**STATE OF NORTH CAROLINA**
**UTILITIES COMMISSION**
**RALEIGH**

**DOCKET NO. E-7, SUB 989**

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| In the Matter of<br>Application of Duke Energy Carolinas, LLC<br>for an Increase in and Revisions to its Rates<br>and Charges Applicable to Electric Utility<br>Service in North Carolina | )<br>)<br>)<br>)<br>) | **BRIEF OF NORTH CAROLINA ATTORNEY GENERAL** |

The North Carolina Attorney General's office respectfully submits this Brief in opposition to Duke Energy Carolina's Application for Rate Increase filed in this above-captioned docket on July 1, 2011.

## INTRODUCTION AND SUMMARY OF ARGUMENT

The Attorney General respectfully requests that this Commission deny Duke Energy Carolina's (the "Applicant" or "Duke") requested rate increase. There is insufficient evidence in the record to allow the Commission to establish a reasonable rate of return pursuant to N.C. Gen. Stat. § 62-133. The rate of return expert witnesses failed to consider all requisite statutory factors for establishing a return on equity that is fair to consumers as well as utility investors. Specifically, the witnesses failed to consider the impact of changing economic conditions on consumers when making their return on equity recommendations. Without such evidence in the record, the Commission cannot legally make a proper determination as to a fair and reasonable return on equity.

Alternatively, should the Commission decide there is sufficient evidence in the record to evaluate the statutorily mandated factors and determine an appropriate return on equity, the Commission should adopt a return on equity below the 10.5% level proposed in the Stipulation.

When weighing the impact of different returns on consumers and Duke, the Commission should come down on the side of protecting consumers, especially in this economy. The impact of the Stipulation's proposed return and its resulting 7.2% rate increase on consumers is concrete and certain. As noted by many consumers in testimony at the public hearings, North Carolinians face economic challenges and a rate increase will have a detrimental impact on consumers who are finding it harder to make ends meet and pay for necessities such as utilities. By contrast, the expert testimony regarding return on equity is inherently speculative in that, in the end, the expert testimony largely consisted of educated guesses as to what different returns might mean for Duke in terms of Duke's ability to keep Wall Street investors interested in the company's stock. Moreover, Duke has indicated that it intends to file for yet another rate increase later this year. Therefore, in the unlikely event there is any adverse market reaction to a return established below 10.5%, the Commission will be in a position to analyze the market effect and make any adjustments it deems appropriate.

In any event, none of the expert testimony specifically supported the 10.5% return on equity set forth in the Stipulation. Except for Duke's expert (who proposed a higher return), the experts proposed lower returns than the one set forth in the Stipulation. The Commission should consider all relevant factors in establishing a return on equity that is fair to both utility investors and customers, including the impact of the current economy on electric customers. As utilities are considered safer investments during economic downturns, Duke's return on equity and capital structure should not be overstated at the expense of customers.

## ARGUMENT

### I. There is Insufficient Evidence in the Record to Support an Increase in Duke's Electric Rates

The process for establishing rates for regulated public utilities like Duke is set forth in Chapter 62 of the North Carolina General Statutes and has been developed by appellate court case law. "The burden of proof is upon the utility seeking a rate increase to show that the proposed rates are just and reasonable." State ex rel. Utilities Comm'n v. Central Telephone Co., 60 N.C. App. 393, 394 (1983). N.C. Gen. Stat. § 62-133 lays out how rates are fixed for all regulated public utilities and includes a directive that "the Commission shall fix such rates as shall be fair both to the public utilities **and to the consumer**." (emphasis added.) Section 62-133(b)(4) provides details regarding the establishment of the rate of return that a public utility is authorized to earn on its invested property, which is also known as its rate base. In making this determination, the Commission is required to:

> Fix such rate of return on the cost of the property ascertained pursuant to subdivision (1) of this subsection as will enable the public utility by sound management to produce a fair return for its shareholders, **considering changing economic conditions and other factors**, including, but not limited to, the inclusion of construction work in progress in the utility's property under subdivision b. of subdivision (1) of this subsection, as they then exist, to maintain its facilities and services in accordance with the reasonable requirements of its customers in the territory covered by its franchise, and to compete in the market for capital funds on terms that are reasonable and that are fair to its customers and to its existing investors.

N.C. Gen. Stat. § 62-133(b)(4) (emphasis added).

Thus, the statute lists numerous factors that the Commission must consider when establishing the rate of return on rate base, including sound management of the utility, a fair return to shareholders, construction work in progress, maintenance of facilities and services, market competition for capital funds, and changing economic conditions. Per N.C. Gen. Stat. § 62-133, the Commission is required to weigh these factors in a manner that is fair to both the utility's customers and the utility's investors. The Commission must then make a judgment and conclusion of law based on the various factual considerations. Duke Power v. Public Staff, 322 N.C. 689, 693 (1988) ("Duke Power I"). However, in order for the Commission to weigh these factors, there must be evidence in the record with respect to each of these factors. Without such evidence, the Commission cannot adequately consider these statutorily mandated factors.

The North Carolina appellate courts have construed this statute and provided guidance for establishing the rate of return on a utility's property. "The primary purpose of Chapter 62 of the General Statutes is not to guarantee to the stockholders of a public utility constant growth in the value of and in the dividend yield of their investment, but is to assure the public of adequate service at a reasonable charge." State ex rel. Utilities Comm'n v. General Telephone Co., 285 N.C. 671, 680 (1974). The legislative intent of these provisions is that the Commission "fix rates as low as may be reasonably consistent with the requirements of the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States, those of the State Constitution, Art. I, § 19, being the same in this respect." State ex rel. Utilities Comm'n v. Duke Power Co., 285 N.C. 377, 388 (1974). "What constitutes a fair rate of return on equity . . . is ultimately a matter of judgment. Matters of judgment are not factual; they are conclusory and based ultimately on various factual considerations." General Tel. Co., 285 N.C. at 693.

