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APPLICATION OF SOUTHWESTERN § BEFORE THE STATE OFFICE
PUBLIC SERVICE COMPANY FOR § OF
AUTHORITY TO CHANGE RATES § ADMINISTRATIVE HEARINGS

SUPPLEMENTAL DIRECT TESTIMONY

of

ROBERT B. HEVERT

on behalf of

SOUTHWESTERN PUBLIC SERVICE COMPANY

(Filename: HevertRRSuppDirect.doc)

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GLOSSARY OF ACRONYMS AND DEFINED TERMS

<u>Acronym/Defined Term</u>	<u>Meaning</u>
CAPM	Capital Asset Pricing Model
Commission	Public Utility Commission of Texas
DCF	Discounted Cash Flow
Fitch	Fitch Ratings
Moody's	Moody's Investors Service
ROE	Return on Equity
S&P	Standard and Poor's
SPS	Southwestern Public Service Company, a New Mexico corporation
TCJA	Tax Cuts and Jobs Act of 2017

LIST OF ATTACHMENTS

Attachment	Description
RBH-RR-11(SUPP1)(CONF)(CD)	Supplemental Testimony Workpapers of Robert B. Hevert <i>(Provided in native format on Confidential CD)</i>

**SUPPLEMENTAL DIRECT TESTIMONY
OF
ROBERT B. HEVERT**

I. WITNESS IDENTIFICATION

1
2 **Q. Please state your name and business address.**

3 A. My name is Robert B. Hevert. My business address is 1900 West Park Drive, Suite
4 250, Westborough, Massachusetts 01581.

5 **Q. By whom are you employed and in what position?**

6 A. I am a Partner at ScottMadden, Inc.

7 **Q. On whose behalf are you testifying in this proceeding?**

8 A. I am filing this supplemental direct testimony on behalf of Southwestern Public
9 Service Company, a New Mexico corporation (“SPS” or the “Company”).

10 **Q. Are you the same Robert B. Hevert who provided pre-filed direct testimony in**
11 **this case?**

12 A. Yes, I am.

13 **Q. What is the purpose of your supplemental direct testimony?**

14 A. The purpose of my supplemental direct testimony is to inform the Public Utility
15 Commission of Texas (“Commission”) of recent market developments that are
16 contemporaneous with, or that have occurred since, the enactment of the Tax Cuts
17 and Jobs Act of 2017 (“TCJA”), as well as the effect of those developments on
18 electric utility companies. Specifically, I discuss the performance of electric utilities
19 relative to other market sectors, electric utility company dividend yields, the
20 implications of the tax legislation for utility credit ratings, and the reaction of other
21 jurisdictions to the newly passed legislation. If the Commission incorporates the

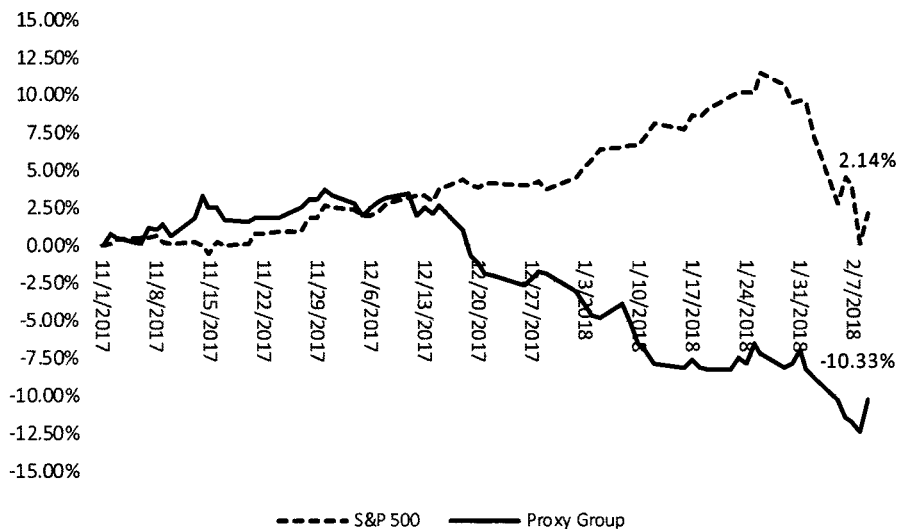
1 change in federal tax rates implemented by the TCJA in the Company's revenue
2 requirement, the Commission also should consider the effect of the legislation on
3 SPS's financial integrity and Cost of Equity. The cumulative effects of the TCJA
4 clearly support the Return on Equity ("ROE") range set forth in my initial testimony
5 and a finding that the Company's requested ROE of 10.25% in this case is just and
6 reasonable.

