividends. However, regardless of the method, for purposes of determining the market-required return on common equity, one must attempt to estimate investors' consensus about what the dividend or earnings growth rate will be, and not what an individual investor or analyst may use to make individual investment decisions.

As predictors of future returns, security analysts' growth estimates have been shown to be more accurate than growth rates derived from historical data.[12] That is, assuming the market generally makes rational investment decisions, analysts' growth projections are more likely to influence observable stock prices than growth rates derived only from historical data.

For my constant growth DCF analysis, I have relied on a consensus, or mean, of professional security analysts' earnings growth estimates as a proxy for investor consensus dividend growth rate expectations. I used the average of analysts' growth

[11] *The Value Line Investment Survey*, August 2, August 23, and September 20, 2013.
[12] *See, e.g.,* David Gordon, Myron Gordon, and Lawrence Gould, "Choice Among Methods of Estimating Share Yield," *The Journal of Portfolio Management*, Spring 1989.

rate estimates from three sources: Zacks, SNL, and Reuters. All such projections were available on September 24, 2013, and all were reported online.

Each consensus growth rate projection is based on a survey of security analysts. There is no clear evidence whether a particular analyst is most influential on general market investors. Therefore, a single analyst's projection does not as reliably predict consensus investor outlooks as does a consensus of market analysts' projections. The consensus estimate is a simple arithmetic average, or mean, of surveyed analysts' earnings growth forecasts. A simple average of the growth forecasts gives equal weight to all surveyed analysts' projections. Therefore, a simple average, or arithmetic mean, of analyst forecasts is a good proxy for market consensus expectations.

Q WHAT ARE THE GROWTH RATES YOU USED IN YOUR CONSTANT GROWTH DCF MODEL?

A The growth rates I used in my DCF analysis are shown in Exhibit MPG-4. The average growth rate for my proxy group is 4.95%.

Q WHAT ARE THE RESULTS OF YOUR CONSTANT GROWTH DCF MODEL?

A As shown in Exhibit MPG-5, the average and median constant growth DCF returns for my proxy group are 9.19% and 8.99%, respectively.

Q DO YOU HAVE ANY COMMENTS ON THE RESULTS OF YOUR CONSTANT GROWTH DCF ANALYSIS?

A Yes. The constant growth DCF analysis for my proxy group was based on a long-term sustainable growth rate of 4.95%. This growth rate is slightly above, but comparable to, my estimate of a maximum long-term sustainable growth rate which I

discuss later in this testimony. Hence, I believe the constant growth DCF analysis produces reasonable return estimates. However, to enhance the accuracy of my recommended return on equity I have developed alternative DCF models as discussed below.

Q WHAT IS YOUR ESTIMATE OF A MAXIMUM LONG-TERM SUSTAINABLE GROWTH RATE?

A A long-term sustainable growth rate for the utility stock, or any Company investment, cannot exceed the growth rate of the economy in which it sells its goods and services. Hence, a reasonable proxy for the long-term maximum sustainable growth rate for a utility investment is best proxied by the projected long-term Gross Domestic Product ("GDP"). *The Blue Chip Financial Forecasts* projects that over the next 5 and 10 years, the U.S. nominal GDP will grow in the range of 4.8% to 5.0%. As such, the average growth rate over the next 10 years is around 4.9%, which I believe is a reasonable proxy of long-term sustainable growth.

In the section of testimony addressing my multi-stage growth DCF analysis, I discuss academic and investment practitioner evidence that accepts the projected long-term GDP growth outlook as a maximum sustainable growth rate projection. Hence, recognizing the long-term GDP growth rate as a maximum sustainable growth is logical, and generally consistent with academic and economic practitioner accepted practices.

Sustainable Growth DCF

Q PLEASE DESCRIBE HOW YOU ESTIMATED A SUSTAINABLE LONG-TERM GROWTH RATE FOR YOUR SUSTAINABLE GROWTH DCF MODEL.

A A sustainable growth rate is based on the percentage of the utility's earnings that is retained and reinvested in utility plant and equipment. These reinvested earnings increase the earnings base (rate base). Earnings grow when plant funded by reinvested earnings is put into service, and the utility is allowed to earn its authorized return on such additional rate base investment.

The internal growth methodology is tied to the percentage of earnings retained in the company and not paid out as dividends. The earnings retention ratio is 1 minus the dividend payout ratio. As the payout ratio declines, the earnings retention ratio increases. An increased earnings retention ratio will fuel stronger growth because the business funds more investments with retained earnings.

The payout ratios of the proxy group are shown in my Exhibit MPG-6. These dividend payout ratios and earnings retention ratios then can be used to develop a sustainable long-term earnings retention growth rate. A sustainable long-term earnings retention ratio will help gauge whether analysts' current three- to five-year growth rate projections can be sustained over an indefinite period of time.

The data used to estimate the long-term sustainable growth rate is based on the Company's current market to book ratio and on *Value Line's* three- to five-year projections of earnings, dividends, earned returns on book equity, and stock issuances.

