**BEFORE THE CORPORATION COMMISSION**
**OF THE STATE OF OKLAHOMA**

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| **IN THE MATTER OF THE APPLICATION OF OKLAHOMA GAS AND ELECTRIC COMPANY FOR AN ORDER OF THE COMMISSION AUTHORIZING APPLICANT TO MODIFY ITS RATES, CHARGES, AND TARIFFS FOR RETAIL ELECTRIC SERVICE IN OKLAHOMA** | **CAUSE NO. PUD 2023-000087** |

# REBUTTAL TESTIMONY

OF

DONALD R. ROWLETT

ON BEHALF OF

OG&E SHAREHOLDERS ASSOCIATION

May 17, 2024

**Q. Please state your name and address.**

A. My name is Donald R. Rowlett. My address is 6419 Grandmark Drive, Nichols Hills, OK. I am retired from Oklahoma Gas and Electric Company ("OG&E" or "Company") where my last position was Managing Director of Regulatory Affairs for OG&E.

**Q. Please state your educational qualifications and employment history.**

A. I earned a Bachelor of Science degree in Business with an accounting emphasis (1980) and a Master's in Business Administration (1992), from Oklahoma City University. I also earned a Ph.D. from Oklahoma State University in Business Administration. In 1983, I became a Certified Public Accountant. I joined OG&E in 1989. As Managing Director of Regulatory Affairs I was responsible for overseeing the Company's economic regulatory activities with the Oklahoma Corporation Commission, the Arkansas Public Service Commission, and the Federal Energy Regulatory Commission. I have served in various financial roles in the Company including ten years as Vice President, Controller and Chief Accountant. As the Company's Controller I was responsible for financial and operations accounting, federal, state, and local income and property taxes and budgeting. I have also made investor presentations and participated in numerous public equity and debt offerings. Prior to joining OG&E, I was employed by Arthur Andersen & Co. as a financial consultant and audit manager. During my employment, I performed audits of financial statements in a variety of industries. Additionally, I prepared filings with the Securities and Exchange Commission ("SEC") and provided clients with guidance on the financial reporting requirements of the SEC and Generally Accepted Accounting Principles ("GAAP").

**Q. Have you testified previously before this Commission?**

A. Yes. In addition to testifying before the Commission, I have testified on behalf of the Company before the Arkansas Public Service Commission and the Environmental and Public Works Committee in the United States Senate. I have also filed testimony before the Federal Energy Regulatory Commission.

**Q. On whose behalf are you offering rebuttal testimony?**

A. I am testifying on behalf of the OG&E Shareholder Association ("OG&E SH") which frequently intervenes in ratemaking proceedings in support of positions proposed by OG&E that are believed to be fair and just to both the individual investors in its parent company, OGE Energy Corp., and the customers (ratepayers) of the Company.

**Q. Are you familiar with the OG&E SH's Statement of Position in this cause?**

A. Yes. I have read it and am aware from experience, especially, that the OG&E SH has intervened in prior ratemaking proceedings to encourage the Commission to continue a supportive regulatory environment.

**Q. Is a supportive regulatory environment important to the Company and its shareholders?**

A. Absolutely, a supportive regulatory environment at the Commission is very important to the financial stability of the Company which serves the public interest in low rates and reliable service. And supportive regulation is essential to the preservation and enhancement of the capital investment of its shareholders through stock price increases and regular dividends. A constructive regulatory environment is one that balances those important interests of the ratepayers and investors.

**Q. What is the purpose of your rebuttal testimony?**

A. The purpose of my testimony is to address several issues raised in Responsive Testimony by the Public Utility Division ("PUD"), Oklahoma Attorney General ("AG"), the Oklahoma Industrial Energy Consumers ("OIEC") and the Federal Executive Agencies ("FEA"). These issues include the Return on Equity, Capital Structure, and disallowances for capital investment recommended by one more of these intervening parties.

**Q. Can you summarize your rebuttal?**

A. Specifically, PUD proposes to lower the ROE to 9.3% [1] and to disallow approximately $115 Million of capital investments.[2] The Commission should not do either. The ROE should be increased, not decreased. Capital investments made in the past should not be disallowed. The AG proposes to retain the existing 9.5% ROE[3] but to lower the equity capital for ratemaking to 50%.[4] Worse yet, OIEC seeks to reduce the ROE to 9.0%[5] and to lower the equity capital for ratemaking to 44.8%.[6] The FEA proposes to not increase the ROE above the existing 9.5%[7] and to lower the equity capital for ratemaking to 52% from the existing 53.5% equity.[8] The Commission should reject all of those recommendations. Instead, the ROE should be increased, not decreased. The existing capital structure should be retained for ratemaking purposes. Management's judgment about capital is presumed valid and cannot lawfully be ignored unless there is evidence of inefficiency or imprudence. There is no such evidence.

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1 Responsive Testimony of Geoffrey M. Rush filed April 26, 2024, p. 33, ll. 10-11.
2 Responsive Testimony of Dennis Stephens filed April 26, 2024, p. 27, ll. 7-8, and p. 28, l. 8, and ll. 19-20.
3 Responsive Testimony of J, Randall Woolridge, filed April 26, 2024, p. 9, ll. 15-16.
4 *Id.* at p. 103, ll. 20-21.
5 Responsive Testimony of David J. Garrett filed April 26, 2024, p. 4, l. 19.
6 *Id.* at l. 20.
7 Responsive Testimony of David J. Garrett filed April 26, 2024, p. 4, l. 19.
8 *Id.* at ll. 17-20.

## RETURN ON EQUITY

**Q. Why is a reasonable Return on Equity ("ROE") important?**

A. Electricity generation and distribution is a capital-intensive business. It requires long-lived assets and supporting capital to match, both equity and debt capital. OG&E must compete with other investment opportunities for that capital. Investors have many competitive options when it comes to deciding where to invest in equity. ROE is, essentially, a measure of the opportunity cost of equity. In exchange for the investor's commitment of equity capital, they require competitive, adequate, and stable returns over the long life of these investments. Without a reasonable ROE, OG&E cannot attract equity capital efficiently.

In addition, a reasonable ROE is important to investors, the Company, and the State of Oklahoma for the reasons stated in the pertinent supporting Direct Testimony of OG&E's witnesses, especially Ann E. Bulkley and Charles B. Walworth, with whom I agree.

**Q. What is OG&E current authorized ROE?**

A. OG&E's authorized ROE has been 9.5% since it was authorized in Cause No. PUD 2015000273, the 2015 general rate case.

**Q. What ROE is OG&E seeking in this proceeding?**

A. OG&E is seeking a 10.5% ROE. This proposed ROE is based on OG&E witness Bulkley's recommendation which fairly compensates investors, maintains OG&E's credit strength, and, based on current market conditions, attracts the capital required for investments.

**Q. How did OGE's ROE at 9.5% compare to the national average authorized ROEs in 2015 when OG&E filed its 2015 rate case?**

A. The awarded 9.5% ROE in the 2015 rate case was significantly below the 9.78% national average for the electricity companies in 2015 as shown on Table 3 in the Responsive Testimony of J. Randall Woolridge, Ph.D., Table 3, p. 23.

**Q. Is OG&E's ROE still below the national average?**

A. Yes. OG&E's authorized ROE is still 9.5%, which is significantly less than the average reported by S&P Global's most recent data. OG&E witness Charles Walworth stated in his testimony:

> According to S&P Global Regulatory Research Associates' Major Energy Rate Case Decisions Report, released November 1, 2023, the average authorized ROE for vertically integrated electric utilities through September 30, 2023 has been 9.74%, which is greater than OG&E's currently authorized ROE of 9.50%. The 2023 average authorized ROE is similar to the 9.75% average for the calendar year 2022 and is an increase from the 9.70% average for the calendar year 2021, and the 9.55% average for the calendar year 2020.

I believe the average ROE for vertically integrated utilities has remained the same since Mr. Walworth filed this testimony in December 2023. Even Attorney General Witness Woolridge shows that ROE awards are increasing in his Table 3 on page 23 of his rebuttal testimony. Despite the fact that he does not use ROEs of just vertically integrated utilities in his annual averages, this average ROE for electric utilities is now 9.6% (*i.e.*, higher than his own recommendation) and he shows an upward trend in awarded ROEs. This upward trend is reasonable since interest rates have increased in the past several years. This data is more reason to increase the ROE to the recommendation of Ms. Bulkley at 10.5% ROE or, at the minimum, to the industry average.

**Q. How do the risks OG&E faces today compare to when its ROE was set at 9.5% in the 2015 rate case?**

A. I believe those risks have increased significantly since the 2015 rate case. The possibility of early plant closures or expensive modifications caused by environmental regulations could shorten the useful lifespan of existing generating units. Investors are seeing reduced returns for the undepreciated balance on these plants, which increases the risk and required return associated with future investments. Shareholders as well as customers are facing the risk of utility investments being damaged or destroyed by unavoidable catastrophic events. Just a single event could cause equity shareholders to lose much of the value of their investment, while creating distress for the Company and injuring customers by significantly raising the cost of the future capital to operate, re-build and maintain the electric system.

