be applied to NIPSCO's return on equity if costs are recovered through a rider compared to those recovered through base rates.

Q YOU ALSO SAID THE COMMISSION COULD REFLECT THIS RISK REDUCTION THROUGH APPROVAL OF A CAPITAL STRUCTURE APPROPRIATE FOR TDSIC COSTS. PLEASE EXPLAIN THIS ALTERNATIVE.

A Adjusting the capital structure to reflect greater cost recovery risk is generally consistent with credit rating agencies' assessment of appropriate credit metrics based on the business and financial risk of a utility. Specifically, S&P's credit rating guidelines state that if a company has a higher business profile score (lower business risk), then it can have a higher percentage of debt capital while still maintaining an investment grade bond rating. Conversely, a utility with a weaker business profile score (greater business risk) must finance with less financial risk in order to maintain an investment grade bond rating. S&P notes this as companies with stronger business profile scores ("Excellent" to "Strong") can have more financial risk (financial risk profile score of "Aggressive" to "Highly Leveraged") while still maintaining an investment grade bond rating.[4]

Q PLEASE PROPOSE A CAPITAL STRUCTURE THAT CAN BE USED IN THE TDSIC WHICH REFLECTS THIS COST RECOVERY RISK REDUCTION.

A I recommend a capital structure composed of 40% common equity and 60% debt capital. This is the same capital structure mix that NIPSCO agreed to for a major environmental project in its last base rate settlement in Cause No. 43969. (Final Order at 8, Paragraph C).

[4] *Standard & Poor's RatingsDirect, Key Credit Factors*: "Business and Financial Risk in the Industrial and Utility Industry," November 26, 2008.

This capital structure can be used in concert with NIPSCO's current authorized return on equity for base rates, and updated embedded debt costs.

Q IF NIPSCO'S PROPOSAL TO INVEST OVER $1 BILLION IN RATE BASE OVER THE NEXT SEVEN YEARS IS APPROVED WHAT WILL HAPPEN IF NIPSCO FUNDS THOSE INVESTMENTS WITH ITS PROPOSED CAPITAL STRUCTURE MIX?

A If NIPSCO is authorized to make a significant investment in rate base at its current capital structure mix, those investments will further exacerbate an unreasonable embedded common equity ratio, which in turn will further inflate NIPSCO's unreasonable cost of capital. If NIPSCO is directed to use a 40% common equity and 60% debt incremental capital mix for its TDSIC investments, there will be an improvement to the reasonableness of NIPSCO's common equity ratio and capital structure over time.

Considering that NIPSCO will likely not file another rate case for seven years after approval allowing it to lock in an inflated or incentive rate of return could lead to unreasonable and unjust retail rates.

The direction from the IURC for NIPSCO to use a 40%/60% equity/debt capital structure for TDSIC investments would <u>not</u> be a hypothetical capital structure but rather establishes an expected movement by NIPSCO to better manage its capital and reduce the cost of its TDSIC investments and overall cost of service. This will provide a clear instruction by the IURC to NIPSCO of a capital structure mix that it finds to be reasonable and prudent and should be pursued by NIPSCO for funding its incremental investments in these projects.

Q WHY DO YOU BELIEVE THAT NIPSCO DOES NOT REFLECT ITS ACTUAL CAPITAL STRUCTURE ON ITS PETITIONER'S EXHIBIT NO. DJI-1, EXHIBIT 2, SCHEDULE 1 USED TO DEVELOP ITS WEIGHTED AVERAGE COST OF CAPITAL FOR THE TDSIC INVESTMENTS?

A As shown at page 65 of the Final Order in NIPSCO's last base rate case (Cause No. 43969 dated December 21, 2011), NIPSCO's actual capital structure sources for investments in utility plant and equipment include investor capital (common equity and long-term debt), but also customer-supplied capital (customer deposits, deferred income taxes, post-retirement liability, and post-1970 investment tax credits ("ITC")). These sources of customer-supplied capital are lower cost than investor-supplied capital. NIPSCO did not include these lower cost capital sources in its proposed capital structure for the TDSIC. By ignoring these lower-cost sources of capital, NIPSCO is substantially overstating its cost of capital for the TDSIC investments.

Q WERE THE CUSTOMER-SUPPLIED SOURCES OF CAPITAL LIMITED TO ONLY INVESTMENTS MADE IN BASE RATES?

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Q IF THE COMMISSION DOES NOT ACCEPT YOUR RECOMMENDATION TO ESTABLISH A TARGET CAPITAL STRUCTURE MIX FOR NIPSCO IN ITS TDSIC INVESTMENT, SHOULD THE COMMISSION REQUIRE NIPSCO TO USE ITS TOTAL CAPITAL STRUCTURE EQUIVALENT TO THAT USED TO ESTABLISH ITS WEIGHTED AVERAGE COST OF CAPITAL IN BASE RATES FOR ITS TDSIC PURPOSES?

A Yes.

Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A Yes, it does.