1 **II. EFFECT OF TAX CUT AND JOBS ACT ON ROE**

2 **Q. Please briefly summarize utility market price performance in relation to the**
3 **TCJA.**

4 A. Since shortly before the TCJA was signed, electric utilities (as measured by my
5 proxy group) have significantly underperformed the overall market. As Chart RBH-
6 RR-S1 (below) demonstrates, from November 1, 2017 through February 9, 2018 the
7 Standard & Poor's ("S&P") 500 gained as much as 11.38%, although it was about
8 2.00% higher as of February 9, 2018. In stark contrast, my proxy group lost about
9 10.30% , underperforming the overall market by about 12.50% .

10 **Chart RBH-RR-S1:**
11 **Relative Performance Since November 2017¹**



12
13 A reasonable inference to be drawn from that data is that investors have been re-
14 evaluating electric utilities relative to other market sectors. To the extent investors

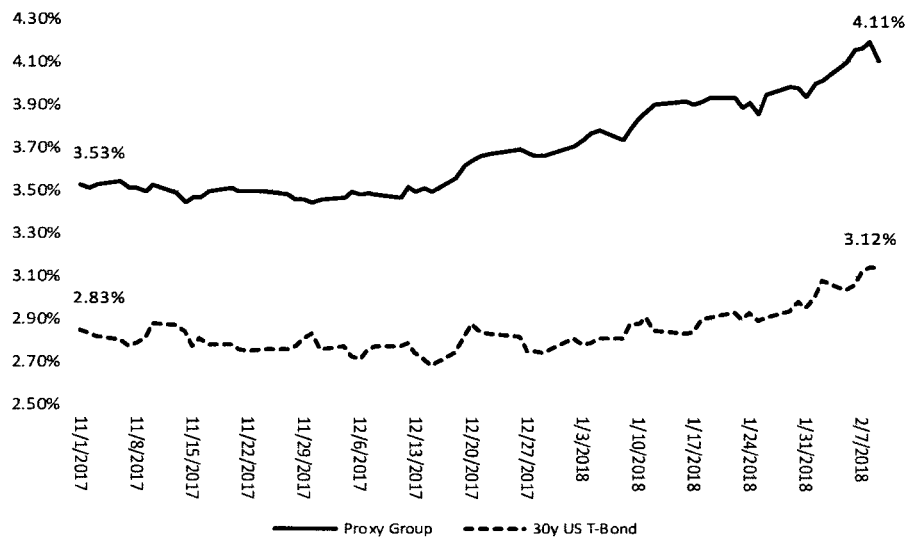
¹ Source: S&P Global Market Intelligence. My proxy group calculated as an index.

1 now view electric utilities as less attractive relative to alternative investments
2 because they do not benefit from the TCJA's lower tax rate in the same way other
3 companies do (tax expense at the operating utilities is generally considered a pass-
4 through cost), the proxy companies' prices will underperform, and the dividend
5 yields will increase. As explained below, because rating agencies have begun to
6 discuss the consequences of the TCJA for utilities' cash flow, a reasonable
7 conclusion is that equity investors also have begun recognizing those consequences
8 and allocating their capital to other market sectors.

9 **Q. Have the proxy companies' dividend yield increased coincident with the TCJA?**

10 A. Yes, since the beginning of November 2017, the dividend yield for my proxy group
11 increased by 58 basis points, whereas the 30-year Treasury yield increased by 29
12 basis points (*see* Chart RBH-RR-S2 below). Again, that suggests the fall in price
13 among utility stocks may be a matter of relative value stemming from concerns
14 regarding the TCJA's effect on utilities' cash flow. As discussed below, Moody's
15 Investors Service ("Moody's"), S&P, and Fitch Ratings ("Fitch") recently evaluated
16 the utility sector in the context of the TCJA, with Moody's noting negative ratings
17 implications for many of the utilities it covers, including SPS.

**Chart RBH-RR-S2:
Proxy Group Dividend Yield vs. 30-Year Treasury Yield²**



Q. What concerns have rating agencies raised as they consider the implications of the TCJA for utilities' cash flow?

A. As discussed in SPS witnesses Ellen Lapson's and Brian Van Abel's supplemental direct testimonies, rating agencies have observed that a reduction in utilities' revenue associated with lower income taxes, together with the loss of bonus depreciation, will put downward pressure on the cash-flow-related metrics that rating agencies rely on in assessing credit quality.³ Ms. Lapson, for example, notes that Moody's explained the negative implications of the TCJA for utilities in general, and SPS in particular. Ms. Lapson also refers to Fitch, which stated, "Absent mitigating strategies on the regulatory front, [the TCJA] is expected to lead to weaker credit metrics and negative

² Source: S&P Global Market Intelligence. My Proxy group calculated as an index.