Inflation remains higher than the desired target. The cost of raw materials, components, and finished machinery and equipment used in the electricity industry have all risen significantly. Along with the challenges of load growth, transmission inadequacy, cyber-attacks, and network congestion, those cumulative threats have caused NERC and other regulators to issue warnings of rolling blackouts. Blackouts in any portion of the grid are dynamic and to some extent place all connected points at higher risk of degraded performance or failure. The trend of risk is up; the direction of allowed ROE in Oklahoma should be up as well.

**Q. Is "diversification" a reasonable way for OG&E's shareholders to eliminate the company-specific risks facing OG&E?**

A. No. Fidelity Investments defines diversification as the practice of spreading your investments around so that your exposure to any one type of asset is limited. This

practice is designed to help reduce the volatility of your portfolio over time.[9] PUD witness Geoffrey Rush [10] and OIEC witness David Garrett [11] both make the claim that company specific risks can be managed – even "easily" managed – by investors through diversification. While diversification can be a great tool for investors to reduce the overall risk of their portfolio, it does nothing to help OG&E reduce its risk as a company. Further, this argument assumes OG&E's authorized return corresponds to the risks that it now faces. Even assuming equal risk across the utility industry, investors have the choice to move their dollars to other utilities with authorized returns much closer to the industry average and are commensurate with their risk. Put another way, a below average ROE is itself a company specific risk.

**Q. Would customers benefit from an increase to OG&E's authorized ROE in this case?**

A. Yes. Appropriately compensating shareholders for the risk of their investment would signal to the investment community that Oklahoma recognizes the continued need for investment in infrastructure. Customers would benefit if OG&E could continue to attract capital at reasonable cost and keep its rates among the lowest in the country.

**Q. What ROEs are recommended by interveners in this proceeding?**

A. PUD is recommending 9.3%, the AG and the FEA are recommending 9.5%, and the OIEC is recommending 9.0%.

**Q. Are these ROE recommendations reasonable?**

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9 What Is Portfolio Diversification? – Fidelity

10 Responsive Testimony of Geoffrey M. Rush filed April 26, 2024, p. 13, l. 17.

11 Responsive Testimony of David J. Garrett filed April 26, 2024, p. 11, ll. 18-19.

A. No, those recommendations are not reasonable. The Commission should be awarding a higher ROE than OG&E's currently authorized 9.5%. It does not appear any intervening party has appropriately considered recent increases in interest rates, industry risks, or company specific risks in their recommendations. The Commission should authorize an ROE within the 10.25% – 11.25% range, consistent with the analysis of Ann E. Bulkley, but certainly not less than the national average discussed in Mr. Walworth's direct testimony.

## CAPITAL STRUCTURE

**Q. What is the Company's existing capital structure?**

A. The Company's actual capital structure is 53.5% equity and 46.5% debt. That is the capital structure proposed by the Company for ratemaking in this proceeding. I agree with using that actual capital structure.

**Q. Which parties propose to depart from the actual capital structure and what do they propose?**

A. The Oklahoma Industrial Energy Consumers ("OIEC") departs the most by proposing the use of 44.8% equity. The Federal Executive Agencies ("FEA") proposes the use of 52% equity. The Attorney General ("AG") proposes the use of 50% equity.

**Q. Is there any substantial evidence to support a deviation from that actual capital structure?**

A. Not in my opinion. The capital structure is a product of the past presumptively valid discretionary management decisions regarding capital formation and market forces.

There is no evidence in any responsive testimony that those management decisions were inefficient or imprudent when made.

**Q. Are you aware of any Oklahoma legal authority that addresses management's discretion to establish the Company's capital structure?**

A. I am aware that the Oklahoma Supreme Court in *Turpen v. Oklahoma Corporation Commission*, 1988 OK 126, 769 P.2d 1309, 1314, 1329-1331 (Okla. 1988) decided that management's decision regarding capital outlays from which capital structure is measured are presumed to have been made in good faith and, hence, are not to be overruled by the Commission in the absence of evidence of inefficiency or imprudence.

**Q. How do you understand the policy implications of the *Turpen* case?**

A. I understand that, in citing two U.S. Supreme Court cases, the *Turpen* decision held there is a presumption that the actual capital structure resulting from management decisions is valid, i.e., should not be replaced with any hypothetical capital structure without a showing of inefficiency or imprudence by management. Specifically,

> As noted by the U.S. Supreme Court, *there is, in essence, no difference between capital costs and operating expenses. Each is a necessary cost of supplying the service and must be paid for out of current income.*[56] Since good faith is presumed on the part of public utility managers, their judgment about prudent outlays, including outlays for capital, should not be overruled unless inefficiency or imprudence on their part is shown.[57] The Commission's decision not to overrule the judgment of SWBT's managers concerning the appropriate capital structure for SWBT and impute a hypothetical debt-equity ratio for purposes of ratemaking is clearly sustained by the law and substantial evidence.

*Turpen v. Oklahoma Corporation Commission*, 1988 OK 126, 769 P.2d 1309, 1329-30. (Okla. 1988) (emphasis added, footnotes in original)

**Q. To which cases did our Supreme Court refer for guidance?**

A. In fn 56 above, the *Turpen* decision cited *Missouri ex rel. S.W. Bell T. Co.* v. Public Serv. Com., 262 US 276, 306-307, 43 S. Ct. 544, 552-553, 67 L. Ed. 981-993 [1923] (Brandeis, J., concurring) by paraphrasing the italicized portion below:

> In essence, *there is no difference between the capital charge and operating expenses, depreciation, and taxes. Each is a part of the current cost of supplying the service; and each should be met from current income.* When the capital charges are for interest on the floating debt paid at the current rate, this is readily seen. But it is no less true of a legal obligation to pay interest on long-term bonds, entered into years before the rate hearing and to continue for years thereafter; and it is true, also, of the economic obligation to pay dividends on stock, preferred or common. The necessary cost, and hence the capital charge, of the money embarked recently in utilities, and of that which may be invested in the near future, may be more, as it may be less, than the prevailing rate of return required to induce capital to enter upon like enterprises at the time of the rate hearing ten years hence. To fix the return by the rate which happens to prevail at such future day, opens the door to great hardships. Where the financing has been proper, the cost to the utility of the capital, required to construct, equip, and operate its plant, should measure the rate of return which the Constitution guarantees opportunity to earn . . . . The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definiteness to these two factors involved in rate controversies . . . . (emphasis added).

In fn 57 above, the *Turpen* court cited to *West Ohio Gas Co. v. Public Utilities Com.* , 294 U.S. 63, 72, 55 S. Ct. 316, 321, 79 L.Ed. 761, 769 [1935] wherein the U.S. Supreme Court upheld management's discretion:

> The company made claim to expenses incurred in procuring new business or in the endeavor to procure it, such expenses amounting on the average to $12,000 a year. The commission did not question the fact of payment, but cut down the allowance to $5,000 a year on the ground that anything more was unnecessary and wasteful. The criticism has no basis in evidence, either direct or circumstantial. Good faith is to be presumed on the part of the managers of a business. In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay (citations omitted).

**Q. Would you expect the capital structures of all vertically integrated electricity utilities to be the same?**

A. Certainly not. Each separate company's capital needs will vary over time and amount, and often by the terms of a specific capital transaction whether equity or debt. One would expect, however, prudent capital investment decisions, which are then reflected in a calculation of capital structure, would all fall within what many observers would consider a reasonable range. Those that fall outside the range might then be considered inefficient or imprudent.

**Q. In its guidance to regulators on capital structure has the National Association of Regulatory Utility Commissions ("NARUC") presented its analysis and a "rule of thumb" range of reasonableness?**

A. Yes, NARUC has published its analysis and recommendation about the range of reasonable capital structures as the "80/20 rule". In "Cost of Capital and Capital Markets: A Primer For Utility Regulators," the author explains the complexities of financial theories, and suggests an 80/20 rule by which:

> [I]it is possible that a utility's capital structure can deviate so significantly such that a hypothetical capital structure is appropriate. One way to think about this is the 80%/20% rule. If a capital structure contains more than 80% common equity, for instance 100%, hypothetical capital structure ratios can be imputed to reduce the common equity ratio down to 80%. On the other hand, if a capital structure contains less than 20% common equity, for instance 0% or below, hypothetical capital structure ratios can be imputed to increase the common equity ratio up to 20%.

https://pubs.naruc.org/pub.cfm?id=CAD801A0-155D-0A36-316A-B9E8C935EE4D (excerpt "4. Capital Structure Components," attached hereto as Rebuttal Exhibit DRR 1, p. 13).

