

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF NEBRASKA**

In the Matter of the Application of)	
Black Hills/Nebraska Gas Company, LLC)	Application No. NG-0086
d/b/a Black Hills Energy for Approval of)	
its Cost of Service Gas Hedge Agreement with)	
Black Hills Utility Holdings, Inc.)	

REBUTTAL TESTIMONY OF

ADRIEN M. MCKENZIE, CFA

**On Behalf of Black Hills/Nebraska Gas Utility Company, LLC, d/b/a Black Hills Energy
And
Black Hills Utility Holdings, Inc.**

March 29, 2016

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I. INTRODUCTION

1 **Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A1. Adrien M. McKenzie, 3907 Red River, Austin, Texas, 78751.

3 **Q2. DID YOU PREVIOUSLY SUBMIT DIRECT TESTIMONY IN THIS CASE?**

4 A2. Yes, I did.

5 **Q3. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

6 A3. The purpose of my rebuttal testimony is to respond to the direct testimony of Mr.
7 Michael J. McGarry Sr., submitted on behalf of the Nebraska Public Advocate (“PA”),
8 and Mr. Stephen Bennett, on behalf of Constellation NewEnergy-Gas Division, LLC
9 (“CNEG”), concerning the fair rate of return on common equity (“ROE”) and capital
10 structure provided for by the Cost of Service Gas Program (“COSG Program”).

11 **Q4. PLEASE SUMMARIZE THE PRINCIPAL CONCLUSIONS OF YOUR**
12 **REBUTTAL TESTIMONY.**

13 A4. My rebuttal testimony demonstrates that:

- 14 • PA and CNEG offer an incomplete portrayal of the risks to
15 shareholders and the benefits to customers under the COSG Program;
- 16 • Contrary to PA and CNEG’s position, investors in the COSG Program
17 are not guaranteed a return that will compensate them for their cost of
18 equity capital;
- 19 • The ROE benchmark under the COSG Program expands regulatory
20 oversight to include returns that are now governed solely by
21 competitive market forces;
- 22 • PA’s ROE proposal ignores the unified, multi-jurisdictional nature of
23 the COSG Program, and would lead to greater administrative costs and
24 complexity;
- 25 • Contrary to CNEG’s assertions, the traditional regulatory paradigm
26 does not guarantee a static ROE and the Regulatory Research
27 Associates’ (“RRA”) benchmark specified under the COSG

- 1 Agreement offers an objective, unbiased approach to accommodate
2 changes in capital market conditions on an ongoing basis;
- 3 • The ROE provision under the COSG Program is consistent with
4 regulatory mechanisms employed throughout the utility industry,
5 which include formula rates; and
 - 6 • The capital structure specified under the COSG Agreement falls within
7 the bounds of utility industry benchmarks and reflects the hybrid
8 nature of the COSG Program and its specific risks and capital
9 requirements.

II. RESPONSE TO PA

10 **Q5. WHAT IS THE PURPOSE OF THIS SECTION OF YOUR REBUTTAL**
11 **TESTIMONY?**

12 A5. This section responds to the direct testimony of Mr. McGarry concerning the ROE
13 and capital structure applicable to the COSG Program.

A. Return on Equity

14 **Q6. DO YOU AGREE WITH MR. MCGARRY'S PORTRAYAL OF**
15 **SHAREHOLDERS' RISKS UNDER THE COSG PROGRAM?**

16 A6. No. Mr. McGarry's description of the risks assumed by common equity investors is
17 incomplete and inaccurate. Specifically, while acknowledging that the ROE under
18 the COSG Program may fall 100 basis points below the cost of equity benchmark
19 established by the COSG Agreement ("Allowed ROE"),¹ Mr. McGarry wrongly
20 asserts that Nebraska customers "will absorb any and all fluctuations in costs of this
21 program" and that investors' return is "guaranteed."²

¹ McGarry Direct Testimony, Page MJM-19.