As shown in Exhibit MPG-7, page 1, the average sustainable growth rate for the proxy group using this internal growth rate model is 4.28%.

Q WHAT IS THE DCF ESTIMATE USING THESE SUSTAINABLE LONG-TERM GROWTH RATES?

A A DCF estimate based on these sustainable growth rates is developed in Exhibit MPG-8. As shown there, a sustainable growth DCF analysis produces proxy group average and median DCF results of 8.50% and 8.23%, respectively.

Multi-Stage Growth DCF Model

Q HAVE YOU CONDUCTED ANY OTHER DCF STUDIES?

A Yes. My first constant growth DCF is based on consensus analysts' growth rate projections, so it is a reasonable reflection of rational investment expectations over the next three to five years. The limitation on the constant growth DCF model is that it cannot reflect a rational expectation that a period of high/low short-term growth can be followed by a change in growth to a rate that is more reflective of long-term sustainable growth. Hence, I performed a multi-stage growth DCF analysis to reflect this outlook of changing growth expectations.

Q WHY DO YOU BELIEVE GROWTH RATES CAN CHANGE OVER TIME?

A Analyst projected growth rates over the next three to five years will change as utility earnings growth outlooks change. Utility companies go through cycles in making investments in their systems. When utility companies are making large investments, their rate base grows rapidly, which accelerates their earnings growth. Once a major construction cycle is completed or levels off, growth in the utility rate base slows, and its earnings growth slows from an abnormally high three- to five-year rate to a lower sustainable growth rate.

As major construction cycles extend over longer periods of time, even with an accelerated construction program, the growth rate of the utility will slow simply because rate base will slow, and the utility has limited human and capital resources available to expand its construction program. Hence, the three- to five-year growth rate projection should be used as a long-term sustainable growth rate but not without making a reasonable informed judgment to determine whether it considers the current market environment, the industry, and whether the three- to five-year growth outlook is sustainable.

Q IS THE USE OF A MULTI-STAGE DCF MODEL SUPPORTED IN ACADEMIC AND INDUSTRY LITERATURE?

A Yes. In his book *New Regulatory Finance*, Dr. Roger Morin states the following:

> Dividends need not be, and probably are not, constant from period to period. Moreover, there are circumstances where the standard DCF model cannot be used to assess investor return requirements. For example, if a utility company is in the process of altering its dividend payout policy and dividends are not expected to grow at the same rate as earnings during the transition period, the standard DCF model is inapplicable. This is because the expected growth in stock price has to be different from that of dividends, earnings, and book value if the market price is to converge toward book value.
>
> * * *
>
> A Non-Constant Growth DCF model is appropriate whenever the growth rate is expected to change, and the only way to produce a change in the forecast payout ratio is by introducing an intermediate growth rate that is different from the long-term growth rate, as in the previous example.[13]

[13] *New Regulatory Finance*, Roger A. Morin, PhD, 2006 Public Utilities Reports, Inc., Vienna, Virginia, pp. 264 and 267.

Q PLEASE DESCRIBE YOUR MULTI-STAGE GROWTH DCF MODEL.

A The multi-stage growth DCF model reflects the possibility of non-constant growth for a company over time. The multi-stage growth DCF model reflects three growth periods: (1) a short-term growth period, which consists of the first five years; (2) a transition period, which consists of the next five years (6 through 10); and (3) a long-term growth period, starting in year 11 through perpetuity.

For the short-term growth period, I relied on the consensus analysts' growth projections described above in relationship to my constant growth DCF model. For the transition period, the growth rates were reduced or increased by an equal factor, which reflects the difference between the analysts' growth rates and the long-term sustainable growth rate. For the long-term growth period, I assumed each company's growth would converge to the maximum sustainable long-term growth rate—the nominal U.S. GDP growth rate.

Q WHY IS THE GDP GROWTH PROJECTION A REASONABLE PROXY FOR THE MAXIMUM SUSTAINABLE LONG-TERM GROWTH RATE?

A Utilities cannot indefinitely sustain a growth rate that exceeds the growth rate of the economy in which they sell services. Utilities' earnings/dividend growth is created by increased utility investment or rate base. Such investment, in turn, is driven by service area economic growth and demand for utility service. In other words, utilities invest in plant to meet sales demand growth, and sales growth, in turn, is tied to economic growth in their service areas.

The Energy Information Administration ("EIA") has observed that utility sales growth tracks, albeit is lower than, the U.S. GDP growth, as shown in Exhibit MPG-9. Utility sales growth has lagged behind GDP growth for more than a decade. As a result, nominal GDP growth is a very conservative proxy for electric utility sales

growth, rate base growth, and earnings growth. Therefore, the U.S. GDP nominal growth rate is a conservative proxy for the highest sustainable long-term growth rate of a utility.

Q IS THERE RESEARCH THAT SUPPORTS YOUR POSITION THAT, OVER THE LONG TERM, A COMPANY'S EARNINGS AND DIVIDENDS CANNOT GROW AT A RATE GREATER THAN THE GROWTH OF THE U.S. GDP?