**Q. How do you understand the NARUC guidance?**

A. I understand the NARUC author's 80/20 rule as a suggested approach to discerning when a utility's capital structure, determined by management decisions, "deviate[s] so significantly such that a hypothetical capital structure is appropriate." That 80/20 rule is tantamount to placing metrics around the *Turpen* standard that management's "judgment about prudent outlays, including outlays for capital, should not be overruled unless inefficiency or imprudence on their part is shown." The NARUC author concluded that:

> [F]inancial theory and practice indicate that a regulator has little to gain by attempting to micro-manage capital structure ratios unless they significantly deviate from relevant standards of comparison. (*Id.*)

**Q. Did any party apply a reasonable-range analysis similar to the "80/20 rule"?**

A. Yes, PUD's witness Mr. Rush testified he used what he considered a reasonable range for a balanced capital structure, saying:

**Q. What is PUD's recommended capital structure in this Case?**

A. "PUD believes that a balanced capital structure falls within a between a range of 40%-60% debt and 40%-60% equity. Because OG&E's requested capital structure is 46.5% debt and 53.5% equity, PUD believes the Company's requested capital structure is reasonable and does not object to the request in this Case."

(Responsive Testimony of Geoffrey M. Rush, filed April 26, 2024, p. 32, ll. 14-17.)

**Q. What inference regarding reasonableness and prudence should be drawn by comparing OG&E's 53.5% equity and 46.5% debt to the capital structures of the proxy group used by OG&E's witness Ann Bulkley and the proposed 44.80% equity (OIEC), 50% equity (AG), and 52% equity (FEA)?**

A. The proper inference to be drawn from that evidence is that OG&E's capital structure at 53.5% equity and 46.5% debt is not the result of management's inefficiency or

imprudence but is reasonable and prudent for ratemaking. Consequently, the Commission should not depart from the existing capital structure and replace it with any of the opponents' alternative hypothetical structures.

**Q. Can you elaborate on your opinion?**

A. Ms. Bulkley listed in Exhibit AEB-15 her capital structure analysis of 16 comparable or proxy companies over the 8 quarters. I have displayed in Rebuttal Exhibit DRR-2 that same data of the proxies' equity percentages in three groups: 1) below 50% equity; 2) proxies between 50% equity and OG&E's 53.5% equity; and 3) those proxies above 53.50 % equity. OG&E's existing actual capital structure falls comfortably within that range, but the alternatives suggested by other parties do not.

**Q. What do Direct Exhibit AEB-15 and Rebuttal Exhibit DRR-2 show?**

A. Those exhibits show a number of things in my opinion:

1. The range of the proxies' equity values is from the lowest at 45.52% equity to the highest at 61.29% equity.

2. The average equity value of all 16 proxies was 52.82% equity, demonstrating Ms. Bulkley's conclusion that, "The Company's proposed equity ratio of 53.50 percent is well within the range of equity ratios of the proxy group, and just slightly above the average." (Direct Testimony of Ann E. Bulkley, p. 68, ll. 6-8.)

3. None of the proxies' values was as low as OIEC's proposed 44.8% equity. It is an outlier when compared not only to OG&E but also to the other 16 companies on Direct Exhibit AEB-15 and Rebuttal Exhibit DRR-2. As such, 44.8% should be rejected.

4. Only 5 proxies out of 16 or 31.25% were below 50% equity. There is nothing about that observation of comparable companies to recommend that a 50/50 hypothetical, or any other capital structure should be imposed to correct some unidentified past management inefficiency or imprudence under the *Turpen* standard.

5. OG&E's management decisions are not out of line, unreasonable, inefficient or imprudent when its equity capital metrics are only slightly above the average of the proxy group (52.82% equity) and six (6) other proxies out of 16 or 37.5% have equity capital percentages above OG&E's 53.5%. There is nothing about an equity ratio of 53.50% that calls into question management's efficiency and prudence in the absence of evidence as required by the *Turpen* standard.

**Q. Is the Turpen standard consistent with the majority rule in other states?**

A. Yes, the *Turpen* presumptively-valid standard is consistent with my understanding of the majority rule in other states and is, in my opinion, the better view. *Cf.*, Brehl, James W. and Gallagher, James A. (1982) "Response to the Case for the Use of an Appropriate (Hypothetical) Capital Structure in Utility Ratemaking," ("The rule in Minnesota is, and should remain, consistent with that in most jurisdictions. There will not be a departure from the utility's actual capital structure unless it is first established by material, creditable evidence that the actual capital structure is unreasonable and imprudent. This rule provides a sound and practical approach to the resolution of capital structure issues and is fair to both utilities and customers;" at p. 16). *William Mitchell Law Review*, Vol. 8: Iss. 2, Article 9, p. 16; 8 William Mitchell Law Review 449, p. 16. *Cf.*, http://open.mitchellhamline.edu/wmlr/vol8/iss2/9. Rebuttal Exhibit DRR–3.

In accordance with *Turpen* opinion, the judgment of the Company's management regarding its capital structure should not be overruled without a showing of inefficiency or imprudence. Such a showing has not been made in this cause. The actual capital structure is 53.5% equity and 46.5% debt; and is presumed valid. The critics have not produced any substantial evidence to the contrary. The capital structure of 53.50% equity and 46.5 % debt should be used for ratemaking purposes in this cause.

## INVESTED CAPITAL DISALLOWANCES

**Q. What capital disallowances have been recommended in this case?**

A. The PUD is recommending approximately $115 Million of disallowances to OG&E's invested capital in transmission and distribution plant. These disallowances are unwarranted as the Company has prudently managed its capital budget and made improvements in reliability for its customers, all while keeping its rates low.

**Q. Does this recommended disallowance send a negative signal to the investment community?**

A. Yes. PUD has increased the risk to OG&E in this case by recommending the disallowance of invested capital. Unfortunately, even if the Commission rejects their recommendation, coverage of the disallowance may cause concern for investors as they continue to evaluate OG&E's company-specific risks. Current and potential OG&E investors must now face the prospect of no return for their investment in addition to the lower-than-average return on investment they currently receive.

## CONCLUSION

**Q. Do you have any concluding remarks?**

A. Yes. OG&E is a company with rates well below the national average and offers electric service that is reliable. For a relatively small investor-owned electric utility, OG&E is recognized in the electric utility industry as being a leader. The Company gained those distinctions through hard work, good planning, innovative thinking, and a strong focus on the customer in all that it does.

OG&E faces an increasingly risky financial market environment. Maintaining affordable rates for its customers should be balanced with the recognition these low rates are accomplished through the procurement of low-cost capital from its shareholders. The Commission should recognize the rising interest rate environment and potential risks to investors by using the Company's existing capital structure in ratemaking and awarding an increase to its authorized ROE. The Commission should also reject the invested plant disallowances introduced in this case by the PUD. OG&E's investments provide reliable service for customers and the shareholders who provide the capital for those investments should be compensated appropriately.

**Q. Does this conclude your testimony?**

A. Yes.

## AFFIDAVIT OF DONALD ROWLETT

STATE OF OKLAHOMA )
) ss.
COUNTY OF OKLAHOMA )

I, Donald Rowlett, on oath, depose and state, that the foregoing is true and correct to the best of my knowledge and belief.

DONALD ROWLETT

Subscribed and sworn to before me this 17th day of May, 2024.

Notary Public

My Commission Expires: 01/30/28

## CERTIFICATE OF MAILING

This is to certify that on this 17th day of May, 2024, a true and correct copy of the above and foregoing document was electronically served, via email, to:

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10933.041/(20240516).plea

Rebuttal Exhibit DRR-1

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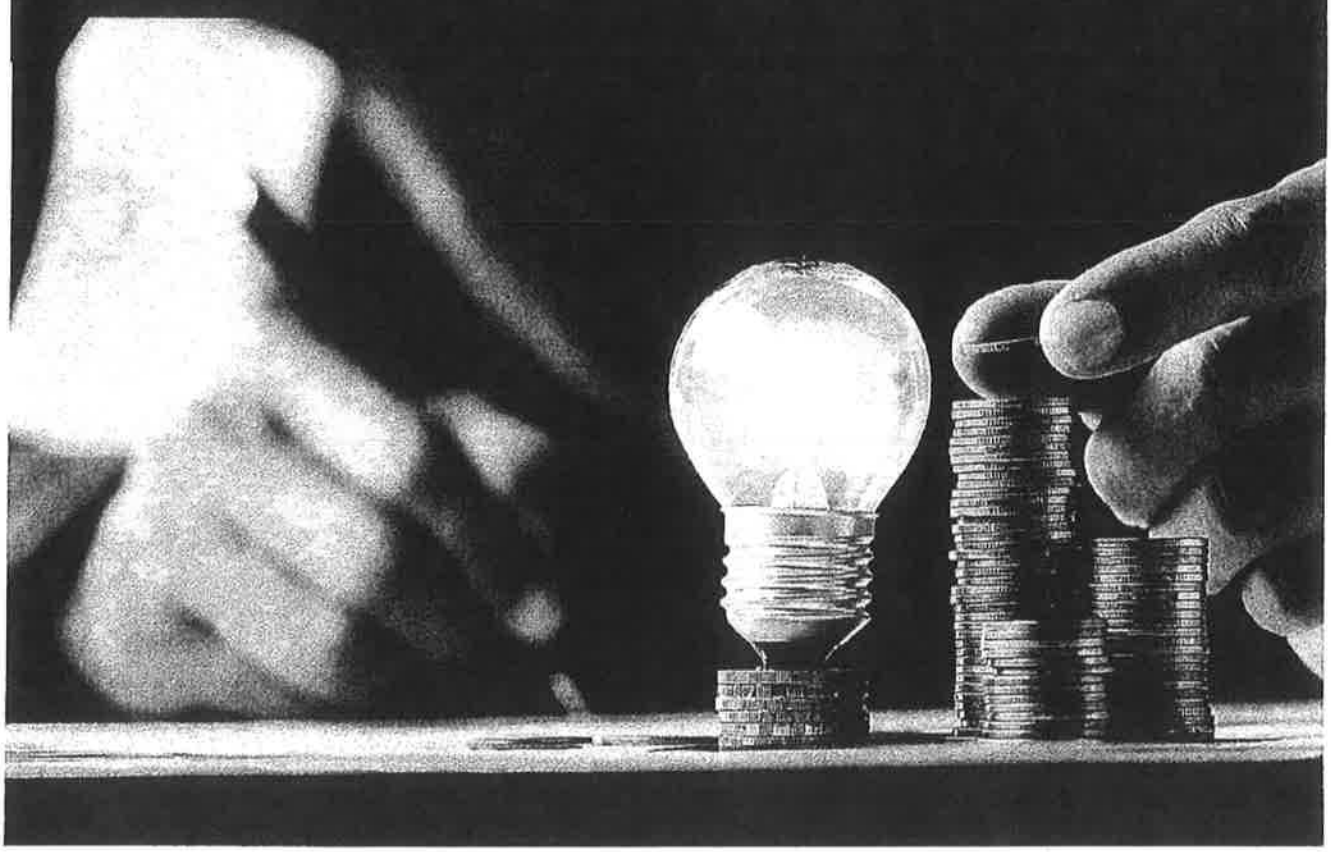
# COST OF CAPITAL AND CAPITAL MARKETS