² *Id.*, Pages MJM-18-19.

1 **Q7. ARE INVESTORS GUARANTEED TO EARN THEIR COST OF CAPITAL**
2 **UNDER THE COSG PROGRAM?**

3 A7. No. As Mr. McGarry correctly points out,³ the actual ROE achieved under the COSG
4 Program may fall 100 basis points below the Allowed ROE established by the COSG
5 Agreement. As a result, investors assume the risk that the actual realized ROE will
6 fall between the Allowed ROE (intended to reflect the actual cost of equity) and 100
7 basis points below this threshold. There are also other risks addressed by Mr. Vancas
8 in his rebuttal testimony. Thus, there is no guarantee that shareholders will actually
9 earn their required return, as reflected in the opportunity cost benchmark represented
10 by the Allowed ROE specified in the COSG Agreement.

11 **Q8. MR. MCGARRY IMPLIES THAT THE TRUE-UP PROVISIONS UNDER**
12 **THE COSG PROGRAM WILL SERVE TO GUARANTEE INVESTORS A**
13 **RETURN EQUAL TO THEIR COST OF EQUITY.⁴ IS THIS ACCURATE?**

14 A8. No. While the provisions of the COSG Agreement, including the opportunity for an
15 annual true up, ensure that some level of return will be provided on the equity capital
16 invested in the COSG Program, this return may fall below the Allowed ROE by 100
17 basis points. The true up provisions do not insulate stockholders from the potential
18 for the ROE earned by investors to fall short of the cost of equity, which disproves
19 Mr. McGarry's assertion that the return to shareholders "is actually guaranteed."⁵

³ McGarry Direct Testimony, Page MJM-19.

⁴ *Id.*, Pages MJM-17-18.

⁵ *Id.*, Page MJM-18. My rebuttal testimony on this point applies equally to the direct testimony of Ms. Beth Ackland, on behalf of the Public Alliance for Community Energy, who wrongly states that shareholders "will have a guaranteed return on equity." Ackland Direct Testimony, Page 7.

1 **Q9. UNDER THE PROVISIONS OF THE COSG AGREEMENT, COULD THE**
2 **SHORTFALL BETWEEN THE REALIZED ROE AND THE ALLOWED ROE**
3 **PERSIST OVER TIME?**

4 A9. Yes. Contrary to Mr. McGarry’s portrayal, the COSG Program could conceivably
5 result in a scenario where investors are chronically denied the opportunity to earn the
6 cost of equity. While the Company fully expects that the COSG Program will produce
7 significant benefits for customers, it is possible to envision a market environment
8 whereby revenues from gas and hydrocarbon sales are sufficient to cover the related
9 costs, but result in a realized ROE that falls below the Allowed ROE by up to 100
10 basis points for a prolonged period. Under such a scenario, customers would continue
11 to receive the benefits of a cost-free, physical hedge against rising gas prices while
12 shareholders would earn a return that persistently falls below their opportunity cost
13 of capital. Moreover, unlike a traditional utility that may seek to increase its rates
14 when returns are inadequate to produce a fair ROE, investors in the COSG Program
15 have no such redress with respect to a potential 100 basis-point shortfall in the Actual
16 ROE.⁶

17 **Q10. DO INVESTORS FACE OTHER RISKS ASSOCIATED WITH THE COSG**
18 **PROGRAM?**

19 A10. Yes. The opportunity to recover Hedge Costs through the COSG Program ultimately
20 depends on the Company’s ability to collect revenues from retail customers through
21 the Purchased Gas Adjustment Clause, as approved by the Nebraska Public Service

⁶ As described in the direct testimony of Mr. Kilpatrick, “Actual ROE” is computed by dividing Net Income by Invested Equity, as defined in the COSG Agreement. Kilpatrick Direct Testimony, Page 5, Line 18 to Page 6, Line 2.