Qualifications of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

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Exhibit MPG-1

Northern Indiana Public Service Company

Utility Bond Yields

Line	Date	"A" Rated Utility Bond Yield[1] (2)	"Baa" Rated Utility Bond Yield[1] (3)
1	10/04/13	4.77%	5.27%
2	09/27/13	4.73%	5.23%
3	09/20/13	4.79%	5.27%
4	09/13/13	4.85%	5.37%
5	09/06/13	4.86%	5.37%
6	08/30/13	4.67%	5.17%
7	08/23/13	4.79%	5.32%
8	08/16/13	4.83%	5.39%
9	08/09/13	4.61%	5.17%
10	08/02/13	4.63%	5.18%
11	07/26/13	4.62%	5.13%
12	07/19/13	4.62%	5.12%
13	07/12/13	4.76%	5.28%
14	**Average**	**4.73%**	**5.25%**
15	**Yield Spread**		**0.52%**

Sources:
[2]http://credittrends.moodys.com/.

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF NORTHERN INDIANA PUBLIC SERVICE COMPANY FOR (1) APPROVAL OF A TRANSMISSION, DISTRIBUTION AND STORAGE SYSTEM IMPROVEMENT CHARGE ("TDSIC") RATE SCHEDULE, (2) APPROVAL OF PETITIONER'S PROPOSED COST ALLOCATIONS, (3) APPROVAL OF THE TIMELY RECOVERY OF TDSIC COSTS THROUGH PETITIONER'S PROPOSED TDSIC RATE SCHEDULE, AND (4) AUTHORITY TO DEFER APPROVED TDSIC COSTS, PURSUANT TO IND. CODE CH. 8-1-39.	**CAUSE NO. 44371**

Verification

I, Michael P. Gorman, a consultant and Managing Principal of Brubaker & Associates, Inc., affirm under penalties of perjury that the foregoing representations are true and correct to the best of my knowledge, information and belief.

Michael P. Gorman
10/11/2013

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF NORTHERN INDIANA PUBLIC SERVICE COMPANY FOR APPROVAL OF PETITIONER'S 7-YEAR PLAN FOR ELIGIBLE TRANSMISSION, DISTRIBUTION AND STORAGE SYSTEM IMPROVEMENTS, PURSUANT TO IND. CODE § 8-1-39-10(a).	)	**CAUSE NO. 44370**

Direct Testimony and Exhibit of

Michael P. Gorman

On behalf of

The NIPSCO Industrial Group

October 11, 2013

BRUBAKER & ASSOCIATES, INC.

Project 9830

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

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Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael P. Gorman. 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 DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A This information is included in Appendix A to my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A The NIPSCO Industrial Group ("Industrial Group"). Industrial Group members purchase substantial quantities of electricity from Northern Indiana Public Service Company ("NIPSCO" or "Company").

Q WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A I will respond to the proposed method of developing the overall rate of return applied to develop the post in-service carrying cost which NIPSCO proposed to seek recovery of for the semi-annual Transmission, Distribution and Storage System Improvement Charge ("TDSIC").

Q PLEASE DESCRIBE NIPSCO'S PROPOSED SCHEDULE TO DEVELOP THE WEIGHTED COST OF CAPITAL WHICH NIPSCO PROPOSES TO APPLY TO THE TDSIC INVESTMENTS.

A On its Petitioner's Exhibit DJI-1, Exhibit 2, Schedule 1 attached to the Verified Direct Testimony of NIPSCO witness Derric J. Isensee, NIPSCO proposes to develop the overall rate of return based on long-term debt and equity balances at a specific point in time, and the current embedded cost of debt rate, and the last approved return on equity (10.2%). As shown on NIPSCO's Petitioner's Exhibit DJI-1, Exhibit 2, Schedule 1, NIPSCO is proposing an overall return on equity of 8.59% based on a 60.9% common equity ratio and a 10.2% return on equity.

Q IS THIS WEIGHTED AVERAGE COST OF CAPITAL APPROPRIATE FOR THE TDSIC?

A No. This overall rate of return is excessive for several reasons. First, NIPSCO failed to reflect the risk reduction aspects of recovering these costs in a rider mechanism. This reduced risk should be reflected in either a capital structure adjusted to reflect the risk reduction or a reduction to the authorized return on common equity used in the tracker. Second, NIPSCO's proposed capital structure is inappropriate for any aspects of rate-setting by NIPSCO. A 60.9% common equity ratio simply reflects a

failure of NIPSCO to manage its capital structure and support a competitive rate structure. Third, this capital structure does not reflect NIPSCO's actual capital components used to support its investments in utility plant and equipment. NIPSCO's proposed capital structure should be rejected as unreasonable.

Q WHY DO YOU BELIEVE THAT RECOVERING COSTS THROUGH A RIDER MECHANISM WILL LOWER NIPSCO'S COSTS?