## A PRIMER FOR UTILITY REGULATORS



**December 2019**
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# COST OF CAPITAL AND CAPITAL MARKETS PRIMER FOR UTILITY REGULATORS

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|---|---|
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# Table of Contents

# List of Acronyms or Abbreviations

| | |
|---|---|
| BVPS | Book Value per Share |
| CAPM | Capital Asset Pricing Model |
| DCF | Discounted Cash Flow |
| EPS | Earnings per Share |
| FASB | Financial Accounting Standards Board |
| FERC | Federal Energy Regulatory Commission |
| GAAP | Generally Accepted Accounting Principles |
| ROE | Return on Equity |
| ROR | Overall Rate of Return |
| WACC | Weighted Average Cost of Capital |
| USoA | Uniform System of Accounts |

## Acknowledgements

This primer was developed in partnership with the National Association of Regulatory Utility Commissioners (NARUC) with the generous support of the United States Agency for International Development (USAID). This primer is one in the series of various primers on cost-reflective tariffs and will be incorporated into a larger comprehensive guide on tariff settings, the Cost-Reflective Tariff Toolkit.

## About the Author

John D. Quackenbush, CFA is the President of JQ Resources, LLC. His cost of capital and capital markets qualifications include roles on the Illinois Commerce Commission finance staff testifying and briefing commissioners on cost of capital and capital markets issues, in the regulatory and treasury departments at Sprint Corporation, a global telecommunications firm that operated regulated local exchange carriers in 20 states, as a Senior Investment Analyst in the capital marketplace at UBS, a global Swiss bank, as a state regulator serving as Chairman of the Michigan Public Service Commission, and as an expert witness on cost of capital and capital markets as a consultant.

John obtained the Chartered Financial Analyst (CFA) designation in 1993, and continues to participate in the CFA Continuing Education Program while participating as a member of the CFA Institute and the CFA Society of Chicago. He served on the Board of the Society of Utility and Regulatory Financial Analysts (SURFA) from 1998 to 2008.

John served as a member of the National Association of Regulatory Utility Commissioners and its Committee on Gas, Committee on Consumer Affairs, and Subcommittee on Pipeline Safety during 2011-2016, the United States Department of Transportation Technical Hazardous Liquid Pipeline Safety Standards Committee during 2014-2016, and the Gas Technology Institute Public Interest Advisory Council during 2013-2016. He earned an MBA with a concentration in Finance from Michigan State University.

## 4. Capital Structure Components

All sources of investor-supplied capital are typically included in the capital structure. Investor-supplied capital includes long-term debt, short-term debt, preferred stock, and common equity. Typically, most utilities have long-term debt and common equity outstanding, while only some utilities have short-term debt and preferred stock outstanding. For ratemaking purposes, sometimes non-investor-supplied capital such as deferred taxes or customer deposits also is included in the capital structure rather than being treated through the rate base calculation, but that is beyond the scope of this primer.

Long-term debt can consist of mortgage bonds, debentures, convertible debt, bank loans, and municipal bonds and is generally reflected in the capital structure at its principal amount adjusted for the unamortized balance of issuance costs and discount or premium. To match the costs with the time period that the rates and tariffs will be in effect, it is possible to project the long-term debt that will be outstanding at a future balance sheet date by reflecting new issuances and maturities. Equity can consist of both common equity and preferred stock.

Short-term debt can consist of bank loans and commercial paper. Short-term debt, if it exists on the balance sheet, can be included or excluded in the capital structure as a matter of regulatory practice. Short-term debt is often used by utilities to finance construction and meet working capital needs in the short-run until it is replaced with long-term financing. Some regulators will exclude short-term debt with the view that it is temporary and will eventually be replaced with long-term capital. Other regulators will include short-term debt if the utility appears to employ it routinely on an ongoing basis.

Investor-supplied capital is recorded on a utility's balance sheet. A well-developed Uniform System of Accounts will ensure that debt and equity are accurately recorded on the balance sheet. The debt and preferred stock accounts on the liability side of the balance sheet are relatively straightforward with debt and preferred stock recorded based on issuance amount.

The common equity account on the balance sheet represents total assets minus total liabilities and generally covers the accounts of common stock, paid-in capital, retained earnings, and treasury stock. The common stock and paid in capital amounts generally result from stock issuances and the treasury stock amount generally results from stock that has been bought back by the company from investors. Besides obtaining new capital by issuing debt and equity, a utility can internally reinvest earnings not paid out as dividends and grow the retained earnings account.

Investors recognize that accounting principles, standards, and procedures, including Generally Accepted Accounting Principles ("GAAP") promulgated by the Financial Accounting Standards Board ("FASB"), ensure a level of consistency in the calculation of the common equity account that makes it easier for investors to analyze and extract useful information from financial statements. Utility investors recognize that a Uniform System of Accounts ("USoA") provides requirements that ensure additional consistency in the calculation of the book value of common equity.

A USoA enhances uniformity, comparability, accuracy, reliability, and consistency for reporting, cross-company benchmarking comparisons, rate regulation, rate studies, cost-of-service studies, depreciation studies, market oversight, and financial audits. Although part of an investment analyst's duty is to scrutinize the financial statements, the existence of GAAP and the USoA provide a solid foundation for calculating the book value of common equity.

One of the primary issues when determining the capital structure for ratemaking purposes is the corporate level at which to measure the capital structure. The capital structure is typically measured at the corporate level at which the utility actually interfaces with the capital markets. Some utilities participate directly in the capital market and have a capital structure disciplined by the capital markets.

Actual capital structure ratios are generally used for a utility that has market-traded stock and/or debt directly issued to investors. Utilities that are subsidiaries of parent companies may interface with the capital markets at the parent level instead. If so, that parent capital structure can be considered for ratemaking purposes. However, parent companies may have significant non-utility operations of different risk that may render the use of the parent company capital structure inappropriate.

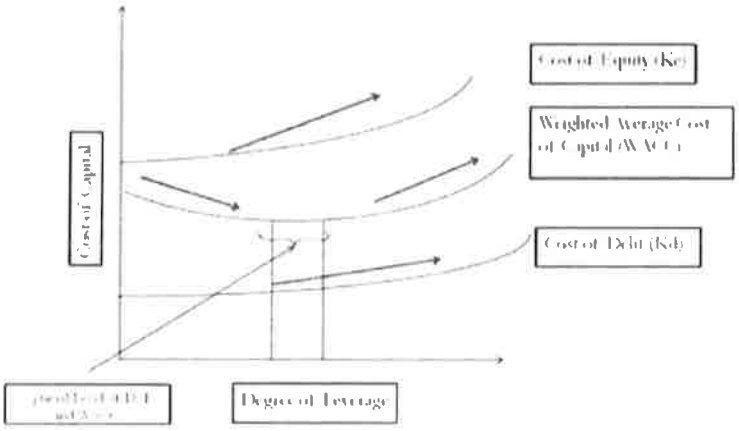
Hypothetical capital structures can be useful if the utility and/or the parent does not have an interface with the capital marketplace or the capital structure ratios are difficult to determine or significantly deviate from standards of comparison. But before considering the use of a hypothetical capital structure, it is worthwhile to explore optimal capital structure theory.

