OFFICIAL COPY

Nov 06 2019

STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH
DOCKET NO. E-22, Sub 562

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of Application of Virginia Electric and Power Company, d/b/a Dominion Energy North Carolina, for Adjustment of Rates and Charges Applicable to Electric Service in North Carolina,	))))))	BRIEF OF THE ATTORNEY GENERAL'S OFFICE

The North Carolina Attorney General's Office (the "AGO") respectfully submits this Brief in opposition to the application for a general rate increase filed by Virginia Electric and Power Company, d/b/a Dominion Energy North Carolina ("Dominion" or "DENC" or the "Company") in the above-captioned docket.

TABLE OF CONTENTS

INTRODUCTION 2

ARGUMENT 4

I. DOMINION'S PROPOSAL TO FIX AN UNJUSTIFIABLY HIGH 9.75% RATE OF RETURN ON EQUITY WOULD ADD BETWEEN $6.1 AND $8.2 MILLION ANNUALLY TO THE REVENUE REQUIREMENT. 4

A. Dominion's ROE must be fixed at a rate that is fair to investors and to customers and should not be based on improper considerations. 5

1. The return on equity must be set at an amount that is fair to customers and investors, taking into account changing economic conditions. 5

2. Certain factors are not proper considerations in the determination of an authorized ROE. 7

a. Other utilities' and regulators' authorized returns 7

b. Existence of a partial settlement 9

B. Dr. Randall Woolridge demonstrated that a rate of return on equity between 8.75% to 9.0% is supported by market data and analysis showing what investors require under current economic conditions. 11

OFFICIAL COPY

Nov 06 2019

1. Dr. Woolridge's DCF analysis supports an ROE of between 8.55% and 8.95% based on conservative factors from reliable sources of market data. 12

2. Dr. Woolridge employed the Capital Asset Pricing Model ("CAPM") as a check. 15

3. The results of Dr. Woolridge's ROE analysis are consistent with current economic conditions. 16

C. Dominion failed to meet its burden to support a 9.75% ROE rate. 18

1. Mr. Hevert's DCF Model employs an upwardly-biased growth factor. 19

2. Mr. Hevert's Capital Asset Pricing Model and Empirical CAPM analyses also rely on upwardly-biased factors. 20

3. The other approaches used by Mr. Hevert are problematic. 26

4. Other issues that Mr. Hevert took into consideration do not affect the results. 27

D. Public input has raised concerns about the rate increase. 28

II. IF DOMINION IS ALLOWED TO RECOVER COAL ASH COSTS FROM RATEPAYERS, IT SHOULD NOT BE ALLOWED TO ADD A RATE OF RETURN TO THOSE COSTS. 30

A. Coal ash costs were not spent on property that is used and useful for providing current utility service. 32

B. Dominion's creation of an Asset Retirement Obligation does not entitle the Company to a return on expenditures that are not 'property used and useful' in providing utility service. 37

C. The rate of return Dominion proposes to recover on coal ash expenditures is not "working capital" that may be included in rate base simply because the expenditures were made from utility funds. 38

CONCLUSION 41

INTRODUCTION

Dominion bears the burden of proof to show that its proposed rate increase is both just and reasonable,[1] and Dominion has failed to meet that burden even under the terms set out in the partial Stipulation.

[1] N.C. Gen. Stat. §§ 62-75; 62-134(c).

OFFICIAL COPY

Nov 06 2019

In this Brief, the AGO focuses on two key problems with Dominion's proposed rate increase.

First, the 9.75% rate of return on equity proposed in the Stipulation[2] is significantly higher than necessary to attract investors. Dr. Randall Woolridge (who submitted expert testimony for the Public Staff) recommended a rate of return on equity ("ROE") of either 9.0% or 8.75%, depending on the ratio of equity to debt in the Company's capital structure. He testified that those ROEs would be sufficient for Dominion to successfully compete for investment capital under current market conditions. (Tr. Vol. 6 pp 532-33)[3] His recommendation falls at the upper end or slightly above the results produced from his market-based studies.[4] Mr. Hevert (in testimony submitted for Dominion) initially recommended a 10.75% ROE — near the upper end of his 10%-11% range – but later testified in support of the 9.75% ROE proposed in the Stipulation. His excessively high ROE recommendations were based on some factors that are upwardly-biased and others that are specifically prohibited under North Carolina precedent. The Stipulation ROE of 9.75% is a compromise that is not supported by current market data, and it would unnecessarily recover more than $6.1 million each year in revenues from

[2] On September 17, 2019, Dominion and the Public Staff – North Carolina Utilities Commission filed an Agreement and Stipulation of Partial Settlement among those parties (the "Stipulation") that stipulated to a resolution of most matters in the case, including the rate of return on common equity that Dominion should be allowed an opportunity to earn. (Stipulation at 4)

