

**BEFORE THE PENNSYLVANIA PUBLIC
UTILITY COMMISSION**

**PENNSYLVANIA PUBLIC UTILITY
COMMISSION**

v.

PEOPLES GAS COMPANY

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:

DOCKET NO. R-2018-3006818

SURREBUTTAL TESTIMONY OF

KEVIN W. O'DONNELL, CFA

**ON BEHALF OF
OFFICE OF CONSUMER ADVOCATE**

June 12, 2019

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1 **I. Introduction**

2 **Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS**
3 **FOR THE RECORD.**

4 A. My name is Kevin W. O'Donnell. I am President of Nova Energy Consultants, Inc.
5 My business address is 1350 Maynard Rd., Suite 101, Cary, North Carolina 27511.
6

7 **Q. ON WHOSE BEHALF ARE YOU PRESENTING TESTIMONY IN THIS**
8 **PROCEEDING?**

9 A. I am testifying on behalf of the Pennsylvania Office of Consumer Advocate (OCA).
10 The OCA represents consumers before the Pennsylvania Public Utility
11 Commission (Commission).
12

13 **Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING?**

14 A. Yes, I did.
15

16 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

17 A. The purpose of my surrebuttal testimony in this proceeding is to address the
18 comments filed by Company Witness Moul in his rebuttal testimony as well as to
19 comment upon the requested 25 basis point ROE adder of Company Witness
20 O'Brien..
21

22 **Q. PLEASE LIST THE MAJOR AREAS OF DISAGREEMENT BETWEEN**
23 **YOU AND MR. MOUL THAT YOU WILL ADDRESS IN THIS**
24 **SURREBUTTAL TESTIMONY.**

25 A. I will address the following issues raised by Mr. Moul in his rebuttal testimony:
26

- 27 1. The relevancy of the Tax Cut and Jobs Act (TCJA) in this current
28 proceeding;

- 1 2. The duty of this Commisison and Mr. Moul's statements in regard to
- 2 precedent;
- 3 3. The importance, or lack thereof, of this Commission's regulatory ranking;
- 4 4. Market returns versus book returns;
- 5 5. The plowback method and how a utility actually grows its earnings; and
- 6 6. My application of the CAPM and the results therein.

7

8 **I. Tax Cut and Jobs Act**

9

10 **Q. PLEASE EXPLAIN THE TAX CUT AND JOBS ACT (TCJA) AND ITS**

11 **IMPACT ON UTILITIES.**

12 A. The TCJA took effect on January 1, 2018 and lowered the corporate tax rate from

13 35% to 21%. On the surface, a lower tax rate bodes well for consumers. However,

14 accompanying this reduction in taxes is a requirement that taxes, which were

15 accumulated in the past at the 35% tax rate, will now be required to be paid at the

16 21% tax rate. As a result, utilities had to book this overcollection in income taxes

17 as excess deferred income taxes (EDIT).

18

19 **Q. PLEASE EXPLAIN HOW EDIT WAS CREATED.**

20 A. In the past, utilities used accelerated depreciation in tax calculations. However, for

21 regulatory purposes, utilities and state regulators had developed rates based on

22 straight-line depreciation. This mismatch between what will be paid out to the

23 federal government by the utility and what was actually collected is referred to as

24 excess deferred income taxes.

25

26 **Q. HOW HAVE UTILITIES USED EDIT IN THE PAST?**

27 A. Utilities have historically used EDIT for cash flow purposes. Consumers, in

28 recognition of their claim to EDIT, received a rate base offset for the EDIT.

29

30 **Q. ARE THERE DIFFERENT TYPES OF EDIT?**

1 A. Yes. A portion of the EDIT is called “protected” EDIT and, per tax normalization
2 rules, the refund of those funds must flow back over the life of the assets for which
3 they were used to finance.