Utility management's goal is to manage the capital structure such that the WACC is minimized. Financial theory indicates that an optimal capital structure range exists that will minimize the WACC, but, in practice, it is very difficult to pinpoint optimal capital structure ratios with any degree of accuracy. To begin with, academic references about optimal capital structure are relatively vague and do not offer any empirical evidence to pinpoint one. In the real world practical corporate finance environment, academic theoretical references are interesting and may be thought-provoking, but do not provide a useful tool to fine tune a company's capital structure.

A utility management must be permitted latitude, discretion, and flexibility in managing capital structure ratios. Since there is no practical methodology to pinpoint theoretically optimal capital structure ratios, targeted ratios can only be broadly conceptualized. Appropriate ratios may shift over time as capital market conditions or business risk characteristics change. Additionally, the timing of upcoming issuances and maturities may influence the capital structure ratios because both the size and frequency of issuances are affected by the relative cost-effectiveness of various issuance increments.

Given these practical considerations, capital structure ratios cannot be deemed to be inappropriate unless the ratios greatly diverge from sound industry practice and cause a lack of financial flexibility that may lead to higher overall costs. The WACC curve is shaped like a very shallow dish such that large variances in capital structure ratios lead to minimal change in overall costs, as demonstrated in the following graph:

WACC Curve




As increasing financial leverage shifts the weight from common equity to lower cost debt, it also increases both the cost of debt and the cost of common equity. In practice, these offsetting impacts cancel each other out over a wide range of capital structure ratios, so hypothetical capital structures that micro-manage a utility's capital structure ratios by a 1% or 5% increment offer minimal opportunity to actually reduce the WACC.

Despite these challenges, it is possible that a utility's capital structure can deviate so significantly such that a hypothetical capital structure is appropriate. One way to think about this is the 80%/20% rule. If a capital structure contains more than 80% common equity, for instance 100%, hypothetical capital structure ratios can be imputed to reduce the common equity ratio down to 80%. On the other hand, if a capital structure contains less than 20% common equity, for instance 0% or below, hypothetical capital structure ratios can be imputed to increase the common equity ratio up to 20%.

As a result, financial theory and practice indicate that a regulator has little to gain by attempting to micro-manage capital structure ratios unless they significantly deviate from relevant standards of comparison. If accurate book value information is unavailable or unusual circumstances prevail, it may be appropriate to deviate from using a book value capital structure and instead use a market-value capital structure.

Rebuttal Exhibit DRR- 2

## CAPITAL STRUCTURE ANALYSIS

| OGE | PROXIES' AVERAGE | PROXIES' MEDIAN |
|---|---|---|
| 53.50% Equity | 52.82% Equity | 52.44 Equity |
| 46.5% Debt | 47.10% Debt | 47.46 Debt |

**Group 1: FIVE (5) COMPANIES WITH BELOW 50% EQUITY, AVERAGE 47.96 %**

| | | |
|---|---|---|
| 1. | AEP | 47.90% |
| 2. | AVA | 49.76% |
| 3. | ETR | 47.31% |
| 4. | NWE | 49.29% |
| 5. | POR | 45.52% |

**Group 2: FIVE (5) COMPANIES BETWEEN 50%-53.50% EQUITY, AVERAGE 52.13%**

| | | |
|---|---|---|
| 1. | LNT | 52.09% |
| 2. | AEE | 53.17% |
| 3. | CMS | 51.59% |
| 4. | DUK | 52.80% |
| 5. | PNW | 50.99% |

**Group 3: SIX (6) COMPANIES WITH EQUITY ABOVE 53.50% EQUITY, AVERAGE 57.45 %**

| | | |
|---|---|---|
| 1. | ALE | 58.62% |
| 2. | EVRG | 61.10% |
| 3. | IDA | 53.66% |
| 4. | NEE | 61.29% |
| 5. | SO | 55.56% |
| 6. | XEL | 54.44% |

**Group 2 and 3 : ELEVEN (11) COMPANIES' EQUITY ABOVE 50%, AVERAGE 55.03%**

Rebuttal Exhibit DRR - 3

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# Response to The Case for the Use of an Appropriate (Hypothetical) Capital Structure in Utility Ratemaking

James W. Brehl

James A. Gallagher

# RESPONSE TO *THE CASE FOR THE USE OF AN APPROPRIATE [HYPOTHETICAL] CAPITAL STRUCTURE IN UTILITY RATEMAKING*

JAMES W. BREHL & JAMES A. GALLAGHER



## I. INTRODUCTION

Shortly before the March 1982 Public Utilities Symposium, a paper prepared by Bruce M. Louiselle and Jean M. Heilman, entitled *The Case for the Use of an Appropriate Capital Structure in Utility Ratemaking: The General Rule Versus Minnesota*,[1] was circulated to participants of the Symposium. In reality, the Louiselle-Heilman paper does not state the case for the use of an "appropriate" capital structure. It presents, rather, an argument that a capital structure hypothetically related to the capital circumstances of other companies in the industry, and not a capital structure based on the company's own financial circumstances, is the "appropriate" capital structure that should be used in ratemaking proceedings. The Louiselle-Heilman paper argues that a hypothetical structure may be as safe, and yet more economical, than the utility's actual capital structure, and should be used without regard to whether the company's actual capital is found to be unreasonable or imprudent.[2] The Louiselle-Heilman paper also suggests (what it calls "the General Rule Versus Minnesota") that the approach adopted on capital structure matters by the Minnesota Supreme Court and the Minnesota Public Utility Commission is out of step with the approach utilized in other jurisdictions.[3] As discussed below, both of these claims are of dubious validity.

1. Louiselle & Heilman, *The Case for the Use of an Appropriate Capital Structure in Utility Ratemaking: The General Rule Versus Minnesota*, 8 WM. MITCHELL L. REV. 423 (1982).
2. *Id.* at 434-36.
3. *Id.* at 427-28.

## II. DISCUSSION

Our initial paper for the Public Utilities Symposium reviewed the major Minnesota commission decisions on capital structure matters over the last decade in an attempt to discern the commission's approach.[4] Simply stated, the rule that has evolved in Minnesota is that the utility's capital structure, based upon its actual circumstances, should be used by the commission in a rate case unless it is found that such capital structure is imprudent and unreasonable.[5] This rule is based on the Minnesota Supreme Court's decision in *Northwestern Bell Telephone Co. v. State*,[6] in which the court stated the tenet that guides the commission in capital structure determinations:

> We have difficulty accepting the concept that in a rate case of this kind the state may collaterally attack the judgment of the company in maintaining its embedded debt at a low figure. We agree with the position of the Company that this is a discretionary matter of management which, in the light of soaring interest rates, seems to vindicate the company's decision to keep its debt obligations to a minimum.[7]

The rule is inferred from Minnesota Statutes, sections 216B.23 and 237.075(5). These statutes specifically provide that when the commission determines that rates charged by a utility, or the regulations, measurements, practices, acts or services of a utility, are unjust or unreasonable, the commission then shall determine the rates, regulations, measurements, practices, acts or services to be charged or applied.

At one point, Louiselle and Heilman accept the basic sense of the capital structure rule applied in Minnesota:

> This is not to say that actual capital structure cannot produce reasonable results; it can. *If it can be shown, however, that the actual*

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4. Brehl & Gallagher, *Review of Minnesota Public Utility Commission Decisions Regarding Capital Structure Matters*, 8 WM. MITCHELL L. REV. 379 (1982).

5. North Cent. Pub. Serv. Co., Docket No. G-101/GR-77-221 (Minn. P.S.C. Dec. 30, 1977), at 15-16; Peoples Natural Gas Co., Docket No. G-011/GR-80-850 (Minn. P.U.C. Nov. 25, 1981), at 13-14. In North Cent. Pub. Serv. Co., Docket No. G-010/GR-81-780 (Minn. P.U.C. Dec. 30, 1982), the commission held that it would not depart from the actual capital structure of Donovan Companies, unconsolidated, when it was not shown to be unreasonable or imprudent. In Peoples Natural Gas Co., Docket No. G-011/GR-82-65 (Minn. P.U.C. Jan. 28, 1983), the commission found different circumstances than those present in the preceding *Peoples* rate case. The commission applied a hypothetical capital structure because it appeared that the capital structure of the multi-faceted parent, InterNorth, was not representative of a gas distribution company.

6. 299 Minn. 1, 216 N.W.2d 841 (1974).

7. *Id.* at 14-15, 216 N.W.2d at 850.

> *capital structure* (or the one proposed by the company) *is imprudent and unreasonable*, the commission must reject it and must base the fair overall rate of return on a reasonable, albeit hypothetical, capital structure.[8]

Louiselle and Heilman, however, then depart from this concession and espouse the view that a hypothetical capital structure, not based on the actual capital structure, should be imposed without the necessity of establishing the actual capital structure is unreasonable and imprudent.

Although not always articulating the rule exactly as in Minnesota, the bulk of the jurisdictions that have considered the matter take essentially the same approach that has been adopted in Minnesota. In most cases, the actual capital structure is departed from only *after* there has been a determination that the actual capital structure is unreasonable and imprudent in some significant respect.[9] These cases recognize, as the Louiselle-Heilman paper ad-

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8. Louiselle & Heilman, *supra* note 1, at 426 (emphasis added).