[3] Dr. Woolridge recommended the 9.0% ROE as his primary recommendation, along with his recommendation of a 50% equity / 50% debt capital structure. Alternatively, he recommended an 8.75% ROE if Dominion's 53.65% / 46.35% equity to debt ratio is allowed. (Tr. Vol. 6 pp 532-33)

[4] Table 5 (Tr. Vol. 6 p 588) reflects the results of Dr. Woolridge's Discounted Cash Flow ("DCF") analysis which produced an 8.55% to 8.95% equity cost rate. Table 6 (Tr. Vol. 6 p 603) reflects the results of his Capital Asset Pricing Model ("CAPM") which produced a 7.2% to 7.3% equity cost rate.

ratepayers as compared to the revenues needed to provide an ROE of 8.75% or 9.0%. *See infra* pp 4 - 30. Keeping more than $6 million in the local communities annually will better serve ratepayers and will be sufficient for Dominion to provide adequate service.

Second, Dominion's proposed increase includes not only the costs of closing coal ash ponds, but *also* adds a rate of return to those costs as they are deferred and again as they are amortized. Assuming *arguendo* that Dominion has demonstrated that the coal ash costs are recoverable, it is not appropriate or lawful for the Commission to authorize Dominion to add a rate of return on the costs during deferral and amortization. *See infra* pp 30 - 41.

ARGUMENT

I. DOMINION'S PROPOSAL TO FIX AN UNJUSTIFIABLY HIGH 9.75% RATE OF RETURN ON EQUITY WOULD ADD BETWEEN $6.1 AND $8.2 MILLION ANNUALLY TO THE REVENUE REQUIREMENT.

The 9.75% rate of return on equity ("ROE") proposed under the Stipulation exceeds what is required under current economic conditions, adding over $6 million to Dominion's annual revenue requirement.[5] Dominion has the burden of proving that a 9.75% ROE is required.[6] Dominion fails to meet this burden because it supports its proposal based on improper factors and upwardly-biased market analyses.

[5] The $6.1 million amount is calculated by comparing the cost of service using Dominion's settlement proposal for a 9.75% ROE and 52% equity capital structure compared to an 9.0% ROE with 52% equity. The $8.2 million amount is calculated by comparing the cost of service using Dominion's settlement proposal for a 9.75% ROE and 52% equity capital structure compared to an 8.75% ROE with 52% equity. (AGO-Johnson Cross Exhibit 1; Off. Ex. Vol. 6 pp 589, 591)

[6] N.C. Gen. Stat. §§ 62-75; 62-134(c).

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

To put the cost impact of the ROE in context, the total increase to the non-fuel revenue requirement proposed by Dominion under the partial stipulation is $8.7 million, and the total proposed by the Public Staff is $4.2 million. (Johnson Settlement Exhibit 1 Schedule 1; Off. Ex. Vol. 6 p 3) Eliminating the $6 plus million per year that is associated with an excessive 9.75% ROE makes a big impact on the rates established in this case.

The Commission should reject the Stipulation ROE and fix a rate that is not more than the ROE recommended by Dr. Woolridge based on existing market conditions, between 8.75% and 9.0%.

A. Dominion's ROE must be fixed at a rate that is fair to investors and to customers and should not be based on improper considerations.

1. The return on equity must be set at an amount that is fair to customers and investors, taking into account changing economic conditions.

Under North Carolina's statutory formula, the Commission must look to current market conditions when setting the rate of return, evaluating what is fair in light of the state of competition for capital. Section 62-133 specifies that the Commission shall fix the rate of return to produce a fair return for shareholders "considering *changing economic conditions*."[7] Under the statute, the rate of return should allow the utility to "compete in the market for capital funds" on reasonable terms.[8] The statute cautions that those terms must be fair not only to the utility's existing investors, but also to its customers.[9] In the words of our state's Supreme Court, the rate of return provision "advances the Legislature's twin goals of

[7] N.C. Gen. Stat. § 62-133(b)(4) (emphasis added).
[8] *Id.*
[9] *Id.*

assuring sufficient shareholder investment in utilities while simultaneously maintaining the lowest possible cost to the using public for quality service."[10]

Dominion's capital structure includes long term debt and common equity.[11] Determining the rate of return on debt is generally straightforward, but the return on common equity ("ROE") is more difficult to determine.[12] The Commission's determination of the appropriate ROE is extremely important, because it is the most expensive form of capital and the cost is paid by ratepayers.[13] As such, the statutory provisions relating to ROE "cannot be read in isolation as only protecting public utilities and their shareholders. Instead, it is clear that the Commission must take customer interests into account when making an ROE determination."[14]