All the provisions of the public utilities statute should be construed together to accomplish the primary purpose of assuring the public of adequate service at a reasonable charge. "[Chapter 62] is a single, integrated plan. Its several provisions must be construed together so as to accomplish its primary purpose. **Its provisions, such as G.S. 62-133, designed**

**to assure the utility of adequate revenues, are in the nature of corollaries to the basic proposition that the public is entitled to adequate service at reasonable rates** and safeguards against administrative action which would violate constitutional protections by confiscation of the utility's property." General Tel. Co, 285 N.C. at 687 (emphasis added). Thus, the rate of return provisions of Chapter 62 should not be read in isolation as only protecting the utility and its shareholders, and should not be analyzed with only those interests in mind. In other words, consumer interests cannot be considered only indirectly or as mere afterthoughts. As the U.S. Supreme Court stated with respect to a similar statute:

> These criteria [relating to whether return on equity is commensurate with returns on other investments and is sufficient to attract capital] scarcely exhaust the relevant considerations. **The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about prospective responses of capital markets; it is instead obligated at each step of the regulatory process to assess the requirements of its broad public interests entrusted to its protection** . . . .Accordingly, the "end result" of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they "maintain credit . . .and . . .attract capital."

In Re Area Rate Proceeding for Permian Basin, 390 U.S. 747, 791 (1968) (emphasis added).

A review of the transcript and evidence shows that while Duke presented evidence with respect to many of the factors listed in § 62-133(b)(4), Duke failed to present any evidence with respect to the impact of "changing economic conditions" on consumers. Duke presented three witnesses with respect to rate of return and capital structure, but none of those witnesses testified with respect to the impact of changing economic conditions on customers. In his testimony, Duke witness Hevert recommended a return on equity ("ROE") range and provided extensive analysis regarding the impact of market volatility on Duke's ability to raise capital and maintain its current debt rating. However, Mr. Hevert's testimony failed to discuss or otherwise consider the impact of changing economic conditions on customers when establishing his recommended range.

The Attorney General's counsel explored Mr. Hevert's testimony on cross examination in an effort to determine to what extent he considered the impact of changing economic conditions on Duke's customers. Mr. Hevert responded to those questions by stating that his analysis relied on market conditions and that to the extent individual economic indicators were a derivative of greater macroeconomic conditions, then those conditions were factored into this analysis. (Vol. 4, p. 10-11). However, Mr. Hevert was unable to articulate how the impact of economic conditions on customers factored into his analysis. Mr. Hevert admitted that he did not specifically consider the unemployment or poverty rates in Duke's service area, the impact on fixed income customers, the impact on cities and counties as ratepayers, or the impact on job creation. (Id. at 12). Mr. Hevert also admitted that he did not review any of the public witness testimony and exhibits, or the correspondence, petitions or comments filed in this docket by customers. (Id. at 13). Thus, Mr. Hevert's analysis supporting his recommended ROE range is insufficient since it fails to account for the impact of changing economic conditions on customers.

Mr. Hevert also testified that he is unfamiliar with the statutory requirements for establishing fair and reasonable returns in North Carolina:

> *Q. To your knowledge, is the* impact *of economic conditions on customers required to be considered in the establishment of fair and reasonable returns in North Carolina?*
>
> *A. (Hevert) The—specifically, in terms of North Carolina, I can't say but I do know that as a general proposition, balancing the interests of customers and investors is an important consideration.*

> *Q. Are you familiar with the statutory provisions for establishing rates in North Carolina?*
>
> *A. (Hevert) Not specifically.*

(Tp. Vo. 4, 13-14). Mr. Hevert's lack of familiarity with North Carolina's statutory parameters for fixing rate of return underscores the deficiency of his analysis.

In this case, Duke has failed to present evidence regarding the current economic conditions as they relate to the utility's customers and it has failed to carry its burden of proof that the proposed rates are just and reasonable. N.C. Gen. Stat. § 62-133 contemplates that a rate of return must consider "changing economic conditions" in order to be fair to existing customers and existing investors. The evidence presented by Duke in this case only considers changing economic conditions as they relate to the utility. While Duke presented extensive evidence regarding the alleged threats to its ability to raise capital in the current economic climate, Duke presented no evidence of changing economic conditions as they relate to customers. While Mr. Hevert attempts to bootstrap this consideration into his existing analysis, the statutory requirement is not satisfied by merely contending that the impact on customers is a derivative of the overall macroeconomic picture. Duke's other ROE witnesses likewise failed to assess the impact of changing economic conditions on customers and the fairness of the proposed ROE for customers.

An examination of the remaining record shows that other ROE witnesses did not consider changing economic conditions with respect to customers either. Mr. O'Donnell's testimony contains no discussion of economic conditions and Duke's customers. Similarly, the Public Staff's expert, Dr. Benjamin Johnson also failed to include any analysis with respect to economic conditions and Duke's customers. Dr. Johnson admitted that he did not consider the impact his recommended ROE range would have on Duke's customers. (Tp. Vol. 5, p. 287-88). Dr. Johnson stated, "[t]he focus of my testimony was more on how investors are dealing with economic conditions and less so on how customers are dealing with those same economic conditions." (Id. at 288). He elaborated that he "was not doing a specific calculation of whether, say, a five percent rate increase is more acceptable than seven and what the impact might be." (Id. at 289). Dr. Johnson confirmed that he did not specifically factor issues such as the unemployment rate, poverty rate, or consumer confidence levels in Duke's service area into his rate of return analysis. (Id. at 289). Instead, he opined that such factors were relevant in evaluating whether to phase-in rates over a period of time. (Id. at 289-90). Like Mr. Hevert, Dr. Johnson testified that he did not review the transcripts or exhibits from the public hearings nor did he review the correspondence, petitions or comments from customers filed in the docket. (Id. at 293). Dr. Johnson did assert that the impact of economic conditions on customers was an appropriate analysis that should be undertaken by the Commission, although he did not clearly explain how the Commission should properly conduct this analysis in light of the fact that the experts witnesses had not specifically undertaken it or provided evidence regarding it. (Id.).