9. For example, in Pacific Northwest Bell Tel. Co. v. Washington Util. & Trans. Comm'n, 98 P.U.R.3d 16 (King County Super. Ct. 1972), the court stated:

> Bearing in mind the respective functions of the commission and management and affirming the proposition that management has the right to determine what the debt equity should be but that it may not always make the ratepayer foot the bill resulting from its choice, it would appear to this Court that the proper rule of law to be set forth in guiding the commission be that the commission may disregard the existing capital structure of a regulated company when it finds from the evidence that the existing capital structure is unreasonable so as to impose an unfair burden on the consumer.

*Id.* at 26.

In New England Tel. & Tel. Co. v. Department of Pub. Util., 360 Mass. 443, 275 N.E.2d 493 (1971), the court stated:

> It would be unreasonable and an undue interference with reasonable Company judgment, for the . . . [Department] to insist that Company's rate of return conform with precision to what the . . . [Department] regards as an optimum 60% debt ratio. Within a substantial range this is a matter for Company's determination . . . . There is no evidence that . . . Company has adopted an unreasonable low debt ratio which may be regarded as a 'company luxury' imposing an undue burden on consumers.

*Id.* at 466-67, 275 N.E.2d at 508, *quoting* Boston Gas Co. v. Department of Pub. Util., 359 Mass. 292, 269 N.E.2d 28 (1970).

Similarly, in Boston Edison Co., 99 P.U.R.3d 417 (Mass. D.P.U. 1973), the commission stated, "Unless the company's actual capital structure is demonstrably unreasonable, determinations of a fair rate of return must be based on the applicable, as opposed to a hypothetical, capital structure." *Id.* at 419.

In Peoples Natural Gas Div. of Northern Natural Gas Co. v. Public Util. Comm'n, 193 Colo. 421, 576 P.2d 377 (1977), the court stated, "Unless it has been demonstrated by a substantial showing that ratepayers are materially prejudiced by the actual capital structure which finances utility operations, the PUC should use the actual capital structure in calculating rates." *Id.* at 425, 576 P.2d at 380.

In Mystic Valley Gas Co. v. Department of Pub. Util., 359 Mass. 420, 269 N.E.2d 233 (1971), the court stated, "[Our decisions] do not permit the D.P.U. to disregard (in fixing

mits,[10] that each case must be resolved on its own facts when determining whether or not the actual capital structure of the utility is unreasonable or imprudent, and if so, what capital structure may be applied as reasonable and prudent under the circumstances.

Additionally, the term "hypothetical" has been used differently in different cases. As a result, a "numbers" game or count of cases, merely by reference to the term "hypothetical" without examining how the term is used in each case, inaccurately reflects the number of jurisdictions that adopt a truly hypothetical capital structure approach. For example, in some cases, "hypothetical" describes adjustments to the actual capital structure when the test period is incomplete at the time the record closes.[11] This certainly is not the type of "hypothetical" capital structure Louiselle and Heilman propose.

In other cases, a "hypothetical" capital structure describes adjustments to an actual capital structure to eliminate non-utility ac-

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rates) existing capital structures of regulated companies unless they so unreasonably and substantially vary from usual practice as to impose an unfair burden on the consumer." *Id.* at 429, 269 N.E.2d at 239.

In Tampa Elec. Co., 92 P.U.R.3d 398 (Fla. P.S.C. 1971), the commission stated:

> In the absence of evidence to the contrary, it must be presumed that management, with full knowledge of the company's particular circumstances and its relationship to the growth and development of its service area, has by deliberate design developed such a capital structure as will keep within reasonable bounds the financial risk of the company and enable it to obtain necessary capital at reasonable cost.

*Id.* at 416.

Likewise, in General Tel. Co. of California, 80 P.U.R.3d 2 (Cal. P.U.C. 1969), the California Public Utilities Commission stated, "In our opinion, it is preferable to use the actual capital structure, or as close an approximation as possible, unless it is entirely inconsistent with good regulatory practice." *Id.* at 23.

In Florida Power & Light Co., 67 P.U.R.3d 113 (Fla. P.S.C. 1966), it was well reasoned that:

> Management lives from day to day with intricate and complex problems of corporate finance, and has the responsibility of seeing that the utility has the financial ability to meet its public duties. The invasion of the field of management in such a sensitive area is justified *only when the public interest requires the exercise of extreme measures* for its protection and benefit.

*Id.* at 162 (emphasis added).

In Pennsylvania Pub. Util. Comm'n v. Bell Tel. Co. of Pennsylvania, 93 P.U.R.3d 13 (Penn. P.U.C. 1971), the commission stated, "However, capital structure is management's prerogative and we do not attempt to transgress this prerogative *unless wide margins of acceptability* are exceeded to points of unreasonableness." *Id.* at 39 (emphasis added).

10. Louiselle & Heilman, *supra* note 1, at 426-34.

11. Laclede Gas Co., 27 P.U.R.4th 241 (Mo. P.S.C. 1978); Central Main Power Co. v. Public Util. Comm'n, 405 A.2d 153 (Me.), *cert. denied*, 447 U.S. 911 (1979); South Cent. Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n, 373 So. 2d 478 (La. 1979).

tivities. In the 1977 and 1980 North Central Public Service Company cases before the Minnesota Public Utilities Commission, the utility made such an adjustment without any objection or challenge by the intervenors. Those adjustments presented both the North Central operating division and Donovan Companies, Inc., unconsolidated as a "gas distribution utility," in conformity with the rate of return testimony presented by the Department of Public Service (Department). In *El Paso Natural Gas Co.*,[12] the Federal Power Commission approved such adjustments, stating:

> In our opinion a fair rate of return should be based upon a capitalization that is associated with the utility business where a separation is feasible, as it is here. When the capitalization reflects investment in properties not related to the jurisdictional business which we are regulating, a distortion of the rate of return determination may result unless capitalization is adjusted to exclude these investments.[13]

Certainly, this is not the type of "hypothetical" capital structure that Louiselle and Heilman propose.

In other cases, particularly telephone cases, the term "hypothetical" describes recognition of the parent-subsidiary relationship and adjustments made to reflect the effects of that relationship upon the capital structure of the subsidiary. At least to the extent that these cases involve the use of "double leverage," even Louiselle and Heilman acknowledge that they do not involve a "hypothetical" capital structure of the sort they sponsor.

Finally, there are cases that involve adjustments to the actual capital structure of a utility for specific reasons found by the regulatory authority. These cases, however, usually do not entail substantial debt/equity percentage differences between the actual structure and the structure ultimately utilized. Again, this is not the type of "hypothetical" capital structure advanced by Louiselle and Heilman.

It simply is inaccurate to suggest, as Louiselle and Heilman do, that most jurisdictions approach the determination of the capital structure applicable in a rate case without beginning with the actual capital structure or the capital structure proposed by the utility based upon the actual circumstances of the utility. Similarly, it is inaccurate to suggest that any more than a small minority of the jurisdictions favor or would adopt a capital structure determined

12. 44 F.P.C. 73, 85 P.U.R.3d 309 (1970), *aff'd*, 449 F.2d 1245 (5th Cir. 1971).
13. *Id.* at 77, 85 P.U.R.3d at 313.

by matters aside from the actual circumstances of the utility, without first determining that the actual capital structure of the utility is unreasonable and imprudent in some substantial respect.

The imaginary or "hypothetical" capital structure sponsored by Louiselle and Heilman, which disregards the actual circumstances of the utility involved, is typified by the Department's "hypothetical" proposals in the 1977 and 1980 North Central Public Service Company rate cases.[14] In both North Central cases, the Department disregarded the actual capital structure of the North Central Public Service Company division and Donovan Companies, Inc., unconsolidated. Instead, it proposed the use of an average of the common equity ratios of a number of "comparison" gas distribution companies, thirteen in 1977 and sixteen in 1980.

The Department also disregarded the equity character of the comparison companies' preferred stock and the costs associated with preferred stock. It averaged only the common equity ratios of the comparison companies, which, in effect, combined preferred stock and debt for the purposes of constructing a "hypothetical" capital structure for North Central Public Service Company. Donovan Companies, Inc. (North Central) has no preferred stock.

The Department made no study of the prudence and reasonableness of the actual capital structure of North Central Public Service Company and Donovan Companies, Inc. The Department neither asserted nor presented any evidence that the actual capital structures were unreasonable or imprudent, but merely asserted that since their actual equity ratio exceeded the average common equity ratio of the so-called "comparison" companies, they should be replaced by a hypothetical capital structure containing a common equity ratio equal to the average of the comparison companies.

In the 1980 North Central case,[15] the Department witness acknowledged that the capital structure used by the utility was "appropriate in that it is real in some sense." He further conceded that there was no ideal capital structure for the company. The Department witness also conceded that he had "perhaps simplified things here too much" when he testified that the actual capital

14. North Cent. Pub. Serv. Co., Docket No. G-010/GR-80-422 (Minn. P.U.C. June 19, 1981); North Cent. Pub. Serv. Co., Docket No. G-101/GR-77-221 (Minn. P.S.C. Dec. 30, 1977).