1 Commission (“PSC”). As noted by the Company’s witness Mr. Vancas, to the extent
2 that BHEP has a role as operator for gas reserves owned by COSGCO, BHEP may
3 have operational risks for which it will not be reimbursed under a joint operating
4 agreement. Further, should BHUH or COSGCO take actions that are not approved
5 under the COSG Program, investors are exposed to the potential that the associated
6 costs will go unrecovered.

7 **Q11. WOULD APPROVAL OF THE ROE BENCHMARK UNDER THE COSG**
8 **PROGRAM USURP THE PSC’S AUTHORITY?**

9 A11. No. Mr. McGarry suggests that reliance on an “external source” would undermine
10 the PSC’s regulatory jurisdiction.⁷ As discussed in my direct testimony,⁸ the
11 customers already pay a return on equity capital to gas producers/suppliers through
12 existing gas supply costs. This return is determined based on competitive market
13 forces and the PSC has no ability to influence or constrain the returns earned by
14 unregulated natural gas suppliers. Meanwhile, the COSG Program offers the
15 opportunity to insulate customers from price risk while limiting the ROE to a
16 reasonable level, predicated on an objective benchmark for regulated utilities. In
17 contrast to Mr. McGarry’s portrayal, the COSG Program expands rather than limits
18 the PSC’s ability to influence the returns on capital associated with the Company’s
19 gas supplies.

⁷ McGarry Direct Testimony, Page MJM-21.

⁸ McKenzie Direct Testimony, Pages 13-14.

1 **Q12. DOES MR. MCGARRY PRESENT AN EVEN-HANDED ASSESSMENT OF**
2 **THE BENEFITS TO CUSTOMERS UNDER THE COSG PROGRAM?**

3 A12. No. Mr. McGarry unfairly portrays the COSG Program as “burdensome,” without
4 acknowledging the significant benefits that would flow to Nebraska customers.⁹ As
5 described in detail in the direct testimony of the Company’s witnesses, the COSG
6 Program is designed to provide a long-term, physical hedge against gas price volatility
7 and long-term price increases through the acquisition of gas reserves. The COSG
8 Program will allow the Company to hedge against the risk of rising and volatile
9 energy commodity prices on a long-term basis by having the cost of a portion of its
10 gas supply effectively linked to more stable production costs. Under the terms of the
11 COSG Agreement, there will be no impact on customers through the imposition of
12 Hedge Costs or Hedge Credits unless the Actual ROE falls above or below the
13 Allowed ROE by more than 100 basis points. As a result, within the 200 basis-point
14 dead-band around the Allowed ROE, customers receive the benefits of a hedge against
15 adverse movements in gas commodity markets at no cost.

16 **Q13. MR. MCGARRY’S DIRECT TESTIMONY SUGGESTS THAT THE ROE**
17 **UNDER THE COSG AGREEMENT WOULD BE FIXED AT 9.86%.¹⁰ IS THIS**
18 **ACCURATE?**

19 A13. No. The ROE under the COSG Program is reset on an annual basis based on RRA’s
20 reported average authorized ROE for utilities in the prior year and would be expected
21 to vary over time. In fact, the average authorized ROE for electric and gas utilities

⁹ McGarry Direct Testimony, Page MJM-19.

¹⁰ *Id.*, Page MJM-21.

1 reported by RRA for 2015 was 9.76%,¹¹ which falls 10 basis points below the
2 benchmark for 2014 reported in my direct testimony.¹²

3 **Q14. DOES MR. MCGARRY PROPOSE AN ALTERNATE METHODOLOGY TO**
4 **ESTABLISH AN ROE FOR THE COSG PROGRAM?**

5 A14. Mr. McGarry recommends that the Allowed ROE for the COSG Program “should be
6 the same as ... the Company’s most recent approved rate of return.”¹³

7 **Q15. DOES MR. MCGARRY’S PROPOSAL REPRESENT A SUPERIOR**
8 **ALTERNATIVE TO THE ROE BENCHMARK UNDER THE COSG**
9 **AGREEMENT?**

