

BEFORE THE CORPORATION COMMISSION OF OKLAHOMA

APPLICATION OF THE EMPIRE
DISTRICT ELECTRIC COMPANY, A
KANSAS CORPORATION, FOR AN
ADJUSTMENT IN ITS RATES AND
CHARGES FOR ELECTRIC SERVICE IN
THE STATE OF OKLAHOMA

CASE NO. PUD 201600468

REBUTTAL TESTIMONY OF

DAVID J. GARRETT

FILED
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CORPORATION COMMISSION
OF OKLAHOMA

ON BEHALF OF

OKLAHOMA INDUSTRIAL ENERGY CONSUMERS

APRIL 3, 2017

Q. State your name and occupation.

1 A. My name is David J. Garrett. I am a consultant specializing in public utility regulation. I
2 am the managing member of Resolve Utility Consulting, PLLC. I focus my practice on
3 the primary capital recovery mechanisms for public utility companies: cost of capital and
4 depreciation.

Q. Did you previously file testimony in this matter?

5 A. Yes. I filed Parts I and II of my Direct Testimony on March 13, 2017, regarding cost of
6 capital and depreciation respectively.

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

7 A. I am testifying on behalf of Oklahoma Industrial Energy Consumers ("OIEC"). OIEC is
8 an unincorporated association of companies with facilities in Oklahoma that require
9 significant energy usage.

Q. What is the purpose of your rebuttal testimony?

10 A. My rebuttal testimony addresses the cost of capital issues in the Responsive Testimony of
11 Geoffrey M. Rush, filed March 13, 2017 on behalf of the Public Utility Division ("PUD").

Q. Please summarize your rebuttal to Mr. Rush's cost of capital testimony.

12 A. There are many aspects of Mr. Rush's testimony that I agree with on a conceptual level,
13 however, I disagree with his overall awarded rate of return recommendation because it does
14 not comport with the rest of his cost of equity analysis and testimony. Mr. Rush presents
15 strong empirical evidence that Empire's cost of equity is well below 8.0%, yet his ultimate

1 recommendation is to simply accept the Company's filed position, which requests a 9.9%
2 return on equity ("ROE").

Q. Describe the parts of Mr. Rush's analysis and testimony with which you agree.

3 A. I agree with many aspects of Mr. Rush's analysis, which are briefly summarized below,
4 and organized by the sections outlined in Mr. Rush's responsive testimony. It is important
5 to identify these areas of agreement because, as discussed later in this testimony, Mr.
6 Rush's final recommendation regarding the awarded return on equity does not comport
7 with these important aspects upon which we agree.

8 1. Legal Standard

9 Mr. Rush correctly states that the Supreme Court standards governing this issue indicate
10 that the allowed rate of return from the Commission should reflect Empire's actual cost of
11 equity.¹ Mr. Rush also states that the best starting point for assessing a reasonable range
12 for the allowed return is the Company's true required rate of return (or actual cost of
13 equity).² I agree.

14 2. DCF Analysis

15 Mr. Rush and I take similar approaches to calculating the DCF Model. Consequently, our
16 DCF Models produced similar results. Specifically, my DCF Model produced a cost of
17 equity of 7.6%, while Mr. Rush's DCF Model produced a lower cost of equity of 7.1%,
18 which is a very reasonable result.³ More importantly, Mr. Rush states that his DCF result

¹ See generally Responsive Testimony of Geoffrey M. Rush, p. 10:11 – p. 11:6.

² See *id.* at p. 11:3-6.

³ *Id.* at p. 25:11.

1 of 7.1% was “the result that was considered in the final cost of capital recommendation,
2 along with the results of the other models.”⁴

3 3. CAPM Analysis

4 Mr. Rush and I also take similar approaches to calculating the CAPM. My CAPM
5 produced a cost of equity of 7.4%, while Mr. Rush’s CAPM produced a lower cost of
6 equity of 6.8%, which I would consider reasonable. As stated in my testimony, because I
7 selected the highest reasonable estimate for the equity risk premium that I could find, the
8 final results of my CAPM (7.4%) are “at the higher end of the reasonable range.”⁵ Thus,
9 in my opinion, Mr. Rush’s CAPM result of 6.8% is within a reasonable range for Empire’s
10 cost of equity. As with Mr. Rush’s DCF result, Mr. Rush said that his CAPM cost of equity
11 of 6.8% was “the rate that was considered in [his] final cost of equity analysis.”⁶

12 4. Comparable Earnings Analysis

13 Although I did not conduct a comparable earnings model in this case, I strongly agree with
14 several points that Mr. Rush makes about this model. The comparable earnings model
15 looks at the earned returns of other utility companies to purportedly assess a fair awarded
16 rate of return. According to Mr. Rush: “Regulators have a duty to stand in the place of
17 competition, and that duty cannot be adequately accomplished by simply awarding returns
18 on equity based on the earned returns of other utilities.”⁷ I strongly agree with this
19 assessment. I also agree with Mr. Rush that the comparable earnings model “is the weakest

⁴ *Id.* at p. 25:11-12.

⁵ Responsive Testimony of David J. Garrett, Part I – Cost of Capital, p. 66:2-4.

⁶ Responsive Testimony of Geoffrey M. Rush, p. 34:7-9.

⁷ *Id.* at p. 35:6-8.