Throughout the testimony in this case, there were several references made by witnesses regarding the overall economic climate. Mr. Brett Carter, one of Duke's witnesses, acknowledged the tough economic climate and the fact that many customers were having a tough time paying their bills. (Tp. Vol. 2, p. 133-34). Dr. Johnson included a discussion of general economic trends in his prefiled direct testimony. (Tp. Vol. 5, p. 180-95). Numerous customer witnesses testified throughout the public hearings regarding the hardship of higher electric bills and their ability – or inability - to pay such bills. (E.g., Tp. Vol. 1, p. 36-37, 56, 62-63, 69-70, 85-86, 92-93, 110-11, 113-15).

Again, however, mere acknowledgement of the overall economic climate and trends is insufficient to satisfy the requirements of § 62-133(b)(4). In order to comply with the statutory framework and requirements, the testimony regarding rate of return should, at a minimum, specifically: (1) evaluate economic conditions relevant to Duke's paying customers; and (2) incorporate those considerations into rate of return analysis and recommendations. The rate of return testimony should balance the rate of return investors expect against the economic conditions and returns the rest of Duke's customers are experiencing, and not just analyze investor expectations in isolation from impact on customers. The rate of return testimony in this case does not consider consumer economic conditions; thus, the record is insufficient to allow the Commission to render a decision regarding a rate of return that is fair to both customers and investors.

Therefore, the appropriate action for the Commission is to deny Duke's request for a rate increase and reject the Stipulation. Without proper evidence in the record, the Commission is unable to render the requisite findings with respect to a fair and reasonable rate of return. As Duke has failed to meet its burden of showing the proposed rates are just and reasonable, Duke is not entitled to a rate increase. In the alternative, the Commission could require the parties to provide additional evidence regarding the changing economic conditions contemplated by § 62-133(b)(4) and the resulting impact on consumers with respect to the witnesses' rate of return recommendations. While it is possible that consideration of the additional evidence may not change the recommended ranges, the Commission cannot make that determination absent such evidence. Additional evidence would provide a full record upon which the Commission can make an informed, legal decision with respect to a fair and reasonable rate of return.

## II. In any event, public policy considerations support a lower ROE and capital structure that is more beneficial for consumers: The detrimental impact of Duke's

**proposed rate increase on consumers is certain, while the expert testimony is speculative regarding the possible impact of a low-range ROE on Duke's ability to attract capital.**

While the lack of evidence in the record justifies the rejection of Duke's proposed rate increase and the Stipulation, should the Commission decide it has sufficient evidence to render a complete decision in this case, the Commission should adopt a lower rate of return and a capital structure that is more beneficial for consumers. The parties to the Stipulation (filed in this docket on December 1, 2011) agreed that the proposed increase in annual sales revenues were intended to provide the Applicant, "through sound management, the opportunity to earn a return on equity of 10.5%" and a capital structure of 53% equity and 47% debt. This will result in a rate increase to Duke customers of 7.2%. (Tp. Vol. 2, p. 57). Homeowners, businesses, and other Duke customers have endured job losses, declining home values, and lower manufacturing and sales in recent years. Thus, the detrimental impact of Duke's proposed rate increase on consumers, in the current economy, is concrete and certain. By contrast, the expert testimony is inherently speculative regarding the possible impact of a low-range ROE on Duke's ability to attract capital. In any event, Duke's status as a regulated public utility that is a monopoly provider of an essential service assures Duke of a relatively continuous and predictable revenue stream and a relative lack of risk compared to unregulated companies. Therefore, in this economic climate, the Commission should come down on the side of protecting consumers.

A. The impact of the proposed rate increase on customers is certain while the expert testimony warning of Duke's ability to attract capital is speculative.

As discussed in Section I above, the current economic environment facing Duke and its customers is directly relevant to the determination of ROE. While Dr. Johnson did not factor the impact of economic conditions on customers into his ROE analysis, his prefiled direct testimony does provide some overview of the current economic climate within which utilities and their customers operate. (Tp. Vol. 5, p. 156-68). Over the past few years, home prices have slumped, housing starts have fallen, manufacturing production and sales are down, GDP has fallen and unemployment has risen sharply. (Id.). Utility customers, both residential customers and businesses, are forced to stretch their dollars further and further in order to make ends meet. (E.g., Tp. Vol. 1, p. 36-37, 56, 62-63, 69-70, 85-86, 92-93, 110-15; Consumer Position Statements filed in Docket No. E-7, Sub 989). Thus, in this economy, the impact of a rate increase on consumers is certain and detrimental.

By contrast, the purported danger of Duke's ability to attract capital is speculative. Duke's ROE witnesses spend considerable time warning against the danger of setting Duke's ROE too low. However, this testimony is inherently speculative as the witnesses could not recall a specific time when Duke experienced difficulties in raising capital as a result of a reduction in authorized ROE. (Tp. Vol. 3, p. 335-36). This remains true even though a review of electric rate cases from the past several decades demonstrates Duke's authorized ROE in North Carolina has steadily declined. (Id.)

The speculative nature of the expert testimony is underscored by the fact that there was no consensus among the experts as to a ROE which would cause Duke to have an inability to attract sufficient capital. Mr. Hevert testified that 10.5% is outside his recommended range and is the lowest ROE that can be established in this case without harming Duke's ability to raise capital. Dr. Johnson and Mr. O'Donnell strongly disagree with his assessment and testified that the ROE could be a full 100 basis points lower without endangering Duke's ability to raise capital or maintain market ratings. (Tp. Vol. 5, p. 282, 286; Tp., Vol. 6, p. 185-98).