1 rating actions for issuers with limited headroom to absorb the leverage creep.”⁴ In a
2 similar fashion, S&P observed that the TCJA is “negative for credit quality because
3 the combination of a lower tax rate and the loss of stimulus provisions related to
4 bonus depreciation or full expensing of capital spending will create headwinds in
5 operating cash-flow generation capabilities as customer rates are lowered in response
6 to the new tax code.”⁵

7 In summary, and as discussed in more detail by Ms. Lapson, all three major
8 rating agencies have observed the potentially negative effects of the TCJA on
9 utilities’ cash flow, and the corresponding negative consequences for utilities’ credit
10 profiles.

11 **Q. Have the rating agencies also discussed possible regulatory reactions to the cash**
12 **flow implications of the TCJA?**

13 A. Yes, they have. Moody’s, for example, identified approaches to help preserve credit
14 profiles, including “accelerated cost recovery of certain regulatory assets or future
15 investment; changes to the equity layer or allowed ROEs in rates, and other actions.”
16 Moody’s also suggested that “[c]hanges to corporate financial policies could include
17 changes to capitalization, the financing of future investments, dividend growth, or

³ See also, S&P Global Market Intelligence, *Rating agencies warn tax reform could draft US utility sector credit quality*, January 25, 2018.

⁴ FitchRatings Special Report, *Tax Reform Impact on the U.S. Utilities, Power & Gas Sector*, January 24, 2018. [clarification added]

⁵ S&P Global Ratings, *U.S. Tax Reform: For Utilities’ Credit Quality, Challenges Abound*, January 24, 2018.

1 others.”⁶ Fitch has also observed that jurisdictions will be balancing rate relief for
2 customers with maintaining the creditworthiness of utilities.⁷ As the rating agencies
3 and Ms. Lapson explain, regulatory responses may vary by company and
4 jurisdiction, but may include a variety of potential approaches.

5 **Q. Are there reasons to expect the TCJA may affect the models used to estimate**
6 **the Cost of Equity?**

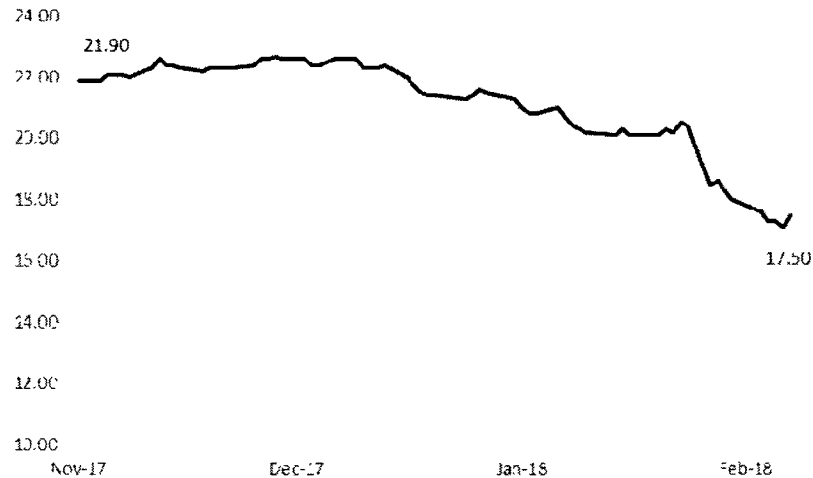
7 A. Yes, there are. As discussed in my direct testimony, the Constant Growth
8 Discounted Cash Flow (“DCF”) model is based on several assumptions that together
9 assume current market conditions essentially will remain in place, unchanged, in
10 perpetuity.⁸ Those conditions manifest themselves in measures such as
11 Price/Earnings ratios, which also have fallen substantially since November 2017 (*see*
12 Chart RBH-RR-S3, below). Because we have seen a significant change in utility
13 valuations—on both absolute and relative terms—we should recognize that the mean
14 DCF results likely are not reliable indicators of the Company’s Cost of Equity.

⁶ Moody’s Investors’ Service, *Rating Action: Moody’s changes outlooks on 25 US regulated utilities primarily impacted by tax reform*, January 19, 2018.

⁷ FitchRatings Special Report, *Tax Reform Impact on the U.S. Utilities, Power & Gas Sector*, January 24, 2018.

⁸ *See*, Hevert Direct, at 26 - 27.

**Chart RBH-RR-S3:
Proxy Group Price/Earnings Ratio⁹**



In addition, the Cost of Equity is affected by the degree of financial leverage, or debt, in the capital structure. Because there is a “tax shield” associated with debt, lower marginal tax rates will increase the effect of leverage on financial risk. In the context of the Capital Asset Pricing Model (“CAPM”), that effect would result in higher Beta coefficients and, therefore, an increased Cost of Equity. As Table RBH-RR-S1 (next page) indicates, all else remaining equal, the effect of the change in taxes alone would increase the Company’s Cost of Equity by approximately 60 basis points.