4

5 Unprotected EDIT are funds that can be returned to consumers at the discretion of
6 the utilities and state regulators. Since the implementation of the TCJA eighteen
7 months ago, I have seen some unprotected EDIT used to offset utility rate hikes and
8 I have seen other unprotected EDIT returned over a 10-year timeframe.

9

10 **Q. PLEASE EXPLAIN MR. MOUL’S POSITION IN REGARD TO HOW THE**
11 **TCJA IMPACTS UTILITIES.**

12 A. Mr. Moul asserts that the loss of the cash flow associated with a decrease in the
13 EDIT on a utility’s books will have a negative impact on utility credit ratings.

14

15 **Q. HOW DO YOU RESPOND TO THIS CONCERN?**

16 A. I disagree with Mr. Moul’s analysis that the TCJA represents an ongoing risk to
17 investors. Mr. Moul’s discussion on the TCJA represents information that is now
18 dated and should be given no weight in the determination of the cost of capital in
19 this proceeding.

20

21 **Q. PLEASE EXPLAIN WHY YOU BELIEVE THE TCJA SHOULD BE GIVEN**
22 **NO WEIGHT IN THIS PROCEEDING.**

23 A. While it is true that credit rating agencies were initially concerned about the impact
24 of the TCJA on utilities credit ratings when the tax cuts were first enacted, that
25 information is now fully encompassed into credit ratings and utility stock prices.

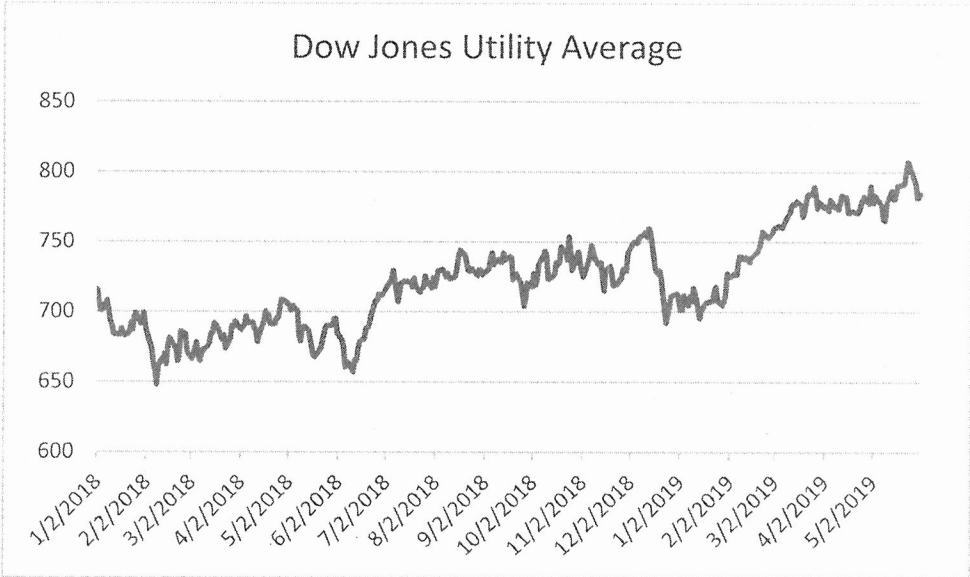
26

27 Tax rates were lowered at the start of 2018. Credit rating analysts and equity
28 investors have had a full 18 months to assess the impact of the decrease in cash
29 flow to utilities. Hence, the “risk” as alluded to by Mr. Moul is now dated
30 information and is no longer relevant.

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Indeed, if the equity market was so nervous about the TCJA, investors would have bid down utility stock prices to re-align the risk and return paradigm. Such, however, has not been the case. Chart 1 below shows how utility stocks have performed since the enactment of the TCJA on Jan. 1, 2018.

Chart 1: Dow Jones Utility Average



Utility stocks have been on a clear and unambiguous upward run since the TCJA was implemented, thereby totally debunking Mr. Moul’s higher risk theory associated with the TCJA. As noted above, the TCJA is simply old news, the effect of which has been incorporated into stock prices.