A It is a generally accepted conclusion that a rider mechanism improves the likelihood of full cost recovery, and lowers the risk of fully recovering the costs recovered in the tracker. In turn, the improvement to cost recovery certainty improves the level and predictability of earnings. Indeed, the Indiana Utility Regulatory Commission ("IURC" or "Commission") recognized that tracker mechanisms lower a utility's risk. For example, in Cause No. 44075, for Indiana Michigan Power Company, in finding a reasonable cost of equity for this utility, the Commission stated:

> We also consider the effect of cost tracking and rate adjustment mechanisms in reducing Petitioner's earnings risks and attempt to properly reflect them in Petitioner's cost of equity.[1]

The IURC also noted risk reduction implemented by tracker mechanisms in a NIPSCO case in Cause No. 43526. There, the Commission awarded NIPSCO a 9.9% return on equity and stated the following:

> We must also consider the effect tracking mechanisms have in reducing risk in order to ensure that these reduced risks are properly reflected in NIPSCO's cost of equity. See Order, Cause No. 42359 at 53. NIPSCO has a number of trackers in place currently, and we have approved additional trackers in this Cause. No witness for NIPSCO addressed the effects of trackers on NIPSCO's cost of capital, which could be considered a fatal failing of its analysis.[2]

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[1]Indiana Utility Regulatory Commission, Cause No. 44075, Order dated February 13, 2013 at 43.

[2]Indiana Utility Regulatory Commission, Cause No. 43526, Final Order dated August 25, 2010 at 32.

The Commission also recognized that trackers reduce utilities' risk in a Southern Indiana Gas and Electric Company filing in Cause No. 43839 in an order dated April 27, 2011 at 31.

Q WHY DO YOU BELIEVE THAT SETTING THE TDSIC REVENUE REQUIREMENT USING A CAPITAL STRUCTURE WITH A 60.9% COMMON EQUITY RATIO IS EXCESSIVE AND WILL RESULT IN AN UNJUST AND UNREASONABLE RATE?

A This capital structure simply does not reflect the investment stability and low-risk nature of an electric utility. Capital structures that are awarded by regulatory commissions reflect this low-risk nature of electric utility operations. As shown in the table below, the industry approved rate of return is based on capital structures that have common equity ratios of between 48% and 51% since 2005. NIPSCO's proposal to set rates using a capital structure of 60.9% results in excessive charges and an unreasonable revenue requirement and ultimately an unreasonable TDSIC charge.

TABLE 1

Awarded Industry Average Common Equity Ratios

Period	Capital Structure
2005 Full Year	46.73%
2006 Full Year	48.67%
2007 Full Year	48.01%
2008 Full Year	48.41%
2009 Full Year	48.61%
2010 Full Year	48.45%
2011 Full Year	48.26%
2012 Full Year	50.55%
2013 1st Quarter	49.02%
2013 2nd Quarter	50.56%
2013 3rd Quarter	50.61%
2013 Year-to-Date	49.86%

Source: Regulatory Research Associates *Regulatory Focus*: "Major Rate Case Decisions—January-September 2013," October 8, 2013, Electric Utilities—Summary Table.

Q WHY WOULD AN EXCESSIVE COMMON EQUITY RATIO INFLATE A UTILITY'S COST OF SERVICE?

A Using a capital structure with an excessive amount of common equity inflates the revenue requirement because the common equity is the most expensive form of capital subject to income tax expense. As an example, an authorized return on equity of 10% has a revenue requirement cost of around 16% after adjustments are made for income taxes (assuming approximately a 40% composite income tax rate). In contrast, debt capital is tax deductible, so a new debt issue is currently around 4.5%

to 5.5% cost to retail customers. As such, common equity is more than three times more expensive than debt capital.

However, the capital structure should have a reasonable mix of debt and equity in order to manage the financial risk of the utility and its investment grade bond rating, but should do so at a reasonable cost to customers. NIPSCO's capital structure does not reflect any design to mitigate costs to customers.

Q WHAT OPTIONS DOES THE IURC HAVE TO REFLECT THIS RISK REDUCTION ASPECT IN DEVELOPING AN APPROPRIATE WEIGHTED AVERAGE COST OF CAPITAL FOR THE TDSIC MECHANISMS?

A The Commission can consider a number of factors in determining a utility's pretax return under IC 8-1-39-13. The Commission could reduce NIPSCO's authorized return on equity of 10.2% to reflect this risk reduction. Alternatively, the Commission can direct NIPSCO to use 40% common equity and 60% debt capital to fund its TDSIC investments.

Q ARE YOU PROPOSING AN ADJUSTMENT TO NIPSCO'S LAST AUTHORIZED RETURN ON EQUITY IN THIS PROCEEDING?

A I have not completed a full cost of equity study for NIPSCO in this proceeding. However, I do believe the increased number of tracker mechanisms has significantly reduced its risk. Therefore, a reduction to its authorized return on equity is appropriate for that basis.

Further, NIPSCO's last authorized return on equity of 10.2% was based on the period where capital market costs were significantly higher than they are currently.

Both of these factors suggest the return on equity for a TDSIC tracker should be significantly lower than NIPSCO's current authorized return of 10.2% for base rates.