The test laid down in N.C. Gen. Stat. § 62-133(b)(4) for determining a rate of return that is fair to investors and ratepayers is whether the rate is "sufficient to enable the utility to attract, on reasonable terms, capital necessary to enable it to render adequate service."[15] The determination must take into consideration changing economic conditions and other factors as they then exist.[16] Early United States Supreme Court cases established the guiding principles, which the General

---

[10] *State ex rel. Utils. Comm'n v. Cooper*, 367 N.C. 430, 440, 758 S.E.2d 635, 641 (2014) ("*Cooper 2"*) (internal quotation marks and citation omitted).
[11] Johnson Settlement Exhibit 1, Line 6; Off. Ex. Vol. 6 p 3.
[12] *Utilities Comm'n v. Public Staff*, 322 N.C. 689, 697-98, 370 S.E.2d 567, 572-73 (1988) ("*Public Staff*").
[13] *Id.*
[14] *State ex rel. Utilities Comm'n v. Cooper*, 366 N.C. 484, 495, 739 S.E.2d 541, 548 (2013) ("*Cooper*").
[15] *Utilities Comm'n v. Duke Power Co.,* 285 N.C. 377, 393, 206 S.E.2d 269, 280 (1974) ("*Duke Power*").
[16] N.C. Gen. Stat. § 62-133 (a)(4); *State ex rel. Utilities Comm'n v. Public Staff*, 331 N.C. 215, 221, 415 S.E.2d 354, 359 (1992) ("*Public Staff 2*").

OFFICIAL COPY

Nov 06 2019

Assembly subsequently incorporated into the North Carolina ratemaking statute.[17] Dr. Woolridge testified that when he develops an opinion about a fair ROE for a regulated entity, he follows guiding principles laid out by the United States Supreme Court that a fair ROE should be 1) comparable to the returns that investors expect on other investments of similar risk; 2) sufficient to assure confidence in the company's financial integrity, and 3) adequate in order to maintain and support the company's credit and to attract capital. (Tr. Vol. 6 pp 529-30) Mr. Hevert refers to the same guiding principles in his testimony. (Tr. Vol. 4 pp 28-29)

2. Certain factors are not proper considerations in the determination of an authorized ROE.

Our appellate courts have concluded that some factors are *not* appropriate considerations for the Commission when it determines a utility's rate of return, and the Commission should reject arguments that would rely on these improper factors.

a. Other utilities' and regulators' authorized returns

Dominion and other parties tend to compare the ROE proposed in this case to the ROEs or the averages of ROEs that have been authorized for utilities by regulatory commissions in other cases (Tr. Vol. 4 pp 53-56, 108-112), but our Supreme Court has concluded that it is not proper to give weight to such other authorized return.[18] For example, in 1992, the Supreme Court overturned this Commission's order granting a rate increase to Duke Power in part because the

[17] *See Duke Power*, 285 N.C. at 388, 393, 206 S.E.2d at 276-77, 280; *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virgini*a, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Co*., 320 U.S. 591 (1944).
[18] *Public Staff 2,* 331 N.C. at 224, 415 S.E.2d at 360-61; *see also Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643.

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

Commission gave weight to rate-of-return decisions by other regulatory authorities.[19] The Court found that the decisions by other regulatory authorities "fail[ed] to support the Commission's findings because there is nothing in the record to show that the equity return requirement for any of these utilities is comparable to Duke's."[20] In 2014, the Court reversed and remanded an order of this Commission on ROE because of "the Commission's reliance on past ROE determinations authorized for other utilities, without evidence tying those determinations to the facts of the case *sub judice*."[21]

Contrary to the Supreme Court's decisions, Dominion's expert encourages the Commission to rely heavily on the results reached for other utilities by other regulators in other cases. Indeed, Mr. Hevert incorporated authorized returns as a key factor for his Bond Yield Plus Risk Premium model. (Tr. Vol. 4 pp 53-56) In that study he compared long-term (30 year) bond yields to regulators' determinations of *authorized* rates of return. Some of the rates of return in his study were authorized as long ago as 1980, and he used this data in lieu of market data about current market conditions. (Exhibit RBH-R-5 p 2; Off. Ex. Vol. 4 p 41) As such, Mr. Hevert's Bond Yield Risk Premium analysis measures not "the market for capital funds"—the test under N.C. Gen. Stat. § 62-133(b)(4)—but instead the behavior of *regulatory commissions* over time. (Tr. Vol. 6 pp 612-13, 643)[22] As a

[19] *Public Staff 2,* 331 N.C. at 225, 415 S.E.2d at 361.
[20] *Id.*
[21] *Cooper 2*, 367 N.C. at 443, 758 S.E.2d at 643.
[22] Mr. Hevert's analysis is also erroneous because it relies on projected bond yields, as well as current yields, driving the results up. (Tr. Vol. 6 pp 613, 615-16, 642)

OFFICIAL COPY

Nov 06 2019

matter of law, the Commission should disregard Mr. Hevert's Bond Yield Risk Premium analysis.