To the extent the Commission may be inclined to be concerned about Mr. Hevert's remarks about this supposed 10.5% threshold, the potential impact to Duke is ultimately minimal.  Duke stated during the hearing that it intends to file another rate case in 2012 (Tp. Vol. 2, p. 95); such rate case could be filed within months of the decision issued in this case.  Thus, in the unlikely event there is any adverse market reaction to an ROE established below 10.5%, the Commission will be in a position to analyze the market effect and make any adjustments it deems appropriate.  (Tp. Vol. 5, p. 272-73)  "The fixing of a rate of return shall not bar the fixing of a different rate of return in a subsequent proceeding."  N.C. Gen. Stat. § 62-133(e); Utilities Comm'n, 285 N.C. at 395.  This will not likely be necessary based on the extensive analysis provided by Dr. Johnson and Mr. O'Donnell finding that an appropriate and fair ROE falls below the 10.5% recommended in the Stipulation. Therefore, as between an impact on consumers that is certain and detrimental, and an impact on Duke's ability to raise capital that is speculative, the Commission should come down on the side of protecting consumers.

B. Duke's status as a regulated utility and monopoly provider of an essential service provides it with a relatively continuous and predictable revenue stream and a relative lack of risk.

While Duke seeks to justify a higher ROE based on overall market instability, Duke's status as a regulated monopoly affords it protection that most businesses lack.  Duke is different, when compared to unregulated businesses, with respect to the risks associated with its operations.  As monopolies, utilities enjoy exclusive service territories, limited or no competition for the essential services they provide, minimal variations in demand, and less impact from business cycle uncertainties.  (Tp. Vol. 5, p. 171-72).  As a result, the cost of equity for the average regulated utility company is much lower than that of the average unregulated company because revenue flows are more consistent and predictable as compared to unregulated businesses.  (Id. at 170).  While Duke's testimony argues for a higher ROE to attract investors, the North Carolina Supreme Court has opined on this concept:

> To attract capital, a utility does not need to charge, and is not entitled to charge, for its services rates which will make its shares, or its bonds, attractive to investors who are willing to risk substantial loss of principal in return for the possibility of abnormally high earnings. The reason is the utility, having a legal monopoly in an essential service, offers its investors a minimal risk of loss of principal.

Utilities Comm'n v. Telephone Co., 218 N.C. 318, 337-38 (1972). A public utility "has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures." Bluefield Water Works & Improvement Co. v. Public Service Comm'n, 262 U.S. 679, 692 (1923).

To the extent revenue falls below what is required to make a sufficient rate of return, Duke has the ability to apply for a rate increase through a general rate case. During tough economic times, unregulated companies must tighten their belts in order to address issues with their bottom line. An unregulated company may experience reduced profits or losses during economic slowdowns. A regulated utility, such as Duke, has a safety net that allows it to assure the continued recovery of an adequate revenue stream through sound management to support its balance sheet and compete for capital on favorable terms in the market.

An examination of the ROE testimony in this case shows that the experts focused on "investor expectations" with respect to returns on investment. While ROE must be established at a level that allows a utility by sound management to continue to have access to the capital markets, meeting investor expectations is not a component for establishing an ROE. Utility regulation is not designed to guarantee that investors will earn a return on their investments, but rather to ensure the adequacy of utility service to customers. General Telephone Co., 285 N.C. at 680. Duke's ROE should be established at the lowest level at which investors will continue to provide capital, but not at a level that grants shareholders a windfall from the pockets of customers. See Utilities Comm'n, 285 N.C. at 388.

North Carolina's public utilities law, as discussed above, generally entitles Duke to a fair rate of return that allows it, through sound management, the opportunity to: (1) recover its prudently invested capital and (2) earn a reasonable rate of return on that invested capital. However, the evidence presented in this matter does not establish that Duke must receive a ROE of 10.5% in the current economic climate to continue to attract investors. As shown in AG Hevert Cross Exhibit No. 1, during volatile economic times, "investors tend to seek out safe havens for their money, which as far as equities are concerned usually leads them to the utility sector. The industry's relative stability has been highlighted considerably over the past 12 months." (Tp. Vol. 3, p. 314). In the current economic climate, investors are likely to continue moving toward utility stocks due to relative stability and high dividend yields. (Id. at 315). The cost of equity needed to attract investors will continue to decline as more investors move toward utility stocks, particularly for financially strong utilities such as Duke. These factors compel adoption of a lower ROE and a capital structure that is more beneficial to consumers than those put forward in the Stipulation.

The ROE expert witnesses concede that a utility's actual cost of capital is subjective and, thus, recommend ranges within which an appropriate ROE should fall as opposed to a single point or percentage. (Tp. Vol. 5, p. 280-87; Tp. Vol. 3, p. 264-65, 322). Mr. Hevert introduces additional risk factors that he contends justify establishment of an ROE in the upper part of his range. In fact, if anything, additional factors, i.e., the prevailing economic conditions and their impact on customers, compel the targeted ROE to be established in the lower end of the proposed ranges. The failure to consider economic conditions on customers when establishing

ROE produces an overstated ROE that is both contrary to statutory mandates and unfair to customers.

## III. Even the testimony of the ROE witnesses does not support the 10.5% ROE in the Stipulation. Likewise, the Capital Structure set forth in the Stipulation is not supported by expert testimony or any other evidence in the record.

### A. The Expert Testimony in the Record Does Not Support the 10.5% ROE in the Stipulation.

In any event, even the specific testimony of the ROE expert witnesses compels adoption of a lower ROE, should the Commission deem the evidence to be sufficient for adoption of a ROE. Three expert witnesses pre-filed testimony regarding ROE. None of those experts proposed an ROE of 10.5%, the ROE set forth in the Stipulation, and only Duke's expert proposed a higher ROE.