Just as an example, in 2011 when NIPSCO was authorized a return on equity of 10.2%, the industry average authorized return on equity for electric utilities was 10.3%. During the first six months of 2013, excluding returns for Virginia utilities based on statutory mandates for certain generation investments, the industry average authorized return on equity was approximately 9.8%. Regulatory Research Associates stated:

> The average return on equity (ROE) authorized electric utilities in the first three quarters of 2013 was 10.09% (30 observations), in line with the 10.17% authorized in calendar-2012. We note that five surcharge/rider generation cases decided in Virginia in the first and third quarters of 2013 incorporate ROE premiums; Virginia statutes authorize the State Corporation Commission to approve ROE premiums of up to 200 basis points for certain generation projects (see the Virginia Commission Profile). Excluding these Virginia surcharge/rider generation cases from the data, the average authorized electric ROE approximated 9.8% for the first three quarters of 2013; the analogous adjusted average ROE for calendar-2012 approximated 10%. The average ROE authorized gas utilities for the first nine months of 2013 was 9.51% (10 observations), notably lower than the 9.94% authorized in calendar-2012. This report utilizes the simple mean for the return averages.[3]

Hence, a return of equity of approximately 9.55% is appropriate for the tracker. This would reflect a 9.8% industry average return on equity in 2013 less 25 basis points. The 25 basis point reduction is approximately one-half the current spread between "A" and "Baa" utility bond yields. (See Exhibit MPG-1).

The difference in this utility bond yield spread reflects the market pricing for increased cost recovery certainty. That is, investors will pay a higher price (get a lower yield) for a bond rated "A" than they will for a bond rated "Baa" because an "A" rated bond has less risk of default. This same cost recovery certainty and pricing can

[3]Regulatory Research Associates *Regulatory Focus*: "Major Rate Case Decisions—January-September 2013," October 8, 2013.

be applied to NIPSCO's return on equity if costs are recovered through a rider compared to those recovered through base rates.

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Exhibit MPG-1

Northern Indiana Public Service Company

Utility Bond Yields

Line	Date	"A" Rated Utility Bond Yield[1] (2)	"Baa" Rated Utility Bond Yield[1] (3)
1	10/04/13	4.77%	5.27%
2	09/27/13	4.73%	5.23%
3	09/20/13	4.79%	5.27%
4	09/13/13	4.85%	5.37%
5	09/06/13	4.86%	5.37%
6	08/30/13	4.67%	5.17%
7	08/23/13	4.79%	5.32%
8	08/16/13	4.83%	5.39%
9	08/09/13	4.61%	5.17%
10	08/02/13	4.63%	5.18%
11	07/26/13	4.62%	5.13%
12	07/19/13	4.62%	5.12%
13	07/12/13	4.76%	5.28%
14	**Average**	**4.73%**	**5.25%**
15	**Yield Spread**		**0.52%**

Sources:
[2]http://credittrends.moodys.com/.

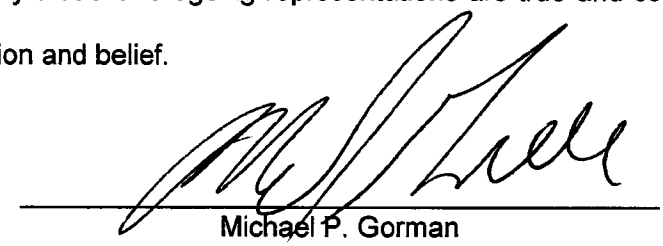
STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF NORTHERN INDIANA PUBLIC SERVICE COMPANY FOR APPROVAL OF PETITIONER'S 7-YEAR PLAN FOR ELIGIBLE TRANSMISSION, DISTRIBUTION AND STORAGE SYSTEM IMPROVEMENTS, PURSUANT TO IND. CODE § 8-1-39-10(a).	**CAUSE NO. 44370**

Verification

I, Michael P. Gorman, a consultant and Managing Principal of Brubaker & Associates, Inc., affirm under penalties of perjury that the foregoing representations are true and correct to the best of my knowledge, information and belief.



Michael P. Gorman
10/11/2013

BEFORE THE

ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF ENTERGY ARKANSAS, INC. FOR APPROVAL OF CHANGES IN RATES FOR RETAIL ELECTRIC SERVICE	**DOCKET NO. 13-028-U**

Surrebuttal Testimony and Exhibit of

Michael P. Gorman

On behalf of

The Federal Executive Agencies

September 16, 2013

BRUBAKER & ASSOCIATES, INC.

Project 9763

BEFORE THE

ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF ENTERGY ARKANSAS, INC. FOR APPROVAL OF CHANGES IN RATES FOR RETAIL ELECTRIC SERVICE	)	**DOCKET NO. 13-028-U**

Surrebuttal Testimony of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A Yes. On August 2, 2013 I filed direct testimony and exhibits on behalf of the Federal Executive Agencies ("FEA") regarding Entergy Arkansas, Inc.'s ("EAI" or "Company") overall rate of return including return on equity, capital structure and embedded debt cost.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to EAI witnesses Dr. Samuel C. Hadaway and Ms. Julie M. Cannell.

Response to Dr. Hadaway

Q DID DR. HADAWAY TAKE ISSUE WITH YOUR RECOMMENDED RETURN ON EQUITY IN THIS PROCEEDING?

A Yes. Dr. Hadaway believes that my return on equity was negatively skewed by my assumptions and the application of my models. In support of this, Dr. Hadaway offers criticisms of my multi-stage growth DCF study and my risk premium analysis.