10 A15. No. Most fundamentally, Mr. McGarry’s proposal ignores the fact that the COSG
11 Program has been designed as a unified approach to be implemented in six separate
12 state jurisdictions. While each of these jurisdictions establishes its own unique
13 authorized ROE reflecting the risks and required returns specific to utility operations
14 (whether electric or gas) under its authority based on capital market conditions
15 prevailing at the time of the decision, there are no differences in the operations or
16 risks of the COSG Program related to jurisdiction that would justify or necessitate a
17 separate ROE specific to a particular state.

18 Moreover, reference to a historical ROE determined in a past proceeding, which may
19 remain in effect for a prolonged period, does not necessarily reflect current capital
20 market conditions on an ongoing basis. As a result, barring frequent rate filings or

¹¹ Regulatory Research Associates, “Major Rate Case Decisions,” *Regulatory Focus* (Jan. 14, 2016). RRA reported that this average was based on results for 46 cases.

¹² McKenzie Direct Testimony, Page 18.

¹³ McGarry Direct Testimony, Page MJM-21.

1 other scheduled proceedings to reexamine the cost of equity, the calculation of Hedge
2 Costs and Hedge Credits could fail to accurately reflect the underlying costs and
3 benefits of the COSG Program. For example, Mr. McGarry argues that the
4 Commission should use the ROE established in the Company's last general rate
5 proceeding in Application No. NG-0061.¹⁴ However, adopting Mr. McGarry's
6 proposed approach would lead to an Allowed ROE for the COSG Program that is
7 *higher* than the 9.86% RRA benchmark for 2014 cited in my direct testimony and
8 decrease potential benefits to customers.

9 While the cost of equity does not move in lockstep with changes in interest rates, this
10 differential is generally consistent with trends in Baa-rated utility bond yields reported
11 by Moody's Investors Service, which averaged 5.55% in August 2010 versus 5.28%
12 in February 2016. Unlike a static, historical ROE value from a past rate proceeding,
13 the ability of the RRA benchmark to track capital market trends provides a superior
14 basis to match the ongoing benefits and costs under the COSG Program. A unified
15 approach to establishing the Allowed ROE also offers administrative advantages by
16 avoiding the protracted, costly, and contentious regulatory proceedings that would
17 otherwise accompany a periodic reevaluation of the cost of common equity for the
18 COSG Program.

¹⁴ McGarry Direct Testimony, Page MJM-21. Mr. McGarry suggests that the ROE should be the same as customers "pay for the infrastructure used to provide service." Of course, no consideration of the capital requirements and operations of the infrastructure needed to implement the COSG Program was incorporated in the Company's last rate proceeding.

1 Moreover, the RRA benchmark under the COSG Program is an independent,
2 objective reference point that balances the interests of customers and shareholders by
3 reflecting broad consensus as to regulators’ assessment of a fair ROE for utility
4 operations. Apart from offering transparency and relative stability to all stakeholders,
5 unlike a case-specific value authorized in a prior rate proceeding, the Allowed ROE
6 specified under the COSG Agreement provides a straight forward method to generally
7 track changes in capital market conditions on an ongoing basis without the need for
8 repeated regulatory proceedings and their associated resources. The overall collective
9 benefits to the Company’s customers are enhanced by referencing one independent
10 ROE benchmark that reflects the unified implementation of the COSG Program to
11 numerous utilities across multiple jurisdictions, provides a comprehensive guide to
12 the cost of equity for regulated utility operations, and minimizes administrative costs
13 and controversy.