In addition, given that, in my DCF analysis, I used stock prices that included the above timeframe, I did, contrary to the claim of Mr. Moul, capture the impact of the TCJA in my analysis.

1 **Q. HOW DO YOU RESPOND TO MR. MOUL’S COMMENT REGARDING**
 2 **THE DECREASE IN THE PRE-TAX INTEREST COVERAGE OF**
 3 **PEOPLES GAS?**

4 A. In his rebuttal testimony, Mr. Moul indicates that the TCJA will lower the pre-tax
 5 interest coverage of Peoples from 6.12X to 5.22X.¹ However, Mr. Moul does not
 6 provide any context to these values. Specifically, he fails to show that the decrease
 7 in the pre-tax interest coverage will negatively impact Peoples which, ironically,
 8 has no debt credit rating.

9
 10 Contrary to Mr. Moul, I did perform an analysis of the impact of the change in the
 11 pre-tax interest coverage as noted by Mr. Moul in his rebuttal testimony. My
 12 analysis shows that such a decrease in the pre-tax interest coverage will not, by
 13 itself, harm the credit standing of Peoples.

14
 15 **Q. PLEASE EXPLAIN HOW YOU DETERMINED THAT THE DECREASE**
 16 **IN THE PRE-TAX INTEREST COVERAGE WOULD NOT NEGATIVELY**
 17 **IMPACT PEOPLES GAS.**

18 A. Table 1 below shows the current Moodys financial metric for interest coverage and
 19 how Mr. Moul’s 5.22X to 6.12X rates fit into the matrix.

20
 21 Table 1: *CFO pre-WC + Interest/Interest*

	CFO pre-WC+Interest/Interest ²					
	Rating					
	Aaa	Aa	A	Baa	Ba	B
Standard Grid	>= 8X	6.0X - 8.0X	4.5X - 6.0X	3.0X - 4.5X	2.0X - 3.0X	1.0X - 2.0X
Peoples			5.22X to 6.12X			

22
¹ Moul Rebuttal, p. 4

² Moody’s Rating Methodology for Gas and Electric Utilities, June 23, 2017, p. 22, available at: https://www.moodys.com/research/Moodys-updates-its-methodology-for-rating-regulated-electric-and-gas--PR_368709.

1 As can be seen in the table above, both of Mr. Moul's values are well within the
2 "A" credit rating band. As noted previously, Peoples Gas does not have a stand-
3 alone credit rating but, if it did, the TCJA change would have little, if any, impact
4 on the Company's credit rating.

5
6 The above table shows, again, Mr. Moul's TCJA arguments are simply outdated
7 and irrelevant.

8
9 **Q. HAS THIS COMMISSION PREVIOUSLY DEALT WITH THE ISSUE OF**
10 **THE TCJA IN TERMS OF ITS IMPACT ON A REGULATED UTILITY'S**
11 **COST OF EQUITY?**

12 A. Yes. In 2018, this Commission issued a final decision in the general rate case
13 application of UGI Electric at Docket No. R-2017-2640058. In that final order, the
14 Commission specifically rejected the Company's requested increase in the ROE
15 due to the TCJA.

16
17 **II. Precedent and the Duty of the Commission**
18

19 **Q. DO YOU AGREE WITH MR. MOUL THAT THIS COMMISSION**
20 **SHOULD ALWAYS ACCEPT A UTILITY'S PROPOSED CAPITAL**
21 **STRUCTURE FOR RATEMAKING PURPOSES?**

22 A. No. The Company's proposed capital structure in this case contains an equity ratio
23 of 53.66%, which is quite high in comparison to the 50.09% average equity ratio
24 granted by state regulators in 2018. Mr. Moul states that the Commission precedent
25 is to accept the Company's proposed capital structure. I believe that accepting such
26 an "equity thick" capital structure will have unnecessary and costly consequences
27 for consumers in Pennsylvania.