Q WHAT ARE DR. HADAWAY'S CONCERNS RELATED TO YOUR MULTI-STAGE GROWTH DCF ESTIMATE?

A Dr. Hadaway takes issue with the GDP growth rate used as a sustainable long-term growth rate. He does not agree with the consensus of independent security analysts' projections of long-term GDP growth rate that I used in my direct testimony. Instead, he recommends using the GDP growth rate he projects in his testimony of 5.63%.

Q IS DR. HADAWAY'S PROPOSAL TO USE HIS LONG-TERM GDP GROWTH RATE IN LIEU OF THE CONSENSUS ECONOMISTS' LONG-TERM GDP GROWTH RATE APPROPRIATE FOR ACCURATELY ESTIMATING EAI'S MARKET COST OF EQUITY IN THIS PROCEEDING?

A No. Dr. Hadaway's proposal is inappropriate for several reasons. First, the objective of analyzing the current market cost of equity is to attempt to measure economic and financial factors used by investors to value stocks. Hence, it is the market's general expectation of future GDP growth which is relevant, not the individual opinion of Dr. Hadaway or me.

My GDP growth forecast is based on consensus published independent economists' projections of future GDP growth. This information is available to

investors, and likely used by investors to make investment decisions. In significant contrast, Dr. Hadaway's GDP growth forecast is found only in his testimony and is highly unlikely to be reflective of consensus investors and that used by investors to value utility securities. It is known with certainty that Dr. Hadaway's GDP outlook is far higher than the consensus of independent economists.

Dr. Hadaway's methodology is simply not a method that reliably captures the consensus of investors' current outlooks. Therefore, he has not produced a reliable estimate of the market's current cost of equity for assuming the investment risk of EAI and the proxy companies.

Second, Dr. Hadaway's method of estimating future GDP growth is tied to historical actual realized GDP growth. Dr. Hadaway's analysis is unreliable because he has not captured the expectation of changes in U.S. GDP growth going forward relative to the past. The U.S. economy is now facing significant competition from other countries around the world which likely will impact its real growth going forward relative to the growth experienced in the past. Therefore, using only historical data to form expectations of the future, does not reflect likely changes in the world economic and competitive positions. These changes are real and are captured by professional economists in their GDP growth projections. Dr. Hadaway's historical growth ignores changes in the world economy, and therefore, does not reflect the consensus of market participant outlooks.

Q WHAT IS A REASONABLE ESTIMATE OF A MULTI-STAGE GROWTH DCF MODEL?

A Using the consensus analysts' GDP growth forecast rather than Dr. Hadaway's individual estimate, my multi-stage growth DCF model produces a result of 8.96%. (See my direct testimony at 28).

Q PLEASE DESCRIBE DR. HADAWAY'S CRITICISMS OF YOUR RISK PREMIUM ANALYSIS.

A Dr. Hadaway believes I have understated the equity risk premium because I have not relied on a simple inverse relationship between interest rates and equity risk premiums. Dr. Hadaway believes that if I would have embraced his proposed simplistic relationship, that the equity risk premium would consistently understate the Company's current cost of equity.

Q ARE DR. HADAWAY'S RISK PREMIUM ARGUMENTS ACCURATE?

A No. The clear finding in academic research on equity risk premiums is that the relationship between interest rates and risk premiums changes over time based on a multitude of factors. Second, academic research concludes that the relationship between equity risk premiums and interest rates changes based on the perception of the risk difference between equity investments and fixed income investments, and not simply interest rates.

This relationship is not based on a simple inverse relationship between risk premiums and interest rates, but rather is tied to perceived risk differentials between the two competing investments, as described in my direct testimony.

Q PLEASE DESCRIBE THE ACADEMIC RESEARCH ON THE RELATIONSHIP BETWEEN EQUITY RISK PREMIUMS AND INTEREST RATES.

A The academic literature on the inverse relationship between interest rates and equity risk premiums has observed that there has been a transient inverse relationship that was not tied to changes in nominal interest rates. It was caused by changes to perceived risk differentials between debt and equity investments. Further, the relationship between interest rates and equity risk premiums is not constant, but rather can change materially over time.

Most of the academic literature addressing this issue that I am familiar with is based on market data from the 1980s and very early 1990s. During the 1980s and very early 1990s, an inverse relationship did exist. However, that relationship did not exist prior to 1980, and it has not been shown to be the case since the early 1990s. For example, in a paper written by Eugene Brigham, Dilip K. Shome and Steve R. Vinson, entitled "The Risk Premium Approach to Measuring a Utility's Cost of Equity," published in *Financial Management/Spring 1985,* the authors stated:

> Any number of events could occur to cause the perceived riskiness of stocks versus bonds to change, but probably the most pervasive factor, over the 1966-1984 period, is related to inflation. Inflationary expectations are, of course, reflected in interest rates. Therefore, one might expect to find a relationship between risk premiums and interest rates. As we noted in our discussion of Exhibit 3, risk premiums were positively correlated with interest rates from 1966 through 1979, but, beginning in 1980, the relationship turned negative.

These academics found that there was a <u>positive</u> relationship between interest rates and equity risk premiums before 1980, and an <u>inverse</u> relationship from 1980-1984. This study does not establish a consistent relationship between interest rates and equity risk premiums over the entire period.