Therefore, as a matter of law, the Commission should disregard Mr. Hevert's Bond Yield Risk Premium analysis.

b. Existence of a partial settlement

Dominion also urges the approval of a 9.75% ROE because it has been accepted by some parties as one piece of a settlement of most issues in the case. (Tr. Vol. 4 p 115) The Commission may consider the Stipulation, but it would be improper and unfair to authorize an excessive ROE settled upon by some parties in exchange for concessions by Dominion as to other unspecified elements of the case. The North Carolina statute that addresses how rates are fixed describes a formula to follow, and expressly requires the Commission to *fix* the rate of return. N.C. Gen. Stat. § 62-133(b)(4). As such, when the Commission considers proposals put forth as part of a non-unanimous stipulation, it must "make its own independent conclusion supported by substantial evidence on the record that the proposal is just and reasonable to all parties in light of all the evidence presented."[23] In its determination of a fair ROE, in particular, the Commission should consider and analyze a stipulated ROE "along with all the evidence regarding proper rate of return" and adduce "its own independent conclusion as to the proper rate of return on equity."[24]

---

[23] *State ex rel. Utilities Comm'n v. Carolina Utility Customers Association*, 348 N.C. 452, 466, 500 S.E.2d 693, 703 (1998) ("*CUCA*") (reversing Commission order fixing ROE because it was adopted from the partial stipulation without Commission consideration and analysis of all the evidence regarding proper rate of return and without an independent conclusion adduced from the evidence).

[24] *Id.* at 466-67, 500 S.E.2d at 703.

OFFICIAL COPY

Nov 06 2019

Dr. Woolridge, who provided expert cost of capital testimony for the Public Staff, did not testify in support of the stipulated ROE.[25] He did not change his recommendation, and nothing in his testimony supports an ROE as high as 9.75%. Indeed, his primary ROE recommendation of 9.0% is slightly above the high end of the results produced by his market-based analyses and his alternative ROE recommendation of 8.75% is near the high end of the results. (Tr. Vol. 6 pp 532-33, 588, 603)

The only evidence in this case that supports the stipulated 9.75% ROE is supplied by Mr. Hevert, whose testimony is influenced by his reliance on upwardly-biased analyses and improper considerations. Testifying in support of the stipulation, he stated that he continued to believe that "10.00 percent to 11.00 percent represents an appropriate and defensible range of the Company's Cost of Equity," (Tr. Vol. 4 p 116), but he noted that the stipulated ROE is within the range of analytical results presented in his testimony. Further, he "recognize[d] the benefits associated with the Company's decision to enter into the Stipulation," and posited that "the Stipulated ROE is a reasonable resolution of a complex, and frequently contentious issue." (*Id.*)

Thus, as in *CUCA,*[26] there is no evidence supporting the ROE in the Stipulation other than the stipulation itself and conclusory testimony from the utility expert as to its reasonableness. This evidence relating to a partial settlement does

[25] Dr. Woolridge is a Professor of Finance and the Goldman, Sacks & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at Pennsylvania State University, and has prepared testimony and provided consulting service for over 25 years on rate of return in regulatory cases. (Tr. Vol. 6 pp 656-58)

[26] *CUCA,* 348 N.C. at 466-67, 500 S.E.2d at 703.

OFFICIAL COPY

Nov 06 2019

not relieve the Commission of the requirement that it must fix a fair ROE by making an independent evaluation.

B. Dr. Randall Woolridge demonstrated that a rate of return on equity between 8.75% to 9.0% is supported by market data and analysis showing what investors require under current economic conditions.

Taking into account all of the evidence in the record, the cost of equity is between 8.75% and 9.0%, and the Commission should fix a rate of return on equity in that range in this case. That determination is supported by the testimony of Dr. Woolridge, the expert witness presented by the Public Staff. (Tr. Vol. 6 pp 561-62) He recommended that an ROE of 9.0% would be appropriate if Dominion is authorized to maintain a capital structure with 50% equity / 50% debt, which is a slightly riskier capital structure than one with a heavier share of equity as compared to debt. He recommended an ROE of 8.75% if Dominion's proposed capital structure is authorized, which uses 53.65% equity. (Tr. Vol. 6 pp 532-33) The partial stipulation proposes a 52% / 48% equity to debt ratio, (Johnson Settlement Exhibit 1, Schedule 1, line 6; Off. Exh. Vol. 6 p 3)[27], which is somewhat less risky for shareholders than Dr. Woolridge's 50% / 50% capital structure recommendation and somewhat more risky for shareholders than Dominion's capital structure recommendation, and suggests that the ROE could fall in between 8.75% and 9.0%. But because Dr. Woolridge's testimony was pre-filed prior to the entry of the stipulation and has not been revised, it does not specify what, if any, adjustment is appropriate to the rate of return on equity based on the

[27] The AGO does not take issue with the stipulated capital structure.