#### 1. The ROE Ranges Presented by Dr. Johnson and Mr. O'Donnell Do Not Support the Stipulated ROE target

The ROE ranges presented by Dr. Johnson and Mr. O'Donnell closely reflect Duke's actual ROE and those of the industry as a whole. Both Dr. Johnson and Mr. O'Donnell used larger proxy groups than the proxy groups used by Mr. Hevert when undertaking their Discounted Cash Flow ("DCF") and Captial Asset Pricing Model (CAPM) analysis. Dr. Johnson analyzed 41 companies and recommended a composite ROE range of 8.68% to 9.79% and, assuming the Commission gives equal weight to the Comparative Earnings and Market Approaches, a specific ROE just above the midpoint at 9.25%. (Id. at 252). Mr. O'Donnell, testifying for the Carolina Utility Customers Association, Inc. ("CUCA"), recommended a ROE range of 8.75% to 9.75% and a specific ROE of 9.5%. (Tr. Vol. 6, p. 185).

##### a. Dr. Johnson's Testimony Supports a Lower ROE

On cross examination, Dr. Johnson testified that he believed the overall stipulation between Duke and the Public Staff seemed "reasonable" to him even though the allowed ROE of 10.5% contained in the Stipulation was higher than and fell outside of his composite recommended range. (Tp. Vol. 5, p. 278). Dr. Johnson admitted on cross examination that a lower ROE of 9.5% would also be reasonable in this case. (Id. at 282, 286). He went so far as to state that an ROE of 9.0% might be reasonable, but he believed additional calculations would need to be performed to ensure there would be no risk to Duke's ability to raise equity or debt. (Id.)

During cross examination, Dr. Johnson attempted to construe his recommended ranges as supporting the Stipulation by pointing to the range produced by his Comparable Earnings analysis, which produced a range of 9.75% to 10.75%. (BJA Schedule 22). On cross examination, Dr. Johnson construed 10.5% as the "midway between the midpoint and the high of the comparable earnings approach" but conceded that such approach "does not focus on short-term securities markets at all; so the recent drop in interest rates and the drop in the opportunity to reach capital that is being signaled by security markets is simply not a part of that analysis." (Tp. Vol. 5, p. 279). Thus, there are significant shortcomings in solely relying on Dr. Johnson's Comparable Earnings approach when establishing ROE. In Duke Power v. Public Staff, 331 N.C. 215, 225 (1992) ("Duke Power II"), the Supreme Court rejected a similar approach where this Commission relied solely on one methodology that was called into question. Id. at 225. The Market Approach used by Dr. Johnson incorporates broader concepts and data and results in a significantly lower ROE range of 7.60% and 8.83%. (BJA Schedule 22).

There are a variety of methods used to estimate a utility's ROE and the Commission has the discretion to give greater or lesser weight to one method versus another. (Tp. Vol. 5, p. 276).

However, there must be adequate evidence in the record, in light of evidence to the contrary, to support the Commission's legal conclusion. Duke Power II, 331 N.C. at 225. Dr. Johnson established his recommended ROE of 9.25% by giving equal weight to both his comparable earnings and market approach methods. (Id. at 252, 280-81). While Dr. Johnson states that the Commission must assign appropriate weight to each methodology, the Commission has been given no reason to assign greater or lesser weight to either of his methods. For the Commission to adopt the 10.5% targeted ROE contained in the Stipulation, the Commission would have to assign significantly more weight to Dr. Johnson's Comparable Earnings approach. The Commission would have to virtually discard Dr. Johnson's Market Approach, which includes DCF and CAPM methods, well-established methods of ROE evaluation. A more appropriate methodology, should the Commission go down this path, would incorporate significant components of both analyses.

b. Mr. O'Donnell's Testimony Supports a Lower ROE

Mr. O'Donnell's recommended ROE range of 8.75% to 9.75% and an actual ROE of 9.5% also falls below the 10.5% targeted ROE contained in the Stipulation. Mr. O'Donnell undertook a DCF analysis and CAPM analysis in reaching his recommendations. Mr. O'Donnell testified that his recommendations are in-line with the testimony of many other rate of return witnesses across the country who have recommended ROEs of 9.4% (Nevada), 9.7% (Nevada) and 10.17% (Virginia). (Tp. Vol. 6, p. 186). Mr. O'Donnell also points out that Duke's ROE testimony is contrary to the 8.5% rate of return it requests the Commission use to base its pension expense calculations. (Id. at 186-87).

c. Mr. Hevert's Analysis Overstates the Appropriate ROE

Mr. Hevert's ROE range is a shifting target, which underscores the subjectivity of his testimony. In his direct testimony dated July 1, 2011, Mr. Hevert stated that he believed that a "rate of return on common equity in the range of 11.00 percent to 11.75 percent represents the range of equity investors' required rate of return for investment in integrated electric utilities similar to Duke Energy Carolinas in today's capital markets. Within that range, I recommend an ROE of 11.50 percent." (Tp. Vol. 3, p. 126). In his rebuttal testimony dated November 16, 2011, Mr. Hevert revised his analysis downward and recommended a range from 10.75% to 11.50% and found 11.25% to be a "reasonable and appropriate estimate of the Company's Cost of Equity." (Id. at 227). Mr. Hevert's recommended range of 10.75% to 11.50% does not encompass the 10.5% ROE contained in the Stipulation. Then, Mr. Hevert's recommendation varied further during cross examination at the hearing when he stated that the 10.50% ROE contained in the Stipulation was fair, even though it fell outside of his recommended range. (Tr. Vol. 3, p. 263).