In the more recent, yet still outdated, study by Robert S. Harris and Felicia C. Marston published in the *Journal of Applied Finance* – 2001, "The Market Risk

Premium: Expectational Estimates Using Analysts Forecasts," the authors expanded an earlier study of risk premiums to cover the period of 1982-1998. In this study, the authors did note a historical inverse relationship between equity risk premiums and interest rates. However, the authors went into detail to explain why that historical relationship was likely affected more by relative investment risk changes, and not simply changes to nominal interest rates as Dr. Hadaway implies in his testimony. The authors state as follows:

> The market risk premium changes over time and appears inversely related to government interest rates but is positively related to the bond yield spread, which proxies for the incremental risk of investing in equities as opposed to government bonds.

Importantly, the authors in that same study concluded as follows:

> As a result, our evidence does not resolve the equity premium puzzle; rather, the results suggest investors still expect to receive large spreads to invest in equity versus debt instruments.
>
> There is strong evidence, however, that the market risk premium changes over time. Moreover, these changes appear linked to the level of interest rates as well as ex ante proxies for risk drawn from interest rate spreads in the bond market.

Clearly, the academic literature does not support a simplistic inverse relationship between interest rates and equity risk premiums. Rather, the authors of these studies recognize that equity risk premiums change with perceived changes in investment risk. Dr. Hadaway's simplistic analysis takes no account of changes to perceived risk, and inappropriately increases equity risk premiums for no other reason than a reduction in nominal interest rates.

Q ARE REDUCTIONS IN NOMINAL INTEREST RATES AN ADEQUATE REASON FOR INCREASES TO EQUITY RISK PREMIUMS?

A No, they are not. Reductions to nominal interest rates are simply not an adequate reason for increases to equity risk premiums. Indeed, decreases to interest rates over the last 10 years have been likely caused by reduced inflation expectations, which would decrease both bond interest rates and common equity required returns. Reduced inflation expectations alone should not change relative debt to equity investment risk, and thus would not cause equity risk premiums to increase. Consequently, Dr. Hadaway's proposal to reflect an inverse relationship between equity risk premiums and bond interest rates is flawed and unreliable, and it should be rejected.

Q USING DR. HADAWAY'S METHODOLOGY, WHAT DO YOU BELIEVE TO BE A REASONABLE EQUITY RISK PREMIUM ESTIMATE IN THIS CASE?

A I do agree with Dr. Hadaway that the Federal Open Market Committee ("FOMC") might change its stimulative policy. This change could cause interest rates to increase. However, I have captured this interest rate uncertainty in my risk premium model by giving 75% weight to the high-end risk premium estimate.

I also have updated my 13-week average "A" and "Baa" utility yields. As shown on my Exhibit MPG-21, the current 13-week average "A" and "Baa" utility yields are 4.64% and 5.18%, respectively. Therefore, applying the same methodology described in my direct testimony, adding the most recent "Baa" utility yield of 5.18% to the equity risk premium range of 3.03% to 4.89% produces a utility equity risk premium in the range of 8.21% to 10.07%. However, reflecting equal

weight to the high and low-end results to recognize the recently increased interest rates indicates a fair return on equity of approximately 9.10%.

Similarly, adding the equity risk premium range of 4.41% to 6.31% as described in my direct testimony to the most recent long-term Treasury bond yield of 4.20%[1] would indicate a return on equity in the range of 8.51% to 10.41%, with a midpoint of 9.56%.

Hence, the return on equity based on my risk premium model will be no higher than 9.60% which was also the risk premium return on equity developed in my direct testimony.

Q DOES YOUR UPDATED RISK PREMIUM MODEL HAVE AN IMPACT ON YOUR RECOMMENDED RETURN ON EQUITY?

A No. My recommended return on equity is still approximately the midpoint of my range of 9.15% to 9.60%.

Q DO YOU HAVE ANY OTHER COMMENTS CONCERNING DR. HADAWAY'S REBUTTAL TO YOUR TESTIMONY?

A Yes. Dr. Hadaway believes that I inappropriately excluded TECO Energy. He believes that the announced acquisition of New Mexico Gas did not have a material impact on TECO's valuation. I disagree.

In fact, two days after the acquisition announcement was made FitchRatings placed TECO Energy and its subsidiaries on rating watch with negative implications because the credit agency believes that the company will incur incremental debt as a

[1] *Blue Chip Financial Forecasts*, September 1, 2013 at 4.

result of the acquisition. Therefore, the transaction is considered material and TECO Energy should be excluded from the proxy group.[2]

Response to Ms. Cannell

Q DO YOU AGREE WITH MS. CANNELL THAT YOUR RECOMMENDED RETURN ON EQUITY OF 9.40% IS INCONSISTENT WITH NATIONWIDE TRENDS FOR ALLOWED RETURNS?

A No. Ms. Cannell claims that since 2009 there are only two authorized returns on equity below my recommended return of 9.40%. However, she failed to acknowledge that authorized returns have declined since 2009. Regulators have cautiously adopted the decline in capital costs and reduced authorized returns on equity. This is evident from the data in Table 1 below.