OFFICIAL COPY

Nov 06 2019

52/48 equity/debt stipulated capital structure, and an ROE somewhere in that range is supported by his recommendation.

Dr. Woolridge's equity cost rate studies indicated an ROE range of 7.20% to 8.95% based on two well-established models: the Discounted Cash Flow ("DCF") model, and the Capital Asset Pricing Model ("CAPM"). (Tr. Vol. 6 pp 571, 588, 603) He relied primarily on the DCF model and gave the CAPM results less weight because risk premium studies (of which the CAPM is one form) provide a less reliable indication of the cost of equity for public utilities. (Tr. Vol. 6 p 571)

The studies performed by Dr. Woolridge are described in the next paragraphs, followed by a discussion of his testimony explaining how current market forces demonstrate support that an ROE substantially lower than 9.75% will continue to provide a sufficient return for the company to compete for capital in current markets.

1. Dr. Woolridge's DCF analysis supports an ROE of between 8.55% and 8.95% based on conservative factors from reliable sources of market data.

Dr. Woolridge's Discounted Cash Flow (DCF) model supports an ROE of between 8.55% and 8.95% ROE. (Tr. Vol. 6 p 588) A constant growth DCF analysis measures the cost of common equity based on the sum of the dividend yield plus the expected rate of growth of dividends for comparable companies.[28] (Tr. Vol. 6 pp 571-75) The DCF approach is the best measure of the equity cost rates for public utilities because of the investment valuation process and because of the relative stability of utilities. (Tr. Vol. 6 p 576) The DCF method is commonly relied

[28] *See State ex rel. Utilities Com. v. Public Staff,* 323 N.C. 481, 488, 374 S.E.2d 361, 365 (1988).

on by cost of capital witnesses and is used in some form by virtually all investment firms as a technique for valuation. (Tr. Vol. 6 p 572)

Dr. Woolridge analyzed two proxy groups of companies to estimate the cost of equity for comparable investments. His electric proxy group consisted of 27 publicly-held electric utility companies with risk profiles similar to Dominion's. The Hevert proxy group consists of the same 21 companies used by Mr. Hevert. (Tr. Vol. 6 pp 549-51) The results of the different proxy groups were similar. (Tr. Vol. 6 pp 588, 603)

Applying the DCF method, Dr. Woolridge calculated the dividend yields for the proxy groups and, from the 30-day, 90-day, and 180-day average stock prices, he selected 3.10% for his electric proxy group and 3.04% for the Hevert group, which are above the mean and median results of each group. (Tr. Vol. 6 p 576) He applied an adjustment for growth over the coming year based on half the growth rate. (Tr. Vol. 6 p 577)

To estimate the rate of growth of dividends for the proxy group, Dr. Woolridge reviewed multiple measures of the long-term dividend growth expected by investors including historical and projected growth rate estimates for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS"). (Tr. Vol. 6 pp 578-79) He described strengths and weaknesses of the different measures. For instance, while he considered analysts' earnings per share projections, he did not exclusively rely on them because of their well-documented tendency to be "overly optimistic and upwardly-biased." (Tr. Vol. 6 pp 579-84) Dr. Woolridge summarized his analysis of growth rates and gave an overall range of

OFFICIAL COPY

Nov 06 2019

projected growth rate indicators (ignoring the somewhat lower historical growth rate data) of 3.7% to 5.5% for his electric proxy group and 3.7% to 5.9% for the Hevert group. (Tr. Vol. 6 pp 587-88) From these results, he selected 5.35% as the appropriate growth rate for the DCF study for the electric proxy group and 5.80 as the appropriate growth rate for the Hevert proxy group, both of which are at the high end of the range of projected growth rates. (*Id*)

Dr. Woolridge's equity cost rates calculated using his DCF analysis reflect the sum of the adjusted yield plus the long-term growth rate, which come to 8.55% for the his electric proxy group and 8.95% for the Hevert proxy group. (Table 5, Tr. Vol. 6 p 588) These results *do not* reflect the low end of the range of data for either the dividend yield or the growth factor. Instead, when examined in detail, the components of Dr. Woolridge's DCF study use reliable sources of data, and the factors selected both for the dividend yield and the growth rate fall somewhat higher than the midpoint of the range of the data. (Tr. Vol. 6 pp 576, 587-88)

Dr. Woolridge refuted the idea that his model underestimates the ROE required by investors under current market conditions. (Tr. Vol. 6 pp 617-18)[29] Quoting from a Moody's article, Dr. Woolridge attributes the lower ROE requirement reflected in the DCF results to a "combination of low capital costs, high equity market valuation multiples (which are better than or on par with the broader market despite the regulated utilities' low risk profile), and a transparent assurance of cost recovery." (*Id.)*

---

[29] Order Approving Stipulation, Granting Partial Rate Increase, Line 434 Revenue Rider, EDIT Riders, Provisional Revenues Rider, and Requiring Customer Notice, issued 31 October 2019 in Docket No. G-9, Sub 743 ("2019 Piedmont Rate Order") at 42.