B. Capital Structure

14 **Q16. WITH RESPECT TO THE CAPITAL INVESTED IN THE COSG PROGRAM,**
15 **MR. MCGARRY ASSERTS THAT “THE FUNDS THAT WILL BE USED TO**
16 **SUPPORT THIS VENTURE ARE RATEPAYER FUNDS.”¹⁵ IS THIS AN**
17 **ACCURATE STATEMENT?**

18 A16. No. While significant capital investment will be required to facilitate the COSG
19 Program, this capital investment is not provided through “ratepayer funds,” nor is the
20 COSG Program supported by any capital investment from the Company. Rather, as

¹⁵ *Id.*, Page MJM-22.

1 noted in my direct testimony,¹⁶ the common equity and long-term debt capital
2 required to implement the COSG Program will be allocated to COSGCO from Black
3 Hills Corporation (“BHC”). There is no basis for Mr. McGarry’s contention that the
4 capital investment needed to implement the COSG Program will come from
5 “ratepayer funds.”

6 **Q17. MR. MCGARRY NOTES THAT THE BUSINESS AND OPERATIONAL**
7 **RISKS OF THE COSG PROGRAM ARE “MUCH LOWER THAN THE**
8 **NORMAL EXPLORATION AND DRILLING COMPANIES.”¹⁷ IS THIS**
9 **OBSERVATION RELEVANT IN EVALUATING THE CAPITAL**
10 **STRUCTURE OR ALLOWED ROE UNDER THE COSG AGREEMENT?**

11 A17. No. Mr. McGarry’s reference to the higher business and operational risks of
12 exploration and production (“E&P”) companies is a straw man that is unrelated to the
13 capital structure and ROE provisions under the COSG Program. I don’t disagree with
14 Mr. McGarry’s conclusion that the risks of E&P companies are significantly greater
15 than those faced by the COSG Program.¹⁸ Indeed as a result, E&P companies will
16 not undertake exploration and development projects unless they foresee rates of return
17 that are much higher than utility rates of return. Because the COSG Program would
18 acquire proved producing reserves and would only develop proved undeveloped
19 reserves, the risk profile is lower than a typical E&P company, and the Allowed ROE
20 is lower than the target ROE of E&P companies in recognition of this fact. The

¹⁶ McKenzie Direct Testimony, Page 6.

¹⁷ McGarry Direct Testimony, Page MJM-22.

¹⁸ This risk distinction is documented in my direct testimony at Pages 35-38.

1 investment in equity capital required to assure customers the benefits of the physical
2 hedge under the COSG Program will be compensated solely on the basis of an
3 objective measure of authorized equity returns for regulated utilities. As a result, Mr.
4 McGarry's references to E&P companies have no bearing on the ROE under the
5 COSG Program and should be ignored.

6 Similarly, the capital structure under the COSG Agreement was not determined based
7 on the risks faced by E&P companies. Rather, the 40% debt and 60% common equity
8 capitalization was established in light of benchmarks in the utility industry, as well
9 the need to accommodate the specific risks and capital requirements associated with
10 the COSG Program. Investors undoubtedly perceive the risks associated with the
11 acquisition of gas reserves as exceeding those of regulated utilities,¹⁹ and while I grant
12 that investors are likely to view the specific risks of the COSG Program as less than
13 those attributable to E&P companies, COSGCO's operations are distinct from those
14 of a traditional utility. Considering the hybrid nature of the COSG Program, an equity
15 ratio from the upper end of the range maintained by gas and combination utilities is
16 warranted. Moreover, a company's capital structure is one of the major
17 considerations in achieving and maintaining a strong credit profile and investment
18 grade credit ratings. The capital structure specified for the COSG Program is
19 consistent with the range of industry benchmarks and reflects the need to
20 accommodate the burden of significant capital expenditures, maintain credit standing,
21 and support access to capital on reasonable terms and on a sustainable basis.