TABLE 1

Electric Industry Average ROE
(Excluding Virginia)

Time Period	ROE
2009	10.48%
2010	10.34%
2011	10.22%
2012	10.01%
Q1, 2013	9.80%
Q2, 2013	9.80%

Source: SNL Financial, RRA.

The authorized returns have declined by 70 basis points since the onset of the Great Recession. In fact, the Arkansas Public Service Commission ("Commission") has also authorized lower returns in the recent years. In 2009, the Commission

[2]SNL Financial: "Fitch places TECO Energy subsidiaries on rating watch negative," May 30, 2013.

authorized a return on equity of 10.25%. In 2010, the authorized return was reduced to 10.20%, and finally in 2011, the most recently authorized return, was further reduced to 9.95%. As I mentioned in my direct testimony, interest rates have decreased significantly since these returns were authorized and even though interest rates are expected to increase due to the government policy, utilities are still operating in a low-cost environment. Therefore, my proposed return on equity is reasonable and in line with recent nationwide trends.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

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Entergy Arkansas, Inc.

Treasury and Utility Bond Yields

Line	Date	Treasury Bond Yield[1] (1)	"A" Rated Utility Bond Yield[2] (2)	"Baa" Rated Utility Bond Yield[2] (3)
1	08/23/13	3.80%	4.79%	5.32%
2	08/16/13	3.86%	4.83%	5.39%
3	08/09/13	3.63%	4.61%	5.17%
4	08/02/13	3.69%	4.63%	5.18%
5	07/26/13	3.61%	4.62%	5.13%
6	07/19/13	3.56%	4.62%	5.12%
7	07/12/13	3.64%	4.76%	5.28%
8	07/05/13	3.68%	4.82%	5.38%
9	06/28/13	3.52%	4.67%	5.23%
10	06/21/13	3.56%	4.72%	5.28%
11	06/14/13	3.28%	4.42%	4.98%
12	06/07/13	3.33%	4.43%	4.96%
13	05/31/13	3.30%	4.36%	4.86%
14	**Average**	**3.57%**	**4.64%**	**5.18%**
15	**Spread To Treasury**		**1.07%**	**1.61%**

Sources:
[1] St. Louis Federal Reserve: Economic Research, http://research.stlouisfed.org.
[2]http://credittrends.moodys.com/.

STATE OF IOWA

DEPARTMENT OF COMMERCE UTILITIES BOARD

IN RE:	)	
	)	**DOCKET NO. RPU-2013-0004**
MIDAMERICAN ENERGY COMPANY	)	

Direct Testimony and Exhibits of

Michael P. Gorman

On behalf of

Iowa Industrial Customers for Affordable Power

September 10, 2013

BRUBAKER & ASSOCIATES, INC.

Project 9720

STATE OF IOWA

DEPARTMENT OF COMMERCE UTILITIES BOARD

IN RE:	)	
	)	**DOCKET NO. RPU-2013-0004**
MIDAMERICAN ENERGY COMPANY	)	

STATE OF MISSOURI	)	
	)	**SS**
COUNTY OF ST. LOUIS	)	

Affidavit of Michael P. Gorman

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

1. My name is Michael P. Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by Iowa Industrial Customers for Affordable Power in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes are my direct testimony and exhibits which were prepared in written form for introduction into evidence in Iowa Utilities Board Docket No. RPU-2013-0004.

3. I hereby swear and affirm that the testimony and exhibits are true and correct and that they show the matters and things that they purport to show.

/s/ Michael P. Gorman
Michael P. Gorman

Subscribed and sworn to before me this 9th day of September, 2013.

/s/ Tammy S. Klossner
Notary Public

STATE OF IOWA

DEPARTMENT OF COMMERCE UTILITIES BOARD

IN RE:	)	
	)	
	)	**DOCKET NO. RPU-2013-0004**
MIDAMERICAN ENERGY COMPANY	)	
	)	

Direct Testimony of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael P. Gorman. 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 of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A This information is included in Appendix A to my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of the Iowa Industrial Customers for Affordable Power ("IICAP"), whose members purchase substantial quantities of electricity from MidAmerican Energy Company ("MidAmerican" or "Company"). These companies are vitally interested in the outcome of this proceeding because it will have a significant impact on their cost of doing business in Iowa.

Q WHAT IS THE SUBJECT OF YOUR TESTIMONY?

A My testimony will address the Company'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 Iowa Department of Commerce Utilities Board (the "Board") award MidAmerican a return on common equity of 9.25%, which is at the approximate midpoint of my estimated range of 9.00% to 9.50% (Exhibit MPG-1) for the rate base not subject to prior ratemaking principles.

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

I will also respond to MidAmerican witness Dr. James H. Vander Weide's proposed return on equity of 10.80%. For the reasons discussed below, Dr. Vander Weide's recommended return on equity is excessive and should be rejected.

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

A I performed three versions of the Discounted Cash Flow ("DCF") model, Risk Premium ("RP") study, and Capital Asset Pricing Model ("CAPM") to a proxy group of publicly traded companies that have investment risk similar to MidAmerican. Based

on these assessments, I estimate MidAmerican's current market cost of equity to be 9.25%.