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

2. Dr. Woolridge employed the Capital Asset Pricing Model ("CAPM") as a check.

Dr. Woolridge also employed the Capital Asset Pricing Model ("CAPM") as a check. The capital asset pricing model is a risk premium analysis that posits that the cost of equity is equal to the sum of the yield on a risk-free bond plus an appropriate risk premium. (Tr. Vol. 6 p 589) He gave his CAPM results less weight than his DCF analysis, because he believes that risk premium studies provide a less reliable indication of equity cost rates for public utilities. (Tr. Vol. 6 p 571)

Dr. Woolridge used 4.0% as the risk-free rate in his study, which is at the high end of the range of the yield on thirty year Treasury bonds over the last several years. (Tr. Vol. 6 pp 589, 591) In order to factor in the risk level of the particular equity investment being assessed, Dr. Woolridge used a beta coefficient from published analyses of 0.60 for Dr. Woolridge's electric proxy group and 0.58 for the Hevert group. (Tr. Vol. 6 p 592-93) The beta is applied as an adjustment to the risk premium of the overall market in order to estimate the expected market risk premium for the particular equity investment, and the fact that these beta values are significantly less than 1.0 indicates that the investment is less risky than the market as a whole, as is true of electric utilities. (*Id.*; Exhibit JRW-8 p 3; Off. Ex. Vol. 6 p 37)

Dr. Woolridge used an expected overall market risk premium ("MRP") of 5.50%, noting that this was "a conservatively high estimate of the MRP considering the many studies and surveys of the MRP." (Tr. Vol. 6 p 603) He described the types of studies that are available to investors, including historical evaluations, studies using expected results, and surveys of financial professionals. (Tr. Vol. 6

pp 594-603; Exhibit JRW-8 pp 4-8; Off. Ex. Vol. 6 pp 38-42) His review of the studies and surveys, giving most weight to the ones he found to be most relevant and timely, suggested that the appropriate market risk premium in the U.S. is in the range between 4.0% and 6.0%. (Tr. Vol. 6 p 603)

From these factors, Dr. Woolridge's CAPM analysis produced an ROE result of 7.3% for his electric proxy group, which is the sum of the 4.0% risk-free rate plus the risk premium of 3.3% (produced from a 0.60 beta adjustment to the market risk premium of 5.5%). (Tr. Vol. 6 p 603) The ROE result was 7.2% for the Hevert proxy group, which is the sum of the 4.0% risk free rate plus the risk premium of 3.2% (produced from a 0.58 beta adjustment to the MRP). (*Id.*)

Thus, the range of appropriate equity costs for Dominion based on Dr. Woolridge's DCF and CAPM studies was 7.20% to 8.95%. (Tr. Vol. 6 p 604) Since, as noted, Dr. Woolridge does not find the CAPM method to be reliable, he did not give the lower results much weight. Thus, his models support his recommendation of an ROE of between 8.75%, which is the midpoint of the DCF result for his electric proxy group and the result for the Hevert proxy group, and 9.0%, which is slightly above the results of his analyses. (*Id.*)

3. <u>The results of Dr. Woolridge's ROE analysis are consistent with current economic conditions.</u>

Recognizing that his analysis resulted in an ROE that was below the authorized returns other utilities regulators have granted, Dr. Woolridge explained in some detail why current economic conditions demonstrate that his cost of equity results and recommendations were appropriate.

OFFICIAL COPY

Nov 06 2019

First, Dr. Woolridge explained that electric utilities are very low risk investments, as indicated by their low betas, high ratings for safety, financial strength, earnings predictability, and stock price stability. (Tr. Vol. 6 pp 551-52)

Second, he showed that the credit ratings issued by S&P and Moody's for DENC indicate that the investment risk for the Company is below the averages of the risks for the electric and the Hevert proxy groups.[30] (Tr. Vol. 6 pp 551-52, 605)

Third, he explained that long-term bond yields for utilities are still historically low and are likely to remain low given low inflationary expectations and slow global economic growth, indicating that capital costs are low for utilities. (Tr. Vol. 6 pp 567, 605; Exhibit JRW-5 p 1; Off. Ex. Vol. 6 p 61)

Fourth, he noted that his recommended equity cost rate is at the high end of the range of the results produced by his studies. (Tr. Vol. 6 p 606)

Fifth, Dr. Woolridge reported that, even though authorized ROEs for electric utility and gas distribution utilities have mostly declined between 2012 and 2019, in his opinion the authorized rates have lagged behind the market cost of capital. (Tr. Vol. 6 p 606)