Indeed, Mr. Hevert's speculation about the minimum level of ROE needed for Duke to attract investment capital is not persuasive given his track record as an expert witness. He conceded during cross-examination that, out of a long list of cases from the last two years in which he testified for utilities in other states, state commissions have ultimately approved ROEs lower than the bottom of his recommended range in all but one case. (Tr. Vol. 3, p. 275).

Simply put, Mr. Hevert's recommended ROE range remains overstated even after his downward adjustments. As Public Staff witness Johnson testified, Mr. Hevert's analyses are "deeply flawed, resulting in equity cost estimates that are substantially higher than would have resulted from the use of less biased, more appropriate data and procedures." (Tp. Vol. 5 p. 245).

Mr. Hevert applied the DCF model and the CAPM in reaching his recommendation. He stated that he took into account other considerations, such as the level of coal-fired and nuclear generation owned by Duke, incremental risks for substantial capital expenditures, and flotation costs associated with equity issuances, when determining Duke's ROE. Several aspects of Mr. Hevert's analysis give an incomplete assessment or cause him to overstate the appropriate ROE range in this case.

First, Mr. Hevert uses an overly narrow proxy group that is not representative of the electric industry as a whole. Mr. Hevert's proxy group eliminates firms that failed to meet any **one** of his criteria, which is overly restrictive. (Tp. Vol. 5, p. 228-30). Such overly selective screens allow Mr. Hevert to cherry pick the data he wishes to include and exclude, thereby biasing his results. (Id. at 233-34). For example, Mr. Hevert's removal of all companies that are not covered by at least two utility industry equity analysts or lack investment grade bond ratings skews the "proxy group away from a true industry average and toward a more elite group of companies that has recently been enjoying better than average financial performance and thus currently displays a lower than average risk profile." (Id. at 231-32). Dr. Johnson discussed this problem in more detail, stating:

> Poorly performing and less successful firms should not be removed from the comparison group, because this skews the data. It is better to start with a broad, unbiased group of firms, and then adjust for any differences in risk that may exist at the end of the process. Rather than cherry picking a specific sample group, it is preferable to follow the process used by professional pollsters, who start with a broad, representative sample, then analyze specific sub-samples, or make explicit adjustments to the data at a later stage in their analysis, when this is unavoidably necessary to deal with unexpected discrepancies in the sample group demographics or other key attributes, relative to the intended population being studied.

(Id. at 233). By including only the most successful firms in his proxy group, Mr. Hevert overstates the ROE for the industry as a whole, which produces an overstated ROE that is larger than necessary for Duke to be able to compete in the capital markets.

Mr. Hevert's attempt to control for discrete risk factors further reduces the size of an already small proxy group. Dr. Johnson testified, "if Mr. Hevert believes there are risk differences (as I do), between a broad cross section of electric utilities and the Company, he should make an explicit adjustment at the end of the analysis to account for those risk differences—and offer testimony defending that adjustment, so the Commission can decide whether it agrees with the adjustment." (Id. at 234). As discussed below, Mr. Hevert introduced several risk factors that he believes should be considered when establishing the ROE, but he failed to make any adjustments related thereto. Mr. Hevert's attempt to account for all risk factors through his screens produces an overly small proxy group size that is unrepresentative of the general industry. Even Mr. Hevert's revised proxy group is overly narrow, adding only three additional companies while eliminating one.

Additionally, Mr. Hevert's original and revised proxy groups contain only two electric utilities located in the southeastern United States and he otherwise fails to account for regional risks that Duke experiences. (Tp. Vol. 3, p. 337). The United States Supreme Court has stated that locality is an appropriate consideration when establishing rate of return. Bluefield, 262 U.S. at 693 (citing Willcox v. Consolidated Gas Co., 212 U.S. 19, 48-50 (1909)); General Tel. Co., 281 N.C. at 340-41 (quoting Smith v. Illinois Bell Tel. Co., 282 U.S. 133, 160). Mr. Hevert passed on the opportunity to include additional regional electric utilities, such as Dominion, Progress Energy and SCANA, thus failing to include a sufficient number of utilities that share the same geographical considerations as Duke. Mr. Hevert conceded that electric utilities in the southeast experience different weather conditions than other parts of the country, but his proxy group is weighted toward other geographic regions. (Id. at 338, 341). The proxy group also does not account for different transmission or customer conditions that are unique to an electric utility located in the southeast, such as Duke. (Id. at 338-39). Each of these conditions represents a risk variable within an electric utility's operation and should be considered when establishing ROE. Without inclusion of sufficient regional electric utilities, Mr. Hevert's proxy group fails to adequately account for regional risks experienced by Duke.

Second, Mr. Hevert identifies a number of issues that he believes impact Duke's cost of equity, including: the level of coal-fired and nuclear generation owned by Duke, incremental risks for substantial capital expenditures, environmental compliance expenditures and flotation costs associated with equity issuances. He contends that these are risks that impact the return that an investor expects to receive on his investment in order to invest in the company. However, none of these risks are sufficiently discrete or unique to justify a higher ROE and Mr. Hevert has failed to provide any quantification of the impact they might have.

The fact that Duke has significant coal-fired generation and existing nuclear generation does not mean there is a material increase in risk as inferred by Mr. Hevert. Mr. Hevert's analysis fails to consider the relative risks of other generating options, such as high dependence on natural gas and oil units. Furthermore, as a regulated public utility in North Carolina, Duke has the opportunity to recover its capital investment, plus a reasonable rate of return, from customers through rates established by the Commission. A plant's fuel source, whether it is gas, coal or nuclear, is not material to a utility's ability to recover its prudently invested capital. Further, while Mr. Hevert implies that changing environmental regulations increases the risk of coal facilities, he overlooks the fact that prudent capital investments undertaken to comply with those environmental regulations can be recovered from customers along with a reasonable rate of return on the capital investment. To the extent that more stringent environmental regulations increase operating expenses, Duke will be able to recover such expenses through rates from customers as well. Mr. Hevert agreed with these concepts during cross examination. (Id. at 295-97). Moreover, as the Commission is aware, Duke is already ahead of other coal-burning electric utilities in addressing new environmental regulations due to the Smokestacks legislation and the conditions in the Cliffside certificate proceeding that require the retirement of certain coal plants.