A Yes. This concept is supported in both published analyst literature and academic work. Specifically, in a textbook entitled "Fundamentals of Financial Management," published by Eugene Brigham and Joel F. Houston, the authors state as follows:

> The constant growth model is most appropriate for mature companies with a stable history of growth and stable future expectations. Expected growth rates vary somewhat among companies, but dividends for mature firms are often expected to grow in the future at about the same rate as nominal gross domestic product (real GDP plus inflation).[14]

Q IS THERE ANY ACTUAL INVESTMENT HISTORY THAT SUPPORTS THE NOTION THAT THE CAPITAL APPRECIATION FOR STOCK INVESTMENTS WILL NOT EXCEED THE NOMINAL GROWTH OF THE U.S. GDP?

A Yes. This is evident by a comparison of the compound annual growth of the U.S. GDP compared to the geometric growth of the U.S. stock market. Morningstar measures the historical geometric growth of the U.S. stock market over the period 1929-2012 to be approximately 5.6% and an inflation rate of 3.0%.[15] During this

[14] *Fundamentals of Financial Management*, Eugene F. Brigham and Joel F. Houston, Eleventh Edition 2007, Thomson South-Western, a Division of Thomson Corporation at 298.
[15] *Morningstar 2013 Valuation Yearbook* at 23.

same time period, the U.S. nominal compound annual growth of the U.S. GDP was approximately 6.3%.[16]

As such, the compound geometric growth of the U.S. nominal GDP has been less than the nominal growth of the U.S. stock market capital appreciation. This relationship shows the U.S. GDP is a conservative estimate of long-term sustainable growth.

Q HOW DID YOU DETERMINE A SUSTAINABLE LONG-TERM GROWTH RATE THAT REFLECTS THE CONSENSUS OF THE MARKET?

A I relied on the consensus analysts' projections of long-term GDP growth. *The Blue Chip Financial Forecasts* publishes consensus economists' GDP growth projections twice a year. These consensus analysts' GDP growth outlooks are the best available measure of the market's assessment of long-term GDP growth. These analyst projections reflect all current outlooks for GDP, as reflected in analyst projections, and are likely the most influential on investors' expectations of future growth outlooks. The consensus economists' published GDP growth rate outlook is 5.0% to 4.8% over the next 10 years.[17]

Therefore, I propose to use the consensus economists' projected 5- and 10-year average GDP consensus growth rates of 5.0% and 4.8%, respectively, as published by *Blue Chip Financial Forecasts,* as an estimate of long-term sustainable growth. *Blue Chip Financial Forecasts'* projections provide real GDP growth projections of 2.8% and 2.5%, and GDP inflation of 2.1% and 2.2%[18] over the 5-year and 10-year projection periods, respectively. This consensus GDP growth forecast

[16] U.S. Bureau of Economic Analysis, December 2012.
[17] *Blue Chip Financial Forecasts*, June 1, 2013 at 14.
[18] GDP growth is the product of real and inflation GDP growth.

represents the most likely views of market participants because it is based on published consensus economist projections.

Q DO YOU CONSIDER OTHER SOURCES OF PROJECTED LONG-TERM GDP GROWTH?

A Yes, and these sources corroborate my consensus analysts' projections. The U.S. EIA in its *Annual Energy Outlook* projects real GDP out until 2040. In its *2013 Annual Report*, the EIA projects real GDP through 2040 to be in the range of 2.0% to 2.9%, with a midpoint or reference case of 2.5%.[19]

Also, the Congressional Budget Office ("CBO") makes long-term economic projections. The CBO is projecting real GDP growth of 2.6% to 2.2% during the next 5 and 10 years, respectively, with GDP price inflation of 2.0%.[20] The CBO's real GDP projections are higher than the consensus, but its GDP inflation is lower than the consensus economists.

The real GDP and nominal GDP growth projections made by the U.S. EIA and those made by the CBO support the use of the consensus analyst 5-year and 10-year projected GDP growth outlooks as a reasonable market assessment of long-term prospective GDP growth.

Q WHAT STOCK PRICE, DIVIDEND, AND GROWTH RATES DID YOU USE IN YOUR MULTI-STAGE GROWTH DCF ANALYSIS?

A I relied on the same 13-week stock price and the most recent quarterly dividend payment data discussed above. For stage one growth, I used the consensus analysts' growth rate projections discussed above in my constant growth DCF model.

[19] *DOE/EIA Annual Energy Outlook 2013 With Projections to 2040*, April 2013 at 56.
[20] *CBO: The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, February 2013 at 64.

The transition period begins in year 6 and ends in year 10. For the long-term sustainable growth rate starting in year 11, I used 4.9%, the average of the consensus economists' 5-year and 10-year projected nominal GDP growth rates.

Q WHAT ARE THE RESULTS OF YOUR MULTI-STAGE GROWTH DCF MODEL?

A As shown in Exhibit MPG-10, the average and median multi-stage growth DCF returns on equity for my proxy group are 9.12% and 9.15%, respectively.