28
29 **Q. CAN YOU CALCULATE THE IMPACT TO CONSUMERS OF THE**
30 **COMPANY'S PROPOSED EQUITY RATIO RELATIVE TO THE**

1 **AVERAGE EQUITY RATIO GRANTED BY STATE REGULATORS IN**
2 **2018?**

3 A. Yes. The cost to Peoples consumers for the inflated equity ratio at the Company's
4 requested ROE is approximately \$8.3 million per year.

5
6 **Q. IS THERE A POLICY ISSUE WITH WHICH THIS COMMISSION**
7 **SHOULD BE CONCERNED IN SETTING THE APPROPRIATE CAPITAL**
8 **STRUCTURE FOR RATEMAKING PURPOSES.**

9 A. Yes. Mr. Moul indicates that the Commission should not stray from precedent by
10 accepting my hypothetical capital structure that reflects the average equity ratio
11 adopted by state regulators in natural gas cases in 2018. The concern I have with
12 such a statement is that Mr. Moul does not offer any upward limit on the equity
13 ratio in capital structures deemed reasonable for setting rates. In this case, the cost
14 to consumers of the Company's high equity ratio capital structure is \$8.3 million.
15 If one were to follow Mr. Moul's logic, the Commission should always accept the
16 Company's proposed capital structure. In the next case, the proposed equity ratio
17 may be 60% or maybe 70% thereby costing Pennsylvania consumers even more in
18 higher rates.

19
20 My recommendation is that the Commission send Peoples Natural Gas a clear
21 message in this case that consumers can no longer afford the unnecessarily high
22 equity ratios propounded by the Company. I recommend the Commission adopt
23 my recommended capital structure for use in this proceeding.

24
25 **III. Regulatory Rankings**

26
27 **Q. WHAT ARE REGULATORY RANKINGS AS NOTED BY MR. MOUL IN**
28 **HIS REBUTTAL TESTIMONY?**

1 A. Regulatory Research Associates, which is a division of S&P Global Market
2 Intelligence, publishes rankings of state/district regulatory climates from the
3 perspective of investors. According to S&P Global Market Intelligence:

4

5 RRA evaluates the regulatory climates for energy utilities of the
6 jurisdictions within the 50 states and the District of Columbia, a total
7 of 53 jurisdictions, on an ongoing basis. The evaluations are
8 assigned from an **investor perspective** and indicate the relative
9 regulatory risk associated with the ownership of securities issued by
10 each jurisdiction's electric and gas utilities.³ (underline and bold
11 added)
12

13 **Q. DO YOU HAVE A CONCERN WITH MR. MOUL INVOKING THE**
14 **REGULATORY RANKING OF THE PENNSYLVANIA PUBLIC UTILITY**
15 **COMMISSION IN HIS DEFENSE OF HIS RECOMMENDED 11.25%**
16 **RETURN ON EQUITY (ROE)?**

17 A. Yes. As noted above, RRA's viewpoint is from the standpoint of investors. As a
18 result, RRA has a natural and understandable bias towards stock and bond
19 investors. However, the job of the Pennsylvania Public Utility Commission is to
20 weigh the evidence brought by both sides and come to a finding that is just, fair,
21 and reasonable. The Commission should not be swayed by a regulatory ranking
22 that is clearly biased. If the Commission were to do so, it would be constantly
23 attempting to please investors at the expense of captive ratepayers.

24

25 **IV. Market returns vs. Book returns**

26

27 **Q. HOW DO YOU RESPOND TO MR. MOUL'S CLAIM THAT FUTURE GAS**
28 **UTILITY RETURNS WILL BE HIGHER THAN CURRENT RETURNS.**

29 A. In this section of this testimony (p. 10, l. 19 to p. 11, l. 6), Mr. Moul cites book
30 returns for gas utilities in the comparable group. Book returns are NOT market

³ State regulatory outlook: states to watch RRA, Monday, May 13, 2019

1 returns, an error that Mr. Moul makes frequently throughout his testimonies in this
2 case.