15. North Cent. Pub. Serv. Co., Docket No. G-101/GR-80-422 (Minn. P.U.C. June 19, 1981).

structure of the company "is simply the product of management decisions and policy." He recognized on cross-examination that there "absolutely are" external factors that influence capital structure.[16]

Nevertheless, the Department in both cases urged that the average equity ratio of the comparison companies was the appropriate capital structure for North Central Public Service. Obviously, if the average equity ratio of the comparison companies was appropriate for North Central, then it follows that it is appropriate for each of the comparison companies, and, for that matter, any other gas distribution company arguably comparable to the comparison companies or North Central. In other words, the Department advanced the average as an "ideal" or "per se" gas distribution company capital structure, the very thing the Department witness conceded did not exist.

Ironically, although espousing the average as *the* appropriate capital structure for North Central and other gas distribution companies, the Department did so without studying the capital structures of the comparison companies, their bond indentures, their bond ratings, the terms of their preferred stock or common stock, the existence or absence of non-utility operations, their size or risk relative to North Central or the other companies, the existence of subsidiary operations, the acknowledged trend in recent years and currently to heavier common equity ratios, the timeliness of the ratios used, or the many other factors individual to each of the companies that might affect the reasonableness or prudency of its capital structure or the appropriateness of its comparison to North Central or any other gas distribution company.

The unavoidable reaction to the Department proposal was stated by the commission in its order in the 1980 North Central case:

> The Commission finds Dr. Rettenmayer's testimony singularly unpersuasive. Although he acknowledged a trend towards higher common equity ratios for gas distribution utilities, he was content to establish an appropriate equity ratio for the Company in the test year ending September 30, 1981 on the basis of 1979 data. Although he acknowledged that preferred stock was equity, and had tax consequences similar to common stock, and a cost higher than that of debt, in his capital structure recommendation he simply treated the 7.7% preferred

16. *Id.* (Hearings Transcript, Vol. III, at 120-21).

stock of his average 1979 capital structure as debt, and at the cost of debt. He made no response to the Company's contention that his recommendations would render the Company unable to issue debt under the terms of its bond indenture. Finally, Dr. Rettenmayer made no determination that his proposed hypothetical capital structure was desirable, and no study of the reasonableness or desirability of the capital structures of his 16 companies. This is a significant shortcoming in view of the Commission's discussion of its rejection of a proposed hypothetical capital structure in the previous case:

> [The witness] has shown no reason why it should be assumed that the average capital structure of this group of companies should be assumed to be a desirable capital structure. Since there has been no analysis of the companies' individual capital structures to determine if they are desirable, there is no structure to determine if they are desirable, there is no reason to believe the composite capital structure is desirable. *North Central*, G-010/GR-77-221, at 15, 16.

The commission finds that equity ratios of natural gas distribution companies have been increasing recently; that because the Company has no preferred stock its common equity ratio can be higher than that of a gas distribution company which has preferred stock; that the Company's equity ratio is not out of line with the equity ratios of comparison companies, and that no testimony has shown the Company's proposed capital structure to be unreasonable.[17]

The premise of Louiselle and Heilman, and that of the Department in the two North Central cases, appears to be that even if the capital structure proposed by the utility, based on its actual circumstances, is reasonable and prudent, that capital structure should be disregarded and any hypothetical structure that appears in the short term to be more "economical" should be imposed, unless the utility demonstrates that the hypothetical is unsafe. They argue that a challenge by an intervenor that more debt would be cheaper should trigger imposition of a hypothetical capital structure. Since they claim that debt is always cheaper than equity, a hypothetical capital structure could be adopted in every case. In effect, Louiselle and Heilman refuse to consider the factors that influence the development of a utility's capital structure, which they characterize as totally within "management discretion." To

17. *Id.* at 8.

Louiselle and Heilman, any capital structure with a higher debt ratio than the actual is appropriate.

Professor Phillips, in *The Economics of Regulation*, states:

> [T]here is no ideal capital structure, and even expert opinion can differ. The existing capitalization may well have resulted from sound and economical decisions when made, although a different structure might attract capital at a lower cost at the time of a rate case. While hindsight is often superior to foresight, financial decisions must be made on the basis of a judgment of present and future conditions. "It seems, then, that it is economically sound to leave with management the decision as to proper debt ratio, at least within that area where the directors are not usurping or defaulting on their duties as directors."[18]

In an initial brief filed in *Midwestern Gas Transmission Co.*,[19] testimony of Mr. William R. Field, an economic analyst with H. Zinder and Associates, recounted on behalf of Midwestern some of the different elements and judgments affecting management discretion and evolution of the financial structure of a utility:

> [N]ot only differing facts and circumstances underlying the development of each company and its capitalization but also differing opinions expressed in making honest and good faith business decisions based on those facts and circumstances. Such reasons include: differing perceptions of risks facing the industry as well as the particular entity; differences in age groups and backgrounds (e.g., those who "remember the depression"); different timing as to building the basic system and the different impacts of sinking fund mechanics; differing financial conditions relative to the timing of capital requirements; different perceptions as to where the industry and company stands in its 'life cycle' relative to gas supply and growth opportunities; different opportunities and requirements (sometimes quite fortuitous) as to major expansions, gas storage projects, additional compression, supplemental gas projects, gathering facilities, advance payments, etc.; honest differences of opinions as to the appropriate dividend payout policy; differences in views as to permanency in tax laws as to the deductibility of interest or the treatment of dividends; differences in views of debt and preferred capital as 'obligations' to a similar

18. C. PHILLIPS, THE ECONOMICS OF REGULATION 283 (1969) (footnotes omitted); *see also* J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 243-44 (1962); Foster, *Fair Return Criteria and Estimation*, 28 BAYLOR L. REV. 883, 890-92 (1976).

19. Docket Nos. RP81-17, RP81-57 (F.E.R.C. Mar. 15, 1982) (copy on file in William Mitchell Law Review office).

nature; etc.[20]

Other factors also affect the evolution of the capital structure of each particular utility involved in a rate case proceeding and each utility used as a comparison company in the derivation of an "imaginary" capital structure as was proposed in the North Central cases. In addition, market forces affect the financial structure of each company, as the Department's witnesses acknowledged in the North Central cases. Management discretion obviously does not control all these factors.

Louiselle and Heilman erroneously argue that, since all rates must be "just and reasonable," the actual capital structure of the utility cannot be deemed to be prima facie reasonable and prudent. They insist that the utility must carry the initial burden of proving that its capital structure is reasonable and prudent. To the contrary, substantial authority holds that a utility's expenses are presumed prudently incurred, with the burden upon intervenors to show unreasonableness or imprudence.[21]

By emphasizing the "just and reasonable" requirements of *Bluefield* and *Hope*, and the indication in *Permian Basin* that the regulatory process includes an assessment of the broad public interest, Louiselle and Heilman have neglected the standard established by *Hope*, *Bluefield*, and applicable Minnesota law. A utility is entitled to a fair and reasonable return upon *its investment* for the period during which the rates are collected.

The utility is at all times answerable to the utilities commission, not only for the maintenance of rates which are "just and reasonable," but associated therewith, for the preservation of a capital structure that is reasonable and prudent. Of that there is no argument. Therefore, if the intervenor presents creditable and material evidence of the unreasonable and imprudent nature of the actual capital structure of the utility, the burden shifts to the utility to persuade the commission that its capital structure is actually reasonable and prudent. This ultimate burden of persuasion, however, does not conflict with the sensible rule of Minnesota and other jurisdictions that the actual capital structure, adjusted as may be feasible in the rate case to remove the effect of non-utility

20. *Id.* at 22.

21. *See* West Ohio Gas Co. v. Public Util. Comm'n, 294 U.S. 63 (1935); Anaheim v. Federal Energy Regulatory Comm'n, 669 F.2d 799, 809 (D.C. Cir. 1981), *citing* Missouri *ex rel.* Southwestern Bell Tel. Co. v. Missouri Pub. Serv. Comm'n, 262 U.S. 276, 289 n.1 (1923).

activities and to fit the test period, shall not be departed from unless it has been first established to be unreasonable and imprudent.

The suggestion of Louiselle and Heilman that the commission abandons its regulatory authority over the capital structure of the utility by the rule indicated above is unfounded. Instead, that rule establishes the most reasonable approach to the capital structure issue and assures that the rate of return allowed is based upon *the utility's* investment *at the time the rates are being collected*.

The imposition of a capital structure divorced from the actual circumstances of the utility, while at the same time establishing a rate of return based on a market cost analysis, reduces the effective allowed rate of return and aborts the market cost rate of return determination. The market based rate of return becomes only a pretense because the allowed overall rate of return will be at the lower effective rate after the effects of the hypothetical capital structure are felt.