Q PLEASE SUMMARIZE THE RESULTS FROM YOUR DCF ANALYSES.

A The results from my DCF analyses are summarized in Table 2 below:

TABLE 2

Summary of DCF Results

Description	Proxy Group Average
Constant Growth DCF Model (Analysts' Growth)	9.20%
Constant Growth DCF Model (Sustainable Growth)	8.50%
Multi-Stage Growth DCF Model	9.12%

I conclude that a reasonable DCF return for Sharyland in this case is 9.20%. The constant growth DCF model using analysts' growth estimates produces a very robust estimate in this case that is largely supported by the results of my sustainable growth model, and multi-stage model. The current three- to five-year growth rate projections by analysts is 4.95%. This is reasonably consistent with my estimate of a long-term sustainable growth rate as measured by independent economists' projections of future GDP growth. Therefore, I place primary reliance on analysts'

growth rate projections of the DCF return estimates based on this model in this proceeding for these reasons.

Risk Premium Model

Q PLEASE DESCRIBE YOUR BOND YIELD PLUS RISK PREMIUM MODEL.

A This model is based on the principle that investors require a higher return to assume greater risk. Common equity investments have greater risk than bonds because bonds have more security of payment in bankruptcy proceedings than common equity and the coupon payments on bonds represent contractual obligations. In contrast, companies are not required to pay dividends or guarantee returns on common equity investments. Therefore, common equity securities are considered to be more risky than bond securities.

This risk premium model is based on two estimates of an equity risk premium. First, I estimated the difference between the required return on utility common equity investments and U.S. Treasury bonds. The difference between the required return on common equity and the Treasury bond yield is the risk premium. I estimated the risk premium on an annual basis for each year over the period 1986 through June 2013. The common equity required returns were based on regulatory commission-authorized returns for electric utility companies. Authorized returns are typically based on expert witnesses' estimates of the contemporary investor-required return.

The second equity risk premium estimate is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields. I selected the period 1986 through June 2013 because public utility stocks consistently traded at a premium to book value during that period. This is illustrated in Exhibit MPG-11, which shows that the market to book ratio since

1986 for the electric utility industry was consistently above 1.0. Over this period, regulatory authorized returns were sufficient to support market prices that at least exceeded book value. This is an indication that regulatory authorized returns on common equity supported a utility's ability to issue additional common stock without diluting existing shares. It further demonstrates that utilities were able to access equity markets without a detrimental impact on current shareholders.

Based on this analysis, as shown in Exhibit MPG-12, the average indicated equity risk premium over U.S. Treasury bond yields has been 5.35%. Of the 28 observations, 22 indicated risk premiums fall in the range of 4.41% to 6.31%. Since the risk premium can vary depending upon market conditions and changing investor risk perceptions, I believe using an estimated range of risk premiums provides the best method to measure the current return on common equity using this methodology.

As shown in Exhibit MPG-13, the average indicated equity risk premium over contemporary Moody's utility bond yields was 3.95% over the period 1986 through June 2013. The indicated equity risk premium estimates based on this analysis primarily fall in the range of 3.03% to 4.89% over this time period.

Q DO YOU BELIEVE THAT THESE EQUITY RISK PREMIUM ESTIMATES ARE BASED ON A TIME PERIOD THAT IS TOO LONG OR TOO SHORT TO DRAW ACCURATE CONCLUSIONS CONCERNING CONTEMPORARY MARKET CONDITIONS?

A No. Contemporary market conditions can change dramatically during the period that rates determined in this proceeding will be in effect. A relatively long period of time where stock valuations reflect premiums to book value is an indication that the authorized returns on equity and the corresponding equity risk premiums were

supportive of investors' return expectations and provided utilities access to the equity markets under reasonable terms and conditions. Further, this time period is long enough to smooth abnormal market movement that might distort equity risk premiums. While market conditions and risk premiums do vary over time, this historical time period is a reasonable period to estimate contemporary risk premiums.

The time period I use in this risk premium study is a generally accepted period to develop a risk premium study using "expectational" data. Conversely, studies have recommended that use of "actual achieved return data" should be based on very long historical time periods. The studies find that achieved returns over short time periods may not reflect investors' expected returns due to unexpected and abnormal stock price performance. However, these short-term abnormal actual returns would be smoothed over time and the achieved actual returns over long time periods would approximate investors' expected returns. Therefore, it is reasonable to assume that averages of annual achieved returns over long time periods will generally converge on the investors' expected returns.

My risk premium study is based on expectational data, not actual returns, and, thus, need not encompass very long time periods.

Q BASED ON HISTORICAL DATA, WHAT RISK PREMIUM HAVE YOU USED TO ESTIMATE SHARYLAND'S COST OF COMMON EQUITY IN THIS PROCEEDING?