Sixth, Dr. Woolridge reported the results of a study by Moody's which found that the downward trend in rates of return authorized by regulators has not weakened the credit profiles of utilities. Instead, the companies are still strong in credit agency ratings, and they have continued to be able to raise $50 billion per year in capital. (Tr. Vol. 6 pp 607-609)

---

[30] The S&P rating for DENC and its parent company Dominion were downgraded on February 1, 2016 due to the risk associated with Dominion's acquisition of Questar, but did not reflect the risk of DENC. (Tr. Vol. 6 p 551)

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

Seventh, Dr. Woolridge analyzed ten years of over market-to-book ratios for the proxy group, and demonstrated that they have increased from 1.10 to 1.80. This demonstrates, Dr. Woolridge explained, that returns on equity have been greater than the cost of capital, which means returns on equity have been more than necessary to meet investors' required returns, and that "customers have been paying more than necessary to support an appropriate profit level for regulated utilities." (Tr. Vol. 6 p 568; Exhibit JRW-5 p 3; Off. Ex. Vol. 6 p 63)

Eighth, Dr. Woolridge's testimony showed that capital market conditions support a lower ROE: interest rates are at a historic low, and utility stock prices are at a historic high. (Tr. Vol. 6 pp 533-34, 540, 617-18)

In sum, under existing market conditions and based on the behavior of actual market participants, Dr. Woolridge's testimony and exhibits show that a return of between 8.75% and 9.0% is sufficient for investors and that is where the ROE should be fixed in the case.

C. Dominion failed to meet its burden to support a 9.75% ROE rate.

Dominion has the burden of proof to support a 9.75% ROE,[31] and has failed to meet that burden. The Commission should give little or no weight to the evidence provided by Dominion's expert Mr. Hevert. Mr. Hevert's analyses contain errors that create systemic upward bias, and they rely on methods and data inputs that inflate his cost of equity recommendations. Mr. Hevert's high initial 10.75% ROE recommendation would be reduced under the Stipulation, but even the

[31] N.C. Gen. Stat. §§ 62-75; 62-134(c).

Stipulation's 9.75% ROE exceeds a market-based rate by a substantial amount and is not supported by any analysis.

Mr. Hevert used multiple financial models to estimate Dominion's cost of equity and presented the results, but Mr. Hevert did not indicate what weight he gave to the different approaches. He posited that all models are subject to assumptions and constraints, and stated that equity analysts and investors tend to use multiple methods to develop their return requirements. (Tr. Vol. 4 p 24) He opined that it is important "to apply multiple models and to assess the extent to which their fundamental assumptions align with prevailing and expected market conditions." (Tr. Vol. 4 p 121) He relied on the following approaches: 1) a constant growth discounted cash flow model (DCF); 2) a capital asset pricing model (CAPM); 3) an empirical CAPM or ECAPM; 4) a bond yield plus risk premium (BYRP); and 5) an empirical earnings analysis. (Tr. Vol. 4 p 24)

As discussed in greater detail below, when the unreliable inputs or methods are eliminated, Mr. Hevert's studies indicate a range of ROE between 8.25% and 9.39%. This range overlaps with Dr. Woolridge's range of 7.20% and 8.95%. (Tr. Vol. 6 p 604)

1. Mr. Hevert's DCF Model employs an upwardly-biased growth factor.

This Commission has historically relied primarily on DCF analysis in determining rates of return on equity in general rate cases.[32] Mr. Hevert's DCF analysis on Exhibit RBH-1 shows "low ROE," "mean ROE," and "high ROE" results for the proxy group (including mean and median results) of between 7.92% and

[32] 2019 Piedmont Rate Order at 42.

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

10.38% based on stock prices averaged over 30 days, 90 days, and 180 days. The "mean ROE" results (including mean and median results) are between 9.18% and 9.39%. (Exhibit RBH-1; Off. Ex. Vol. 4 pp 21-23) The results that are based on the most recent stock prices used in Mr. Hevert's study produced the lowest ROE estimates. (*Id.*)

In his DCF model, Mr. Hevert used upwardly-biased earnings per share growth, which this Commission has repeatedly critiqued.[33] Mr. Hevert's DCF model relies on projected earnings-per-share data without exercising judgment about the limitations of that data. (Tr. Vol. 6 pp 618-20) As Dr. Woolridge explained, earnings per share growth rates projected by Wall Street analysts are overly optimistic and upwardly biased. (*Id.*) He commented that Mr. Hevert cites multiple studies to support his use of EPS analysts' growth rate forecasts, but those studies are all at least 20 years old, and the more recent studies conclude that "analysts' three-to-five-year EPS growth rate forecasts are overly optimistic and upwardly biased." (Tr. Vol. 6 p 620)

2. Mr. Hevert's Capital Asset Pricing Model and Empirical CAPM analyses also rely on upwardly-biased factors.

The results Mr. Hevert produced in his Capital Asset Pricing Model ranged from a low of 8.25% to a high of 11.34%. (Tr. Vol. 4 p 49; Exhibit RBH-4; Off. Ex. Vol. 4 p 39) The results of his Empirical Capital Asset Pricing Model were even higher: they ranged from 9.61% to 12.76%. (Tr. Vol. 4 p 52; Exhibit RBH-4; Off.