3

4 Book returns are the return on investment (ROI) that a utility makes relative to its
5 rate base investment. This calculation is simply the utility's net income divided by
6 its gross net plant. I incorporated book returns by using the Comparable Earnings
7 analysis in my direct testimony.

8

9 Market returns are the ROI investors expect by investing in the utility at current
10 prices. Models such as the DCF and CAPM capture market returns which, in a
11 rising market, will typically show lower market returns than book returns.

12

13 The task of this Commission is to assess current financial returns and derive a ROE
14 to be applied to the Company's rate base. In my analysis, I examined market returns
15 and book returns to derive a recommended ROE for use in this proceeding. I did
16 not confuse market returns and book returns, as did Mr. Moul.

17

18 **V. Plowback Analysis**

19

20 **Q. DID MR. MOUL ACCURATELY PORTRAY YOUR PLOWBACK**
21 **ANALYSIS?**

22 **A.** No, he did not. Mr. Moul again confuses market values with book values. In his
23 testimony, Mr. Moul states the following in regard to my testimony:

24

25 Mr. O'Donnell does not and cannot explain why an investor expected
26 return of 10.55% should be reduced to 7.05%.

27

28 This statement by Mr. Moul is in error. The 10.55% is a book return that, through
29 a number of mathematical calculations, he brings down to 7.05%. If Mr. Moul can
30 accept that market values do not equate to book value, I suspect that many of our
31 disagreements would disappear.

1
2 In addition, Mr. Moul’s review of the plowback analysis fails to note that earnings
3 and dividends from utilities are derived by rate base growth. One of the primary
4 means for growing rate base is to make plant investment through the retention of
5 earnings, thus “plowing back” the earnings into rate base investment. Ignoring the
6 plowback ratio is ignoring one of the major sources of rate base growth and, thus,
7 earnings and dividend growth.

8
9 **VI. CAPM Results**

10
11 **Q. MR. MOUL CLAIMS THAT YOUR CAPM RESULTS ARE NOT**
12 **CREDIBLE. HOW DO YOU RESPOND?**

13 A. Mr. Moul does not take issue with the way I calculated the CAPM and my inputs
14 into the model. Instead, he takes issue with the results of the CAPM.

15
16 I have presented this Commission with an honest analysis using three different cost
17 of capital models. I presented my results for the Commission to review, made a
18 recommendation, and provided answers/support for my recommendation.

19
20 **Q. WAS YOUR USE OF THE GEOMETRIC MEAN RETURN THE SOLE**
21 **SOURCE OF THE MARKET RETURN USED IN YOUR CAPM**
22 **ANALYSIS?**

23 A. No, it is not. I also used the arithmetic mean in my CAPM, a fact Mr. Moul fails
24 to acknowledge.

25
26 **Q. CAN YOU PROVIDE ANY OTHER EXAMPLE WHERE MR. MOUL**
27 **CLAIMS YOUR FIGURES ARE “TOO LOW”?**

28 A. Yes. Mr. Moul claims that my risk premium of 4.0% to 6.0% is “too low” for use
29 in the CAPM.⁴ Again, Mr. Moul provides no evidence for his criticism. As stated

⁴ Moul rebuttal, p. 26

1 previously, I provided a robust analysis for the Commission's review. The
2 Commission needs evidence on which to base a decision. Mr. Moul fails to provide
3 that evidence.

4
5 **VII. Requested 25 Basis Point Adder for Performance**

6
7 **Q. DO YOU AGREE WITH MR. MOUL AND MR. O'BRIEN THAT THE**
8 **PUBLIC UTILITY COMMISSION SHOULD AWARD A HIGHER**
9 **RETURN ON EQUITY FOR MANAGEMENT PERFORMANCE AND**
10 **POLICY REASONS?**

11 **A.** No. In my direct testimony, I have opposed the Company's request for an
12 additional 25 basis points for management efficiency. That 25 basis points equals
13 \$3.9 million at the Company's full rate request. Now, Mr. O'Brien and Mr. Moul
14 suggest that the Company should receive, at a minimum, an adjustment at the high
15 end of the witnesses' range or at least 16 basis points as incentive for future
16 performance and to satisfy the capital markets and credit rating agencies.⁵ I
17 disagree.