A The equity risk premium should reflect the relative market perception of risk in the utility industry today. I have gauged investor perceptions in utility risk today in Exhibit MPG-14. On that schedule, I show the yield spread between utility bonds and Treasury bonds over the last 34 years. As shown on this schedule, the average utility bond yield spreads over Treasury bonds for "A" and "Baa" rated utility bonds for this historical period are 1.55% and 1.96%, respectively. The utility bond yield spreads

over Treasury bonds for "A" and "Baa" rated utilities during June 2013 are 1.06% and 1.58%, respectively. The current average "A" and "Baa" rated utility bond yield spreads over Treasury bond yields are now lower than the 34-year average spreads.

A current 13-week average "A" rated utility bond yield of 4.73%, when compared to the current Treasury bond yield of 3.71% as shown in Exhibit MPG-15, page 1 implies a yield spread of around 1.02%. This current utility bond yield spread is lower than the 34-year average spread for "A" utility bonds of 1.55%. Similarly, the current spread for the "Baa" utility yields of 1.55% is lower than the 34-year average spread of 1.96%.

These utility bond yield spreads are clear evidence that the market considers the utility industry to be a relatively low-risk investment and demonstrates that utilities continue to have strong access to capital.

Q HOW DID YOU ESTIMATE SHARYLAND'S COST OF COMMON EQUITY WITH THIS RISK PREMIUM MODEL?

A I added a projected long-term Treasury bond yield to my estimated equity risk premium over Treasury yields. The 13-week average 30-year Treasury bond yield, ending September 20, 2013 was 3.71%, as shown in Exhibit MPG-15, page 1. *Blue Chip Financial Forecasts* projects the 30-year Treasury bond yield to be 4.20%, and a 10-year Treasury bond yield to be 3.20%.[21] Using the projected 30-year bond yield of 4.20%, and a Treasury bond risk premium of 4.41% to 6.31%, as developed above, produces an estimated common equity return in the range of 8.61% (4.20% + 4.41%) to 10.51% (4.20% + 6.31%). My risk premium estimates fall in the range of 8.61% to 10.51%.

[21] *Blue Chip Financial Forecasts*, September 1, 2013 at 2.

I next added my equity risk premium over utility bond yields to a current 13-week average yield on "A" rated utility bonds for the period ending September 20, 2013 of 4.73%. Adding the utility equity risk premium of 3.03% to 4.89%, as developed above, to an "A" rated bond yield of 4.73%, produces a cost of equity in the range of 7.76% (4.73% + 3.03%) to 9.62% (4.73% + 4.89%).

Q WHAT IS YOUR RECOMMENDED RETURN FOR SHARYLAND BASED ON YOUR RISK PREMIUM STUDY?

A My recommendation considers both utility security risk and market interest rate risk. Current interest rate spreads suggest the market is embracing utility investments as relatively low-risk investment alternatives. This is clearly evident from the low utility bond spreads relative to Treasury bonds currently compared to the historical time period studied. (See Exhibits MPG-14 and MPG-15). Also, the market is pricing "A" utility bonds to produce lower yields compared to general "A" rated corporate bond yields. On average over time, "A" utility bond yields are higher than "A" corporate bond yields. (Exhibit MPG-14). All of this supports my conclusion that the utility industry is perceived as a low-risk stable investment.

On the other hand, the Federal Reserve has been procuring long-term Treasury and collateralized bonds in an effort to stimulate the U.S. economy. This stimulus has reduced long-term interest rates. This government stimulus initiative is expected to be suspended in the near future. The suspension of the Federal Reserve's stimulus in long-term interest rate markets could cause long-term market interest rates to increase. As such, I believe there is additional risk in long-term interest rate markets created by this Federal Reserve stimulus policy.

I recommend giving more weight to the high-end of my risk premium results to reflect the greater market interest rate risk in the current market. I propose to provide

75% weight to the high-end of my risk premium estimates and 25% to the low-end of my risk premium estimates. Providing more weight to the high-end risk premium captures the greater market interest rate risk. This results in a risk premium estimate over Treasury bond yields of 10.04%,[22] and a risk premium estimate over "A" utility bond yields of 9.16%.[23]

My risk premium analysis produces a risk premium in the range of 9.16% to 10.04%, with a midpoint of 9.60%.

Capital Asset Pricing Model

Q PLEASE DESCRIBE THE CAPM.

A The CAPM method of analysis is based upon the theory that the market-required rate of return for a security is equal to the risk-free rate, plus a risk premium associated with the specific security. This relationship between risk and return can be expressed mathematically as follows:

$R_i = R_f + B_i \times (R_m - R_f)$ where:

R_i = Required return for stock i

R_f = Risk-free rate

R_m = Expected return for the market portfolio

B_i = Beta - Measure of the risk for stock

The stock-specific risk term in the above equation is beta. Beta represents the investment risk that cannot be diversified away when the security is held in a diversified portfolio. When stocks are held in a diversified portfolio, firm-specific risks can be eliminated by balancing the portfolio with securities that react in the opposite

[22] 75% x 10.51% + 25% x 8.61% = 10.04%.
[23] 75% x 9.62% + 25% x 7.76% = 9.16%.

direction to firm-specific risk factors (e.g., business cycle, competition, product mix, and production limitations).