⁹ Source: S&P Global Market Intelligence. My proxy group calculated as an index.

Table RBH-RR-S1: Effect of TCJA on CAPM Estimates¹⁰

[1]	Risk-Free Rate	2.83%	Exhibit RBH-RR-6
[2]	Assumed MRP	10.69%	Exhibit RBH-RR-6
[3]	Proxy Group Average Equity Beta (pre-TCJA)	0.71	Exhibit RBH-RR-6
[4]	CAPM ROE	10.41%	[1] + ([2] x [3])
[5]	Proxy Group Average Equity Beta (post-TCJA)	0.765	Re-levered Beta at 21% marginal tax rate
[6]	CAPM ROE	11.00%	[1] + ([5] x [2])
[7]	Effect of TCJA	0.58%	[6] - [4]

Although the reduction in utility valuations coincident with the TCJA is consistent with financial theory, the financial models used to estimate the Cost of Equity require some element of judgment in their application, and in interpreting their results. In this instance, we can look to the rating agencies' concerns regarding utilities' cash flows, and the significant, coincident decrease in utility equity values. Intuitively, the two go together: Because cash flows form the basis of equity values, an expected reduction in cash flows would correspond to a reduction in stock prices.

As noted above, in theory the reduction in the tax rate also would increase the Cost of Equity as measured by the CAPM (all else remaining equal).

Q. What conclusions do you draw from the data and information discussed above?

A. There is little question that the major rating agencies found the TCJA to have increased cash-flow-related risks for utilities. Those risks are manifested in the sector's significant underperformance relative to the broad market, and in the comments of financial participants such as Moody's, S&P, and Fitch. As to its implications for the Company, if the Commission reviews the TCJA's implications

¹⁰ All else remaining equal. Calculations based on the "Hamada" adjustment approach.

1 for the Company's revenue requirement, it should include the Cost of Equity in that
2 review. If the Commission does not address the Company's weakened financial
3 position through the higher equity ratio discussed in the supplemental direct
4 testimonies of SPS witnesses Mary P. Schell and Ms. Lapson, or through measures
5 similarly supportive of cash flows, there likely will be upward pressure on the
6 Company's Cost of Equity that should be recognized in a higher authorized ROE.

7 **Q. Are you recommending a ROE higher than 10.25% in this proceeding in**
8 **connection with the TCJA?**

9 A. Not at this time. Rather, I recommend the Commission consider the capital market
10 implications of the TCJA in its review of the Company's ROE. Based on the data
11 and information discussed above, it is my view that the TCJA and its implications for
12 utilities' cash flows and credit profiles provide further support for my ROE range and
13 recommendation.

14 **Q. Does this complete your pre-filed supplemental direct testimony?**

15 A. Yes, it does.

AFFIDAVIT

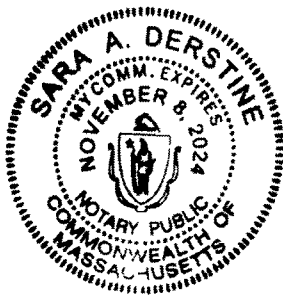
COMMONWEALTH OF MASSACHUSETTS)
)
COUNTY OF WORCESTER)

ROBERT B. HEVERT, first being sworn on his oath, states:

I am the witness identified in the preceding testimony. I have read the testimony and the accompanying attachment(s) and am familiar with the contents. Based upon my personal knowledge, the facts stated in the testimony are true. In addition, in my judgment and based upon my professional experience, the opinions and conclusions stated in the testimony are true, valid, and accurate.


ROBERT B. HEVERT

Subscribed and sworn to before me this 9th day of February, 2018 by ROBERT B. HEVERT.

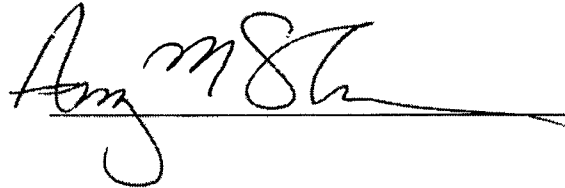


Sara C. Robertson
Notary Public, Commonwealth of Massachusetts

My Commission Expires: 11/8/2024

CERTIFICATE OF SERVICE

I certify that on the 16th day of February 2018, a true and correct copy of the foregoing update testimony was served on all parties of record by electronic service and by either hand delivery, Federal Express, regular first class mail, certified mail, or facsimile transmission.

A handwritten signature in black ink, appearing to read "Amy M. St. John", is written over a horizontal line.

Attachment RBH-RR-11(SUPP1)(CONF)(CD)

**Pages 1 through 1
of
Attachment RBH-RR-11(SUPP1)(CONF)(CD)
Confidential Workpapers of Robert B. Hevert**

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