¹⁹ *Id.*

1 **Q18. DO YOU AGREE WITH MR. MCGARRY THAT THE RISKS OF THE COSG**
2 **PROGRAM ARE NECESSARILY LESS THAN THE COMPANY'S**
3 **NEBRASKA OPERATIONS OR THOSE OF OTHER UTILITIES?**²⁰

4 A18. No. First, while the provisions under the COSG Agreement offer a balanced approach
5 to achieve the benefits of hedging for customers, investors recognize that such
6 formula mechanisms are a two-edged sword. Formula rates might modify risk to the
7 extent that they eliminate the need to file rate proceedings when costs are increasing,
8 but they also lead to downward rate adjustments as costs decline. As a result, under
9 formula rate mechanisms that are tied to cost, there is limited opportunity for investors
10 to earn in excess of the Allowed ROE,²¹ as may be the case with stated rates. In this
11 way, customers also achieve benefits under formula rate mechanisms, since the
12 impact of declining costs and other efficiencies are automatically reflected in lower
13 rates.

14 Second, rate mechanisms analogous to the procedures established in the COSG
15 Agreement are not uncommon in the utility industry. In response to concerns over
16 the inability of traditional rate regulation to meet chronic shortfalls between costs and
17 revenues, alternative approaches have become ubiquitous throughout the utility
18 industry. These include various rate making mechanisms such as balancing accounts,
19 cost trackers to account for increased capital investment without the need for a formal
20 rate proceeding, and other provisions to avoid regulatory lag, along with formula

²⁰ McGarry Direct Testimony, Page MJM-22, Lines 14-15.

²¹ As discussed in my direct testimony, any opportunity to earn a return in excess of the Allowed ROE is capped at 100 basis points, at which point, customers will receive a Hedge Credit associated with the Company's participation in the COSG Program.

1 rates. For example, Moody’s Investors Service has recognized the “robust suite of
2 cost recovery mechanisms” that has become prevalent in the utility industry in recent
3 years.²² Moody’s noted that “[a]cross the U.S., we continue to see regulators
4 approving mechanisms that allow for more timely recovery of costs,” and that these
5 mechanisms “enable utilities to recoup prudently incurred operating costs, including
6 capital investments such as environmental related or infrastructure hardening
7 expenditures.”²³ Indeed, in 2014 Moody’s upgraded most of the bond ratings for
8 utilities to reflect the effect of the proliferation of trackers and adjustment
9 mechanisms throughout the utility industry.²⁴ Similarly, a report by the Edison
10 Electric Institute noted that formula rates have been used at the Federal Energy
11 Regulatory Commission (“FERC”) since the 1950s, with similar mechanisms being
12 approved for retail utilities in Alabama, Georgia, Illinois, Louisiana, Mississippi,
13 Oklahoma, South Carolina, Tennessee, and Texas.²⁵

III. RESPONSE TO CNEG

14 **Q19. MR. BENNETT SUGGESTS THAT COSGCO AGREEMENT PROVIDES A**
15 **“GUARANTEED RETURN” AND THAT THE COSG PROGRAM**

²² Moody’s Investors Service, “Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles,” *Sector In-Depth* (March 2015).

²³ *Id.*

²⁴ Moody’s Investors Service, “US utility sector upgrades driven by stable and transparent regulatory frameworks,” *Sector Comment* (Feb. 3, 2014).

²⁵ Edison Electric Institute, “Alternative Regulation for Emerging Utility Challenges: 2015 Update,” *Pacific Economics Group Research LLC* (Nov. 11, 2015).

1 **“PROVIDES A GUARANTEED PROFIT” TO COSGCO.²⁶ PLEASE**
2 **RESPOND.**

3 A19. As discussed earlier in response to Mr. McGarry, while the provisions of the COSG
4 Agreement provide for compensation to investors for providing the equity capital
5 necessary to achieve the benefits of the COSG Program, there is no guarantee that
6 shareholders will actually earn their cost of equity.