The risks that cannot be eliminated when held in a diversified portfolio are non-diversifiable risks. Non-diversifiable risks are related to the market in general and are referred to as systematic risks. Risks that can be eliminated by diversification are regarded as non-systematic risks. In a broad sense, systematic risks are market risks, and non-systematic risks are business risks. The CAPM theory suggests that the market will not compensate investors for assuming risks that can be diversified away. Therefore, the only risk that investors will be compensated for are systematic or non-diversifiable risks. The beta is a measure of the systematic or non-diversifiable risks.

Q PLEASE DESCRIBE THE INPUTS TO YOUR CAPM.

A The CAPM requires an estimate of the market risk-free rate, the company's beta, and the market risk premium.

Q WHAT DID YOU USE AS AN ESTIMATE OF THE MARKET RISK-FREE RATE?

A As previously noted, *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield is 4.20%.[24] The current 30-year Treasury bond yield is 3.71%, as shown in Exhibit MPG-15, page 1. I used *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield of 4.20% for my CAPM analysis.

[24] *Blue Chip Financial Forecasts*, September 1, 2013 at 2.

Q WHY DID YOU USE LONG-TERM TREASURY BOND YIELDS AS AN ESTIMATE OF THE RISK-FREE RATE?

A Treasury securities are backed by the full faith and credit of the United States government, so long-term Treasury bonds are considered to have negligible credit risk. Also, long-term Treasury bonds have an investment horizon similar to that of common stock. As a result, investor-anticipated long-run inflation expectations are reflected in both common-stock required returns and long-term bond yields. Therefore, the nominal risk-free rate (or expected inflation rate and real risk-free rate) included in a long-term bond yield is a reasonable estimate of the nominal risk-free rate included in common stock returns.

Treasury bond yields, however, do include risk premiums related to unanticipated future inflation and interest rates. A Treasury bond yield is not a risk-free rate. Risk premiums related to unanticipated inflation and interest rates are systematic or market risks. Consequently, for companies with betas less than 1.0, using the Treasury bond yield as a proxy for the risk-free rate in the CAPM analysis can produce an overstated estimate of the CAPM return.

Q WHAT BETA DID YOU USE IN YOUR ANALYSIS?

A As shown in Exhibit MPG-16, the proxy group average *Value Line* beta estimate is 0.73.

Q HOW DID YOU DERIVE YOUR MARKET RISK PREMIUM ESTIMATE?

A I derived two market risk premium estimates, a forward-looking estimate and one based on a long-term historical average.

The forward-looking estimate was derived by estimating the expected return on the market (as represented by the S&P 500) and subtracting the risk-free rate from

this estimate. I estimated the expected return on the S&P 500 by adding an expected inflation rate to the long-term historical arithmetic average real return on the market. The real return on the market represents the achieved return above the rate of inflation.

Morningstar's *Stocks, Bonds, Bills and Inflation 2013 Classic Yearbook* estimates the historical arithmetic average real market return over the period 1926 to 2012 as 8.7%.[25] A current consensus analysts' inflation projection, as measured by the Consumer Price Index, is 2.2%.[26] Using these estimates, the expected market return is 11.10%.[27] The market risk premium then is the difference between the 11.10% expected market return, and my 4.20% risk-free rate estimate, or approximately 6.9%.

The historical estimate of the market risk premium was also estimated by Morningstar in *Stocks, Bonds, Bills and Inflation 2013 Classic Yearbook*. Over the period 1926 through 2012, Morningstar's study estimated that the arithmetic average of the achieved total return on the S&P 500 was 11.8%,[28] and the total return on long-term Treasury bonds was 6.1%.[29] The indicated market risk premium is 5.7% (11.8% - 6.1% = 5.7%). The average of my market risk premium estimates is 6.3% (6.9% to 5.7%).

[25] *Morningstar, Inc., Ibbotson SBBI 2013 Classic Yearbook* at 88.
[26] *Blue Chip Financial Forecasts*, August 1, 2013 at 2.
[27] { [(1 + 0.087) * (1 + 0.022)] – 1 } * 100.
[28] *Morningstar, Inc. Ibbotson SBBI 2013 Classic Yearbook* at 87.
[29] *Id.*

Q HOW DOES YOUR ESTIMATED MARKET RISK PREMIUM RANGE COMPARE TO THAT ESTIMATED BY MORNINGSTAR?

A Morningstar's analysis indicates that a market risk premium falls somewhere in the range of 6.0% to 6.7%. My market risk premium falls in the range of 5.7% to 6.9%. My average market risk premium of 6.3% is in the middle of Morningstar's range.

Morningstar estimates a forward-looking market risk premium based on actual achieved data from the historical period of 1926 through 2012. Using this data, Morningstar estimates a market risk premium derived from the total return on large company stocks (S&P 500), less the income return on Treasury bonds. The total return includes capital appreciation, dividend or coupon reinvestment returns, and annual yields received from coupons and/or dividend payments. The income return, in contrast, only reflects the income return received from dividend payments or coupon yields. Morningstar argues that the income return is the only true risk-free rate associated with Treasury bonds and is the best approximation of a truly risk-free rate.[30] I disagree with this assessment from Morningstar, because it does not reflect a true investment option available to the marketplace and therefore does not produce a legitimate estimate of the expected premium of investing in the stock market versus that of Treasury bonds. Nevertheless, I will use Morningstar's conclusion to show the reasonableness of my market risk premium estimates.