1 of the three models presented in this Cause”⁸ and that it should be “considered with
2 caution.”⁹

Q. Does Mr. Rush’s recommendation regarding the awarded return on equity comport with his analysis?

3 A. No. Mr. Rush conducted a thorough and reasonable analysis regarding Empire’s cost of
4 equity, and I agree with the vast majority of his analysis. The following points summarize
5 the pertinent parts of Mr. Rush’s testimony:

1. The awarded return on equity for Empire should be based on the Company’s cost of equity according to the Supreme Court;¹⁰
2. Empire’s requested return of on equity of 9.9% is well above the Company’s actual cost of equity;¹¹
3. The DCF Model indicates Empire’s cost of equity is 7.12%, which is the result Mr. Rush considered in his ROE recommendation;¹²
4. The CAPM indicates Empire’s cost of equity is 6.79%, which is the result Mr. Rush considered in his ROE recommendation;¹³
5. The comparable earnings model is the weakest of all the models presented in this cause and should be considered with caution;¹⁴
6. “The average cost of equity resulting from each of the three models used in this Cause was 7.91 percent;”¹⁵

⁸ *Id.* at p. 35:10-14.

⁹ *Id.* at p. 35:10-10.

¹⁰ *Id.* at p. 10:48-49.

¹¹ *Id.* at p. 7:15-19.

¹² *Id.* at p. 25:11-12.

¹³ *Id.* at p. 34:7-9.

¹⁴ *Id.* at p. 35:3-17.

¹⁵ *Id.* at p. 36:1-3.

7. “Empire’s true cost of equity is very likely below 8.0 percent;”¹⁶
8. “PUD is recommending an awarded return above the true required return *in the interest of gradualism* and fairness to the Company;”
9. PUD recommends an awarded ROE of 9.9% for Empire.¹⁷

1 The first eight points listed above are all very reasonable statements and assessments with
2 which I do not disagree. These first eight points are based on what appears to be a thorough
3 and reasonable analysis of Empire’s cost of equity. However, the ninth point on the list
4 does not agree with the first eight points. That is, if the awarded return should be based on
5 the cost of equity, and the models indicate that Empire’s cost of equity is below 8.0%, and
6 PUD is expressing an interest in gradualism, then the awarded ROE recommended by PUD
7 should be below Empire’s requested 9.9% ROE. In other words, if we should be gradually
8 moving toward true cost of equity, then accepting Empire’s requested ROE of 9.9% (which
9 we both agree is far above the Company’s actual cost of equity), does not accomplish that
10 objective. Another reason why Mr. Rush’s final ROE recommendation of 9.9% is
11 confusing is because Mr. Rush states that his DCF result (7.12%) and his CAPM result
12 (6.79%) are the results he considered when making his final recommendation.

13 **Q. In your opinion, what awarded rate of return should represent a gradual move
14 towards the Company’s actual cost of equity as suggested in Mr. Rush’s testimony?**

15 **A.** As discussed in my responsive testimony, I believe an awarded return on equity of 9.0%
represents a gradual move towards true cost of equity. Arguably, it would be more “fair”
to award Empire with a return on equity even lower than 9.0%, because when the awarded

¹⁶ *Id.* at p. 7:15-16.

¹⁷ *Id.* at p. 7:16-18.

1 rate of return exceeds true cost of equity, it results in an excess transfer of wealth from
2 customers to shareholders. Mr. Rush also agrees with this conclusion.¹⁸ Empire's current
3 awarded ROE is 10.19%.¹⁹ According to Mr. Rush, Empire's actual, current cost of equity
4 is about 7.91%.²⁰ If this Commission was to start at Empire's current awarded return on
5 equity of 10.19% and move only "halfway" towards Empire's actual cost of equity
6 according to Mr. Rush, then the Commission would arrive at an awarded ROE of about
7 9.0%, which is the awarded ROE that I recommended in my testimony.²¹

Q. Do you agree with Mr. Rush's recommendation regarding Empire's awarded ROE?

8 A. No. Although I agree with the vast majority of Mr. Rush's analysis and assessments
9 regarding Empire's cost of equity, as well as the fact that we should be gradually moving
10 awarded returns on equity towards true cost of equity, I cannot agree with Mr. Rush's
11 recommendation regarding Empire's awarded ROE because it does not comport with the
12 rest of his analysis. However, I would strongly encourage the Commission to consider the
13 first eight points from Mr. Rush's testimony listed above when making its decision
14 regarding Empire's awarded ROE. Both Mr. Rush and I present strong empirical evidence
15 for the fact that Empire's actual cost of equity is well below 8.0%.

¹⁸ *Id.* at p. 10:21-22.

¹⁹ Order No. 592623, entered January 4, 2012 in Cause No. PUD 201100082, p. 5.

²⁰ Responsive Testimony of Geoffrey M. Rush, p. 36:1-3. Note that Empire's actual cost of equity is likely lower than 7.91%. The average of Mr. Rush's DCF and CAPM results in a cost of equity of only 6.96%. Mr. Rush considered the comparable earnings model in order to arrive at the higher cost of equity of 7.91%. Both Mr. Rush and I agree that a regulator standing in the place of competition cannot adequately assess the awarded return by simply looking at the historical earned returns of other utilities, which is what the comparable earnings model does.

²¹ 9.05% is the midway point between Empire's current ROE of 10.19% and Mr. Rush cost of equity estimate of 7.91%.

Q. Does this conclude your testimony?

1 A. Yes. To the extent I did not address an assertion made by another party, it does not
2 constitute an agreement with such assertion.

Respectfully Submitted,



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