Mr. Hevert also cited general fears arising from the Fukushima nuclear power incident in Japan in March 2011 as a risk factor for Duke. On cross examination, Mr. Hevert admitted that the perceived risk to Duke arising out of the incident is speculative. It is also important to note that since potential investors are largely aware of these risks when they choose to invest in a regulated utility (Id. at 322), there is no need to include these risks as an independent factor when establishing ROE.

Mr. Hevert also contends that flotation costs for stock issuances should be considered when establishing ROE. Flotation costs are the costs that a utility incurs when issuing stock. (Tp. 331-32). The North Carolina Supreme Court has rejected attempts to include flotation costs as a component of ROE in the past. Duke Power II, 331 N.C. at 221. In that case, the Supreme Court found that there was insufficient evidence in the record to justify a higher ROE as a result of flotation costs when there was no evidence that Duke intended a prospective stock issuance. Id. at 221. The Court held that consideration of flotation costs was erroneous. Id. The exact same scenario exists in the present case. There is no evidence in the record that Duke plans to issue new stock in the future. In fact, Duke witness DeMay expressly stated that Duke does not intend to make a stock offering in the foreseeable future based on its current business plan. (Tp.

Vol. 3, p. 287). Without evidence of a forthcoming stock issuance, the Supreme Court's holding requires the Commission to ignore flotation costs when establishing ROE.

Notwithstanding this Supreme Court precedent, it would be inappropriate, as a matter of policy, to allow flotation costs to impact the ROE range and recommendation. Mr. Hevert characterized flotation costs as both direct and indirect costs. (Tp. 331-32). To the extent flotation costs are direct and able to be measured, they should be amortized or otherwise quantified in a manner to be recovered in rates. It is unreasonable and inappropriate to extract direct, measurable costs from customers through the subjective adjustment of Duke's ROE. To the extent the costs are indirect, and thus speculative, it is reasonable for shareholders to bear such cost. As the Supreme Court indicated in <u>Duke Power II</u>, it is not the job of the Commission to protect investors from swings in market prices. <u>See</u> <u>id.</u> at 225. Duke's customers should not be required to pay a premium to compensate shareholders for indirect costs resulting from market pressures or diluted earnings associated with floating new stock. (Id. at 331).

Third, it is unclear how Mr. Hevert factored into his ROE recommendation the level of coal-fired and nuclear generation owned by Duke, incremental risks for substantial capital expenditures, and flotation costs associated with equity issuances. Mr. Hevert testified that "[w]hile I did not make any explicit adjustments to my ROE estimates for those factors, I did take them into consideration when determining where [sic] the Company's cost of equity." (Id. at 65). From his answers on cross examination, it appears that Mr. Hevert used these factors to justify an ROE in the higher end of his recommended range. (Id. at 266). However, he admitted that he was unable to quantify the extent to which any single factor justified a higher ROE. (Id.) As discussed above, these risks are overstated and do not reflect actual risks that Duke encounters in the market for capital. For the most part, these risks are already accounted for in the market analysis by Mr. Hevert since investors are aware of these issues. See Bluefield, 262 U.S. at 694 (stating that "[i]nvestors take into account the result of past operations, especially in recent years, when determining the terms upon which they will invest in such an undertaking.") Citing them independently in the ROE analysis skews Mr. Hevert's ROE range and recommendation.

Mr. Hevert's failure to quantify these risks limits the Commission's ability to incorporate any of these factors into its final ROE determination. The North Carolina Supreme Court has stated that specific adjustments for ROE require specific support in the record to permit meaningful appellate review of the Commission's rate of return decision. Duke Power I, 322 N.C. at 701. Duke has failed to present any evidence justifying specific adjustments to the ROE; thus, there appears to be no meaningful way for the Commission to factor in these alleged risks.

d. The Commission Should Deny Duke's Requested Rate Increase or Elicit Additional Testimony to Accurately Establish an Appropriate ROE

The testimony in the record, when considering evidence to the contrary, does not support the target ROE contained in the Stipulation. Therefore, the ROE in the Stipulation must be rejected. The prefiled rebuttal testimony of Mr. Hevert only supports an ROE range of 10.75% to 11.50%. Dr. Johnson's prefiled rebuttal testimony recommended a composite ROE range of 8.68% to 9.79%. Mr. O'Donnell recommended a ROE range of 8.75% to 9.75%. None of these recommended ROE ranges encompasses the 10.5% targeted ROE contained in the Stipulation.

While Mr. Hevert and Dr. Johnson attempted to include 10.5% ROE within their acceptable ranges in response to cross examination in order to support the Stipulation, such "revised recommendations" are unsupported by the factual analysis contained in their prefiled testimonies. Dr. Johnson and Mr. Hevert attempt to reconcile their testimony to support the

Stipulation on the basis that the overall circumstances make it reasonable. However, N.C. Gen. Stat. § 62-133(b)(4) does not provide a mechanism whereby the Commission can vary ROE in exchange for other trade-offs in the case. The Commission must make an independent ROE determination based upon the factual evidence contained in the record. Duke Power I, 322 N.C. at 693. The factual evidence in this case does not support the adoption of a 10.5% ROE.