Morningstar's range is based on several methodologies. First, Morningstar estimates a market risk premium of 6.7% based on the difference between the total market return on common stocks (S&P 500) less the income return on Treasury bond investments. Second, Morningstar found that if the New York Stock Exchange (the "NYSE") was used as the market index rather than the S&P 500, that the market risk premium would be 6.5%, not 6.7%. Third, if only the two deciles of the largest

[30] *Morningstar, Inc., Ibbotson SBBI 2013 Valuation Yearbook* at 55.

companies included in the NYSE were considered, the market risk premium would be 6.0%.[31]

Finally, Morningstar found that the 6.7% market risk premium based on the S&P 500 was influenced by an abnormal expansion of price-to-earnings ("P/E") ratios relative to earnings and dividend growth during the period 1980 through 2001. Morningstar believes this abnormal P/E expansion is not sustainable.[32] Therefore, Morningstar adjusted this market risk premium estimate to normalize the growth in the P/E ratio to be more in line with the growth in dividends and earnings. Based on this alternative methodology, Morningstar published a long-horizon supply-side market risk premium of 6.0%.[33]

Q WHAT ARE THE RESULTS OF YOUR CAPM ANALYSIS?

A As shown in Exhibit MPG-17, based on Morningstar's market risk premium of 6.7%, a risk-free rate of 4.20%, and a beta of 0.73, my CAPM analysis produces a return of 9.10%.

Return on Equity Summary

Q BASED ON THE RESULTS OF YOUR RETURN ON COMMON EQUITY ANALYSES DESCRIBED ABOVE, WHAT RETURN ON COMMON EQUITY DO YOU RECOMMEND FOR SHARYLAND?

A Based on my analyses, I estimate Sharyland's current market cost of equity to be 9.35%.

[31] Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large capitalization benchmarks. *Id.* at 54.
[32] *Morningstar, Inc., Ibbotson SBBI 2013 Valuation Yearbook* at 54.
[33] *Id.*

TABLE 3

Return on Common Equity Summary

Description	Results
DCF	9.20%
Risk Premium	9.60%
CAPM	9.10%

My recommended return on common equity is 9.35%. My recommended return on equity in the range of 9.10% to 9.60% is supported by the results of my DCF studies and my risk premium studies.

Response to Sharyland Witness Mr. Robert Hevert

Q WHAT RETURN ON COMMON EQUITY IS SHARYLAND PROPOSING FOR THIS PROCEEDING?

A Mr. Hevert, who sponsors Sharyland's return on equity recommendation, proposes a return on equity of 10.75%[34] based on a recommended range of 10.50% to 11.25%. He relied on a constant growth DCF analysis, CAPM studies, and a Bond Yield Plus Risk Premium approach to support his recommended return.

Q ARE MR. HEVERT'S RETURN ON EQUITY ESTIMATES REASONABLE?

A No. Mr. Hevert's estimated return on equity of 10.75% is overstated and should be rejected. Mr. Hevert's analyses produce excessive results for various reasons, including the following: (1) his constant growth DCF results are based on excessive, unsustainable growth rates; (2) his CAPM is based on inflated market risk premiums;

[34]Hevert Direct at 12.

and (3) his Bond Yield Plus Risk Premium is based on inflated utility equity risk premiums.

Q PLEASE SUMMARIZE MR. HEVERT'S RETURN ON EQUITY ESTIMATES.

A Mr. Hevert's return on equity estimates are summarized in Table 4 below. In Column 2, I show the results with prudent and sound adjustments to his common equity return estimates. With such adjustments to his proxy group's DCF, CAPM and Risk Premium return estimates, Mr. Hevert's own studies show my recommended return on equity for Sharyland is reasonable.