7 **Q20. MR. BENNETT NOTES THAT NATURAL GAS SUPPLIERS IN THE**
8 **COMMODITY MARKETS HAVE NO ASSURANCE AS TO ROE.²⁷ DOES**
9 **THIS UNDERCUT THE ROE PROVISIONS OF THE COSG AGREEMENT?**

10 A20. No. While I agree with Mr. Bennett’s observation, I disagree with his portrayal of the
11 related impact on customers. As I noted in my direct testimony,²⁸ drillers and
12 producers of natural gas are not constrained by regulation and are not concerned about
13 the prices paid by utility customers. In fact, their motivation as participants in an
14 open market is to secure the highest price possible for their commodity, subject to
15 competitive constraints. Drillers and producers are not subject to PSC monitoring or
16 oversight, and it is in their economic interest to have prices as high as possible. It is
17 only natural and expected that drillers and producers will seek to maximize their ROE,
18 which has no regulatory cap or limit. Mr. Bennett is correct that utilities pass
19 commodity costs through to customers without profit,²⁹ but it is not accurate to
20 suggest that a return on equity capital is absent from market prices.

²⁶ Bennett Direct Testimony, Page 4.

²⁷ *Id.*

²⁸ McKenzie Direct Testimony, Pages 13-14.

²⁹ Bennett Direct Testimony, Page 8.

1 Under the physical hedge offered by the COSG Program, on the other hand, customers
2 are insulated from the risk of higher prices, and so long as the Actual ROE falls within
3 100 basis points of the Allowed ROE, ratepayers reap these insurance benefits cost-
4 free. And unlike competitive market gas suppliers, the COSG Program will forgo any
5 opportunity to earn excess returns, which will instead be returned to customers
6 through Hedge Credits, while the Company will provide a backstop in the form of
7 Hedge Costs. Customers are already bearing the cost of a competitive market ROE
8 and the price risk associated with the potential for volatility in the market for natural
9 gas, which is felt directly through the purchased gas adjustment clause. The COSG
10 Program offers an alternative that insulates customers from these competitive market
11 exposures through a monitored program that is predicated on an ROE for regulated
12 utilities.

13 **Q21. WOULD APPROVAL OF THE ROE BENCHMARK UNDER THE COSG**
14 **PROGRAM USURP THE PSC'S AUTHORITY?**

15 A21. No. Mr. Bennett argues that the Company is asking the PSC to give up “one of its
16 main regulatory controls,”³⁰ but in fact the COSG Program effectively places a
17 function that is now subject only to competitive market forces within the realm of
18 regulatory oversight, and provides customers with the benefit of a transparent
19 limitation on returns that is not present for producers today. As discussed in my direct
20 testimony,³¹ the Company and its customers already pay a return on equity capital
21 through existing gas supply costs. This return is determined based on competitive

³⁰ Bennett Direct Testimony, Page 7.

³¹ McKenzie Direct Testimony, Pages 13-14.

1 market forces and the PSC has no ability to influence or constrain the returns earned
2 by unregulated natural gas suppliers. Meanwhile, the COSG Program offers the
3 opportunity to insulate customers from price risk while limiting the ROE to a
4 reasonable level, predicated on an objective benchmark for regulated utilities. In
5 contrast to Mr. Bennett's portrayal, the COSG Program expands rather than limits the
6 PSC's ability to influence the returns on capital associated with the Company's gas
7 supplies.

8 **Q22. PLEASE RESPOND TO MR. BENNETT'S COMMENT THAT IT IS**
9 **"UNCLEAR" AS TO WHY RATE CASE RESULTS FOR ELECTRIC**
10 **UTILITIES ARE INCORPORATED, ALONG WITH DATA FOR GAS**
11 **UTILITIES, IN THE ALLOWED ROE BENCHMARK UNDER THE COSG**
12 **AGREEMENT.³²**

13 A22. The COSG Program has been proposed as a long-term hedge for BHUH's gas utilities
14 and for the gas-fired generation of its electric utilities. It is designed to provide a
15 long-term, physical hedge against gas price volatility and long-term commodity price
16 increases through the acquisition of gas reserves. However, the fact that the COSG
17 Program represents one aspect of BHUH's efforts to successfully manage gas
18 commodity costs for the benefit of customers does not mean that its underlying risks
19 and required return are more closely aligned with those of a gas distribution utility.
20 The benefits of the COSG Program are not restricted to gas utility customers, and
21 extend to electric utility customers as well. Indeed, equity investors do not have a

³² Bennett Direct Testimony, Page 6, Lines 23-24.