Electric Utility Industry Market Outlook

Q PLEASE DESCRIBE THIS SECTION OF YOUR TESTIMONY.

A I begin my estimate of a fair return on equity for MidAmerican 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 gauge 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 MidAmerican'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, the industry has ample access to low-cost capital to support rate base investments, and electric utilities' stocks have exhibited strong and stable price performance over the last several years.

Moreover, 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 MidAmerican 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]

[1] *Standard & Poor's Ratings Direct*: "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.

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 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]

The Edison Electric Institute ("EEI") also opined as follows:

> **Steady Industry Fundamentals**
>
> Indeed, broad global macroeconomic forces have been the principle [sic] driver of utility stock returns in recent years, relative to other market sectors. Investors now take mostly as a given the industry's reasonably strong business fundamentals. Utilities are undertaking sizeable and wide-ranging capital investment programs that include distribution network upgrades, Smart Grid investments, a significant boost in the pace of transmission investment, rising emissions-related capex driven by the need to comply with EPA regulations, and generation investments in select power markets.

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

* * *

> Credit analysts are generally positive on the industry's ability to finance an aggressive pace of investment, noting that while it is now cash flow negative on an annual operating basis, its balance sheets are generally strong and utilities have access to a diverse range of funding sources. The industry weathered the storm of the 2008/2009 financial crisis by postponing optional capex projects and finding cost savings where possible without jeopardizing service quality. Today's economic backdrop is much improved from that period, and with interest rates at multi-decade lows and investors of all types hungry for yield, the capital markets are wide open for most economic sectors, including utilities. The execution risk inherent in managing large, complex construction projects in a way that addresses the interests of both shareholders and regulators seems far more pronounced than financing risk.[3]

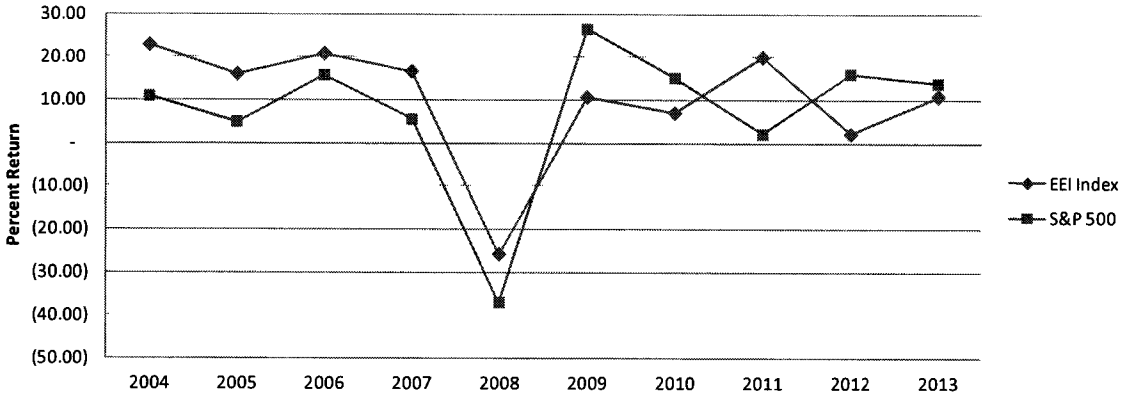
Q PLEASE DESCRIBE ELECTRIC UTILITY STOCK PRICE PERFORMANCE OVER THE LAST SEVERAL YEARS.

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.

[3] *EEI Q3 2012 Financial Update* "Stock Performance" at 5, emphasis added.

FIGURE 1

Index Comparison



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

EEI describes electric utility stock price/valuation as sustainable:

Mixed Valuation Signals

The broad market's gains during Q3 along with the EEI Index's flat performance removed some of the richness to utility share valuations that several analysts noted at the end of Q2. Indeed, the magnitude of underperformance for the first nine months of 2012 is similar to that which occurred during the same period of 2009, after markets bottomed and then recovered from the losses produced by the financial crisis. As the market recovery continued in 2010, with 14% to 17% gains, the staid utility sector's 7% return could not keep pace. Yet when 2011 produced worries of economic slowdown, the worsening of the European debt crisis and the summer's woefully memorable deficit gridlock and S&P downgrade of U.S. Treasury debt in August — along with sharply falling interest rates — the EEI Index powered forward with a 20% return against single-digit gains across the broader markets.

With the industry business models now set on regulated or mostly regulated structures, and with slow growth in earnings and dividends as the main appeal for investors, such periodic reversals of fortune, driven by changing economic prospects and investor sentiments, seem likely to continue. Interest rates are now at multi-decade lows and while analysts still cite utility price/earnings ratios as above average, 4% dividend yields

give utility shares considerable price support relative to the lower yields available from bonds.[4]

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.

MidAmerican Investment Risk

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

A The market assessment of MidAmerican's investment risk is described by credit rating analysts' reports. MidAmerican's current corporate bond ratings from S&P and Moody's are "A-" and "A2," respectively. Both rating agencies have a "Stable" outlook for MidAmerican.

[4] *Id.* at 6, emphasis added.