TABLE 4

Hevert's Return on Equity Estimates

Description	Mean[1] (1)	Adjusted[2] (2)
Constant Growth DCF		
30-Day Average Stock Price	10.30%	9.40%
90-Day Average Stock Price	10.51%	9.63%
180-Day Average Stock Price	10.55%	9.67%
CAPM Results (Bloomberg Beta)		
Current Treasury Yield (Sharpe Ratio – 3.16%)	8.09%	7.85%
Current Treasury Yield (Bloomberg DCF – 3.16%)	10.07%	7.85%
Current Treasury Yield (Capital IQ DCF – 3.16%)	9.96%	7.85%
Near-Term Projected (Sharpe Ratio – 3.30%)	8.23%	8.00%
Near-Term Projected (Bloomberg DCF – 3.30%)	10.22%	8.00%
Near-Term Projected (Capital IQ DCF – 3.30%)	10.10%	8.00%
Long-Term Projected (Sharpe Ratio – 5.10%)	10.03%	9.80%
Long-Term Projected (Bloomberg DCF – 5.10%)	12.02%	9.80%
Long-Term Projected (Capital IQ DCF – 5.10%)	11.90%	9.80%
Average	**10.07%**	**8.60%**
CAPM Results (*Value Line* Beta)		
Current Treasury Yield (Sharpe Ratio – 3.16%)	8.21%	8.00%
Current Treasury Yield (Bloomberg DCF – 3.16%)	10.25%	8.00%
Current Treasury Yield (Capital IQ DCF – 3.16%)	10.14%	8.00%
Near-Term Projected (Sharpe Ratio – 3.30%)	8.36%	8.10%
Near-Term Projected (Bloomberg DCF – 3.30%)	10.40%	8.10%
Near-Term Projected (Capital IQ DCF – 3.30%)	10.28%	8.10%
Long-Term Projected (Sharpe Ratio – 5.10%)	10.16%	9.90%
Long-Term Projected (Bloomberg DCF – 5.10%)	12.20%	9.90%
Long-Term Projected (Capital IQ DCF – 5.10%)	12.08%	9.90%
Average	**10.23%**	**8.70%**
Risk Premium		
Current	10.25%	7.51%
Near-Term Projected	10.26%	7.64%
Long-Term Projected	10.77%	9.50%
Average	**10.43%**	**8.22%**
Range	**10.50%-11.25%**	**8.60%-9.70%**
Recommended Return on Equity	**10.75%**	**9.30%**

Sources:
[1]Hevert Direct Testimony at 5 and 6, and Exhibits RBH-4 through RBH-8.
[2] Exhibit MPG-19.

Q PLEASE DESCRIBE MR. HEVERT'S CONSTANT GROWTH DCF RETURN ESTIMATES.

A His constant growth DCF returns are developed in his Exhibit RBH-4, pages 1-3. Mr. Hevert's constant growth DCF models are based on consensus growth rates published by Zacks and First Call, and individual growth rate projections made by *Value Line*. He relied on dividend yield calculations based on average stock prices over three different periods – 30-day, 90-day and 180-day.

Q DO YOU BELIEVE THAT MR. HEVERT'S CONSTANT GROWTH DCF RETURN MODELS PRODUCE A REASONABLE RETURN ESTIMATE FOR SHARYLAND?

A No. Mr. Hevert relied on growth rate estimates which are far too high to be reasonable estimates of long-term sustainable growth. Also, Mr. Hevert's results are unreasonably affected by certain outliers. For example, he uses Otter Tail Corporation and PNM Resources *Value Line* growth rates of 20.0% and 16.0%, respectively, which are significantly above the sustainable long-term growth rate of 4.9% that I discuss above.

Q PLEASE DESCRIBE THE GROWTH RATES INCLUDED IN MR. HEVERT'S CONSTANT GROWTH DCF RETURN ESTIMATES.

A The growth rate estimates, dividend yields and corresponding DCF return estimates for Mr. Hevert's constant growth DCF studies are illustrated on my Exhibit MPG-18. Mr. Hevert's schedules do not show the details of the DCF estimate.

As shown on that schedule, his DCF return estimates for his proxy group are based on a range of growth rate estimates from a low of 4.51%, to a mean growth rate estimate of 6.23%, and a high DCF growth rate of 8.04%. These growth rate

estimates were used in all of his constant growth DCF study 30-, 90- and 180-day average stock prices.

Q WHY DO YOU BELIEVE THAT MR. HEVERT'S MEAN AND HIGH-END GROWTH RATE ESTIMATES OF 6.23% AND 8.04%, RESPECTIVELY, ARE TOO HIGH TO BE REASONABLE ESTIMATES OF LONG-TERM SUSTAINABLE GROWTH?

A These growth rates cannot be sustained indefinitely for various reasons. First, the consensus of economists is that the GDP growth of the U.S. general economy, which is a proxy for the growth rate of the economies in which these utilities operate, is between 4.7% and 5.1% indefinitely.[35] Hence, the growth rates of 6.23% and 8.04% are substantially higher than the growth outlooks of the economies in which these utilities operate. It is simply not rational to expect that these companies can grow faster than the economies in which they provide service, because utilities provide service to meet the demand of the economies they serve.

Second, growth rates in the range of 6.23% and 8.04% could not be sustained by the current earnings retention rate of utility companies. Indeed, the *Value Line* long-term payout ratio for the proxy group will be about 61.85% (Exhibit MPG-6). In order to sustain growth rates of 6.23% and 8.04%, utilities would have to achieve returns on book equity of 16.33% and 21.07%, respectively, indefinitely.[36] Hence, it is simply not a rational outlook to expect that utilities will be able to produce earnings that could sustain this level of growth indefinitely.

[35] *Blue Chip Financial Forecasts*, June 1, 2013, page 14.
[36] 6.23% ÷ (1 – 61.85%) = 16.33% and 8.04% ÷ (1 – 61.85%) = 21.07%.