Theoretically, one of the purposes for imposing a hypothetical capital structure is to cause the utility to reduce the amount of equity and to increase the amount of debt in its actual capital structure. Since the utility must go to the market for its debt and equity capital based upon its actual capital structure, the imposition of a hypothetical capital structure may make it difficult, if not impossible, for the utility to effect the regulator's desired change in its capital structure. That is, the lowering of the effective rate of return by imposition of the hypothetical capital structure may make it impossible for the utility to increase its debt ratio while at the same time meeting its capital needs. That is clearly the case if the hypothetical structure, being based upon factors other than the actual circumstances of the company, prevents the utility from meeting its bond indenture requirements for the placement of additional debt. If additional debt actually cannot be placed, the capital needs of the utility will then have to be satisfied out of further equity investments. Instead of accomplishing a reduction of the common equity ratio, the effect of the hypothetical structure may be that a heavier equity ratio will actually be necessary. Further, even if some debt can still be placed, the actual circumstances of the utility probably will worsen because the additional debt will either be short term debt at high rates or long term debt at greater rates than would have been demanded by lenders had a higher effective rate of return been allowed on the actual capital structure.

## III. Specific Support for the Minnesota Rule

The reasons supporting the rule established by statute, case authority, and actions of the commission in Minnesota, that the actual capital structure of the utility will not be disturbed unless it is first shown that the actual capital structure is unreasonable and imprudent, are numerous:

a. Each gas and electric utility is required to obtain approval of changes in its actual capital structure and to provide capital structure information regarding both the utility and any parent or subsidiary corporation. Capital structure is defined by statute[22] and discussed by commission rule:

> A rate of return/cost of capital summary schedule showing the calculation of the weighted cost of capital using the proposed capital structure and the average capital structure for the most recent fiscal year and the projected fiscal year. This information shall be provided for the unconsolidated parent and subsidiary corporations. These statutes and rules provide constant scrutiny over the capital structures of utilities.[23]

b. Although the commission may reserve in financial dockets that its approval of the capital structure in those proceedings does not preclude its reconsideration of capital structure in rate proceedings, nevertheless, the capital structure of the utility stands approved by order of the commission in its financial dockets as being in the best interests of both the utility and its customers. Furthermore, if the capital structure of the utility has been considered and approved by the commission in a prior rate proceeding, the capital structure, subject to changes since that time, stands approved and should be regarded as prima facie reasonable and prudent.

c. A presumption, although rebuttable, that the actions of the utility in the regular course of business are legal and proper is appropriate.

d. The *Bluefield* and *Hope* requirement that a fair return be allowed on the investment of the utility at the time the rates are in effect necessarily directs itself to acceptance of the actual capital structure of the utility, at least in the first instance.

e. Presuming that market cost methodology is used for determination of the allowable rate of return, the actual capital structure is that which the market reflects; not a hypothetical. To use a hypothetical aborts the market cost rate of return analysis.

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22. Minn. Stat. § 216B.49(2) (1982).
23. 13 Minn. Code Agency R. PSC 405(D)(1) (1982).

f. The actual capital structure determines the utility's ability to compete for capital. It should not be hamstrung in competing for capital by disregard of the actual capital structure in the rate proceeding, absent a determination that the actual capital structure is unreasonable and imprudent.

g. Utility management carries the day to day responsibility for the financial structure of the utility and is accountable to the regulatory authorities, its investors, and customers. Absent a determination that their actions have been unreasonable and imprudent, it is inappropriate to displace their judgment in favor of that of consultants who have no significant on-going accountability and do not share in the consequences of errors of judgment. This is particularly true when the consultants have no actual experience in the placement of debt and equity capital on behalf of utilities, lenders or underwriters.

h. Louiselle and Heilman assert that it is "an established principle of law that the party asserting or denying the existence of facts has the burden of proof as to those facts."[24] That principle should place the burden upon the party challenging the actual capital structure, the basic factual setting in the case, to establish that the actual capital structure is unreasonable and imprudent. The actual capital structure of the utility is fact, not speculation. Any contrary facts alleged should be the burden of the challenger.

i. No single ideal capital structure exists. Accordingly, the first step of any consideration should be the actual capital structure itself, until it is shown to be unreasonable and imprudent.

j. To maintain economic and efficient rate regulation proceedings, intervenors opposing the use of an actual capital structure should be required to show by material, creditable evidence that the actual capital structure is unreasonable and imprudent.

k. Louiselle and Heilman in effect assert that there exists an impropriety on the part of management in allowing a capital structure to evolve which does not produce the lowest immediate possible cost. Their insinuation, that the application of "management discretion" is improper, should place the burden of proving such a claim of impropriety upon the challenger.

l. Basic fairness dictates that after-the-fact criticism and "Monday morning quarterbacking" not be allowed to upset management judgments exercised in good faith and with reasonable-

24. Louiselle & Heilman, *supra* note 1, at 436.

ness and prudence. Management, investors, and lenders act on a daily basis in reliance upon the actual capital structure of the utility, a capital structure that the commission has approved or permitted to exist or occur. It would be both unfair and unwise to prejudice them by adopting a hypothetical capital structure prior to it being established that management actions have departed from the range of reasonableness and prudence.

## IV. Non-Minnesota Jurisdictions

In all but a very few cases, the regulatory authorities have held that the actual capital structure will be determined unreasonable and imprudent and a "hypothetical" structure imposed only if there is a marked departure from that which might be considered normal. For example, in *Carrabasset Light & Power Co.*,[25] the Maine commission followed a two step process. First, it found that the existing capital structure was unreasonable when it contained only 11.3% debt, all short term, and 88.7% equity. Only then did it impose a hypothetical structure of 50% debt, 15% preferred, and 35% common.[26]

Similarly, in *Communications Satellite Corp. (COMSAT) v. Federal Communications Commission*,[27] a zero debt structure was adjusted to reflect 45% debt only after the federal commission first determined that COMSAT could have leveraged with debt, but unreasonably did not do so.[28] In *Southern Bell Telephone & Telegraph Co. v. Louisiana Public Service Commission*,[29] the court affirmed the commission after the commission had first examined the particular circumstances of the actual capital structure, which contained a debt ratio of 24.7%, and only after finding it unreasonable, applied the so-called "45% debt rule" and imposed a "hypothetical" capital structure.[30]

## V. Conclusion

Louiselle and Heilman, in proposing their test of reasonableness of a capital structure, defeat their principle argument that a hypo-

25. 17 P.U.R.4th 246 (Me. P.U.C. 1976).
26. *Id.* at 247-48.
27. 611 F.2d 883 (D.C. Cir. 1977).
28. *Id.* at 902-06.
29. 239 La. 175, 118 So. 2d 372 (1960).
30. *Id.* at 195-203, 18 So. 2d at 380-82. For additional cases from other jurisdictions, see *supra* note 9.

thetical structure should be imposed without regard to the actual capital structure and without any preliminary showing that the actual capital structure is unreasonable or imprudent. Their "reasonableness test" requires that the beginning point be the actual capital structure of the utility. They further concede that "while such analyses cannot produce the optimum capital structure, they can answer the question of whether a particular capital structure is safe."[31] In other words, they concede that no single ideal capital structure exists. They then make the extreme statement that if a capital structure contains x% debt and is safe, one containing more than x% debt would be even safer. Their rationale is most suspect if it is based upon that conclusion.

Their "test of reasonableness" further acknowledges the difficulty in appraising the reasonableness and prudence of a capital structure and the lack of sense in looking to a hypothetical capital structure divorced from the actual circumstances of the particular utility. They state various factors that must be considered in determining whether the hypothetical is safe, all of which must relate to the particular utility. This conflicts with the use of a hypothetical derived from the data of other companies.

The Louiselle and Heilman argument as to safety of a capital structure is flawed when they suggest that a decline in the bond rating of a utility is acceptable and "not determinative" so long as the bonds remain of investment grade. The safety of a capital structure bearing the affect of a reduction of its bond rating from "AAA" to "Baa" must be suspect in the real world of placement of debt or equity capital, if not in the utopian world of economic theory.

The Louiselle and Heilman discussion of the economy gained through increasing the debt ratio is also flawed because it fails to recognize that the cost of equity will increase as the debt structure and the risk confronted by investors rises. Louiselle and Heilman also fail to recognize an increment of additional debt cost by reason of the fact that the additional debt should be installed at the cost of placement of debt today, rather than at the embedded debt cost.[32]

In conclusion, it appears the basic error of Louiselle and Heilman is their assumption that the sensible rule adopted in Minnesota requires the commission to defer entirely to management with

31. Louiselle & Heilman, *supra* note 1, at 446.
32. *See* Citizens Util. Co., 34 P.U.R.4th 606, 617 (Idaho P.U.C. 1980).

respect to the capital structure of the utility. This is simply incorrect. The commission is not required to withdraw, nor has it withdrawn, from its responsibility to make utilities answerable for reasonable and prudent capital structures. The rule in Minnesota is, and should remain, consistent with that in most jurisdictions. There will not be a departure from the utility's actual capital structure unless it is first established by material, creditable evidence that the actual capital structure is unreasonable and imprudent. This rule provides a sound and practical approach to the resolution of capital structure issues and is fair to both utilities and customers.