18
19 As I noted in my direct testimony, the Company cites four reasons for the
20 performance adder. However, two of the four reasons for the adder cited by Mr.
21 O'Brien have an element of self-interest for the Company whereby they should
22 pursue these opportunities (economic development and accelerate pipe
23 replacement) whereas the two other items (customer service and being a good
24 corporate citizen) are items the Company, having been granted a monopoly service
25 territory by Pennsylvania, should already engage in as part of its service obligation.

26
27 In his rebuttal in this case, Mr. O'Brien opines that there are different levels of
28 service and the Company should be incented to provide top-notch service. I
29 disagree. The Company should always strive to provide top-notch service. It

⁵ Moul rebuttal, p. 30. O'Brien rebuttal, pp. 2-4.

1 should not need to be rewarded by having customers pay higher rates in return for
2 providing high quality service.

3
4 The Company's alternate position, that the extra basis points are needed to incent
5 future performance or to attract capital, is unavailing. If the Company feels that a
6 cost of capital adder is needed for future considerations, it should specifically state
7 what these considerations are and exactly how the 25 basis point adder will help
8 the Company achieve these goals. Otherwise, the Commission simply cannot
9 accept a request that ratepayers pay higher rates for unquantifiable future benefits
10 that may or may not materialize in the future.

11
12
13 **VIII. Summary**

14
15 **Q. MR. O'DONNELL, PLEASE SUMMARIZE YOUR SURREBUTTAL**
16 **TESTIMONY.**

17 **A.** In this case, Mr. Moul's rebuttal testimony is misplaced in the following ways:

- 18
19
- 20 • The TCJA has already been taken into account by stockholders and is
21 embedded in the DCF and CAPM analyses that I presented in this current
22 proceeding;
 - 23 • An increase in the ROE due to the impact of the TCJA, as suggested by Mr.
24 Moul, has already been rejected by this Commission;
 - 25 • Mr. Moul is mistaken in his view of utility capital structure precedence and
26 the duty of this Commission;
 - 27 • This Commission's regulatory ranking should not drive decisions made in
28 this rate case;
 - 29 • Mr. Moul consistently confuses the concept of market returns and book
returns;

- 1 • Mr. Moul's misunderstands my use of the plowback method and how a
2 utility actually grows its earnings;
3 • Mr. Moul criticizes the CAPM results without any corresponding evidence.
4

5 Lastly, with regard to the 25 basis point ROE adder requested by the Company,
6 Peoples has not provided any evidence to financially justify its request in this case.
7 In addition, the reasons cited by the Company for the basis of its performance
8 bonus are items that are either implicit in the provision of monopoly distribution
9 service OR already provide economic incentives for the Company to undertake for
10 the betterment of its own financial position.
11

12 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

13 A. Yes.
14

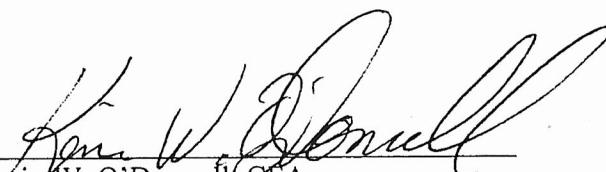
BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission :
v. : Docket No. R-2018-3006818
Peoples Natural Gas Company LLC :

VERIFICATION

I, Kevin W. O'Donnell, hereby state that the facts above set forth in my Surrebuttal Testimony, OCA Statement No. 2-SR, are true and correct and that I expect to be able to prove the same at a hearing held in this matter. I understand that the statements herein are made subject to the penalties of 18 Pa.C.S. § 4904 (relating to unsworn falsification to authorities).

Signature: _____


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