1 choice between gas and electric utility operations when they supply capital to BHC,
2 which is an integrated electric and gas utility. As a result, allowed ROEs for both gas
3 and electric utilities provide a meaningful benchmark in establishing the Allowed
4 ROE under the COSG Program.

5 Moreover, considering average annual allowed ROEs for both electric and gas
6 utilities ensures that the Allowed ROE reflects broad consensus and provides a
7 comprehensive guide to the cost of equity that is insulated from variations attributable
8 to a particular industry or regulatory jurisdiction. In addition, as explained in my
9 direct testimony,³³ while risks associated with the acquisition and development of gas
10 reserves are attenuated in the case of the COSG Program, given its focus on
11 established fields with proven reserves and the oversight and other provisions of the
12 COSG Agreement, these considerations nonetheless distinguish the COSG Program
13 from traditional gas distribution utility infrastructure investment.

14 **Q23. MR. BENNETT NOTES THAT THE ALLOWED ROE WILL CHANGE**
15 **OVER TIME.³⁴ IS THIS UNREASONABLE, IN YOUR OPINION?**

16 A23. No. As noted earlier in response to Mr. McGarry, because the ROE under the COSG
17 Program is reset on an annual basis based on RRA's reported average authorized ROE
18 for utilities in the prior year, it would be expected to vary over time. Of course, to the
19 extent that regulators perceive that investors' cost of equity for utilities is falling,
20 customers would see a reduction, not an increase, in the ROE under the COSG

³³ McKenzie Direct Testimony, Pages 35-36.

³⁴ Bennett Direct Testimony, Page 7.

1 Program. Thus, investors also bear a symmetrical risk that the Allowed ROE will
2 decline, producing larger Hedge Credits or smaller Hedge Costs for customers.³⁵
3 In addition, under the traditional regulatory paradigm, customers are not guaranteed
4 a static ROE. Rather, they are afforded protections under the Supreme Court
5 standards established in *Hope* and *Bluefield*, which mandate that the ROE should be
6 commensurate with those available from other enterprises of comparable risk and
7 sufficient to attract capital and maintain the Company's financial integrity. As the
8 Supreme Court noted in *Bluefield*, "A rate of return may be reasonable at one time
9 and become too high or too low by changes affecting opportunities for investment,
10 the money market and business conditions generally."³⁶ Consistent with these
11 findings, as discussed in my direct testimony, the RRA benchmark specified under
12 the COSG Agreement offers an objective, unbiased approach to accommodate
13 changes in capital market conditions on an ongoing basis, as reflected in the findings
14 of state regulatory agencies.
15 Moreover, one advantage of the RRA benchmark is that it reflects broad consensus
16 and provides a comprehensive guide to the cost of equity that is insulated from sharp
17 variations. This stability is consistent with the Company's intention; *i.e.*, to provide
18 greater long-term price stability to customers. Because it is based on historical data,
19 the Allowed ROE may fall below investors' required return on equity in an
20 environment of rising capital costs. Finally, to the extent that the Actual ROE falls

³⁵ As noted earlier, the ROE benchmark specified in the COSG Agreement declined by 10 basis points from 2014 to 2015.

³⁶ P.U.R. 1923D 11, 43 S.Ct. 675.

1 within the 100 basis point dead-band above or below the Allowed ROE, customers
2 will see no impact whatsoever from a change in the RRA benchmark.

3 **Q24. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

4 A24. Yes, it does.