Only one of Dr. Johnson's analytical components produced a range that encompassed an ROE of 10.5%. However, the Supreme Court has previously rejected the Commission's sole reliance on a single method when the reliability of that method is questioned. See Duke Power II, 331 N.C. at 225. Just as in Duke Power II, sole reliance on Dr. Johnson's Comparable Earnings analysis is insufficient to support a legal conclusion that 10.5% is a fair and reasonable return in this case. Even Duke witness Hevert testified that it is important to use different methodologies when estimating the cost of equity because each model has limiting factors and reliance on any single method can lead to "flawed or irrelevant conclusions." (Tp. Vol. 3, p. 91-92). When considering the entire record and the various methodologies used by the ROE witnesses, the greater weight of the testimony compels that the ROE be established below the 10.5% target contained in the Stipulation.

B. The Capital Structure in the Stipulation is Inappropriate and Should be Rejected

The Commission should also reject the capital structure set forth in the Stipulation because such a change would result in approximately a $7.66 million increase for consumers for each half a percentage point of equity (Tp. Vol. 4, p. 36) and nothing in the record supports such a change. While a significant portion of any rate increase will flow from the established ROE, the allocation of the capital structure for establishing those rates also directly impacts customers. Equity is a more expensive form of capital than debt; thus, Duke's customers will pay higher rates to the extent Duke's authorized capital structure is weighted more heavily toward equity. Duke Power II, 332 N.C. at 697-98, 701-02; Tp. Vol. 3, p. 285.

Duke witnesses Stephen DeMay and Steven Fetter advocate that a 53% equity to 47% debt ratio be used to establish rates in this case. Public Staff witness Johnson recommended that the Commission use a hypothetical 50% equity to 50% debt ratio to establish rates in this case. The capital ratio used to establish rates in the previous Duke rate case was 52.5% equity and 47.5% debt.

Dr. Johnson testified that the average equity ratio for the comparable industry group is 47.5% equity, which is significantly lower than his proposed 50/50 structure or Duke's proposed 53/47 structure. (Tp. Vol. 5, p. 146) A 50/50 capital structure is not dramatically different than Duke's actual capital structure or its consolidated capital structure, thus a 50/50 capital structure would not be burdensome to implement. (Id.). Moreover, Dr. Johnson also points out that it is within the discretion of Duke's management to determine the actual capital structure it wishes to use on a daily basis. (Id. at 147).

Mr. Fetter testified that Duke's actual equity and debt levels are 56% equity and 44% debt, which represents a 3.5% variation from the Applicant's current authorized capital structure. (Tp. Vol. 3, p. 249). There is no evidence in the record that the added equity is needed. Mr. DeMay testified that Duke can vary its capital structure through retained earnings or debt issuances and that it seeks to target its allowed capital structure. The fact that Duke currently deviates from its proposed capital structure by 3.5% begs the question as to whether there would be any material impact if Duke deviated by 4%, 5% or 6%.

Instead of the capital structure proposed in the Stipulation, the Commission should adopt the 50/50 capital structure recommended by Public Staff witness Johnson in this case for the reasons provided in his testimony. A 50/50 capital structure is less costly than the ratio requested by the Applicant (Tp. Vol. 5, p. 146), and there is no evidence in the record that it would be unreasonable to establish rates using such a ratio. Duke remains free to adjust its actual capital structure as it deems appropriate. (Tp. Vol. 4, p. 33); See General Tel. Co., 281 N.C. at 341. In fact, Duke has done this since the previous rate case. In response to questions from Commissioner Culpepper, Mr. DeMay testified that Duke believed that 53% equity was an appropriate capital structure, despite the fact that the Commission authorized a capital structure consisting of 52.5% equity. (Id.)

Duke customers should not be required to pay higher rates simply because Duke prefers to maintain a higher level of equity, as opposed to debt, on its books. While 0.5% may seem trivial on its face, the testimony in the record shows that for each half a percentage point of equity within the capital structure the impact is approximately $7.6 million on what Duke's customers will be required to pay in rates. (Id. at 36). A 50/50 capital structure remains more conservative and more costly to ratepayers than the industry average (Tp. Vol. 5, p. 146), but it is considerably more equitable to ratepayers than the 53/47 structure proposed by the Duke.

In no event should an equity ratio higher than 52.5% (the current ratio) be used to establish rates in this case. Duke has presented no evidence as to why its capital ratio should include an additional .5% equity in this case when compared to the previous rate case. There is no evidence in the record that the previous structure undermined Duke's balance sheet or its credit ratings. There is also no evidence that Duke requires additional equity (as opposed to debt) in order to meet its electric service obligations or undertake necessary projects. As discussed above, Duke has varied its capital structure from the Commission's authorized capital ratio in the previous rate case. If Duke believes that a 53/47 ratio remains preferable going forward, it can continue to maintain that ratio on its books. However, Duke's ratepayers should not be required to pay an additional $7.66 million in rates per half percentage point because of Duke's preference without any evidence in the record that such an increase in equity levels is necessary or appropriate. General Tel. Co., 281 N.C. at 341.

## CONCLUSION

For the foregoing reasons, there is insufficient evidence in the record to allow the Commission to establish a reasonable rate of return because there is insufficient evidence in the record regarding changing economic conditions and the effect of the rate of return on consumers, as required by Chapter 62. If, however, the Commission decides that sufficient evidence has been provided to issue a decision in this matter, public policy considerations and the evidence do not support the excessive return on equity and equity-to-debt capital structure proposed in the Stipulation, and both of those elements should be modified downward by the Commission in order to sufficiently protect consumers.

Respectfully submitted, this the 9th day of January, 2012.

**BY:** ________________

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**CERTIFICATE OF SERVICE**

I, the undersigned counsel for the North Carolina Attorney General's Office, do hereby certify that I served a copy of the foregoing document upon legal counsel for all parties of record in this proceeding by electronic mail or U.S. mail.

This the 9th day of January, 2012.

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Margaret A. Force