[33] *Id.* at 41; *see also* Order Accepting Settlement, Deciding Contested Issues and Granting Partial Rate Increase, issued 23 February 2018 in Docket No. E-2, Sub 1142 at 85 ("Witness Hevert's DCF dividend growth component, based solely on analysts' earnings per share growth projections without consideration of any historical results, is upwardly biased and unreliable").

Ex. Vol. 4 p 39) There are two main flaws in his CAPM analysis that cause his results to be overly high, and the flaws are exaggerated in his ECAPM analysis.

As noted above in Part I.B.2, the CAPM estimates the cost of common equity based on the sum of the interest-free bond rate plus the risk premium associated with equity investments comparable to the subject company. (Tr. Vol. 4 p 45; Tr. Vol. 6 p 589) As such, the risk-free rate and the market risk premium are two significant inputs to a CAPM analysis. Mr. Hevert uses unreliable and upwardly-biased methods for deriving both of these inputs.

First, to estimate the risk-free rate input, Mr. Hevert included an overly high rate of 3.04% for current 30 year Treasury yields, although yields were in the range of 2.6% in months leading up to the evidentiary hearing. (Tr. Vol. 6 pp 621-22; Exhibit RBH-4; Off. Ex. Vol. 4 p 39) Additionally, he increased the estimated risk free rate further by also including *projected* 30 year Treasury yields of 3.25%, adding another 21 basis points to the 'risk free rate' input. (*Id.*) Dr. Woolridge criticized the use of projected yields, in particular, because the projections are unreliable. (Tr. Vol. 6 pp 621-22) Forecasts have predicted interest rate increases for years and have been wrong for years, and the predictions have not deterred investors from continuing to purchase long-term bonds at current rates. (*Id.*) Dr. Woolridge testified that Mr. Hevert's inputs for current and forecasted bond yields added 44 to 65 basis points to his CAPM results. (*Id.*)

Second, with respect to the market risk premium, Mr. Hevert eschewed published studies in favor of performing his own analysis. He performed a DCF analysis (within his CAPM study) to forecast the expected rate of return in the stock

OFFICIAL COPY

Nov 06 2019

market, generally, and subtracted the risk free rate in order to calculate the market risk premium factor. (Tr. Vol. 4 pp 47-48; Exhibits RBH-2, RBH-4; Off. Exh. Vol. 4 pp 24-37, 39) He ran his DCF analysis twice to forecast the expected market ROE for the S&P 500: once using earnings forecast data from Bloomberg for the growth rate input and again using earnings forecast data from Value Line. (*Id.;* Tr. Vol. 4 p 137) He only relied on earnings forecast data to estimate the growth rate factor in the DCF study (the same flow discussed in his DCF discussed in Part I.C.1). His DCF results indicated that the expected ROE for the stock market is 13.68% using the Bloomberg data and 16.61% for the Value Line data. (Tr. Vol. 4 pp 138-140; Exhibit RBH-2 pp 1, 8; Exhibit RBH-4; Off. Ex. Vol. 4 pp 24, 31, 39) From the DCF results, Mr. Hevert subtracted 3.04% (his risk free rate based on current treasury yields) to derive a market risk premium of 10.65% from Bloomberg data, and 13.77% from the Value Line data. (*Id.*)

It is important to contrast this with Dr. Woolridge's approach of using published studies performed by others in determining market risk premiums. Mr. Hevert's "do it yourself" market risk premiums were 10.65% and 13.77%. The range of **all** of the dozens of risk premium studies Dr. Woolridge reviewed was between 1.85% and 7.31%. (Tr. Vol. 6 pp 598-603; JRW-8 p 5; Off. Ex. Vol. 6 pp 39)

Dr. Woolridge explained why Mr. Hevert's market risk premiums greatly exceed reasonable levels. First, he noted that the levels of predicted growth relied on as inputs to Mr. Hevert's DCF analysis are extremely high, causing the market risk premiums to be very high as well. (Tr. Vol. 6 pp 622-23) He found Mr. Hevert's

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

estimates of the expected annual S&P 500 stock market growth are not realistic in the current market. (*Id.*) He testified that Mr. Hevert's estimates are based on the mistaken concept that projections of companies' earnings per share growth rates over three to five years reflect investors' expected long-term earnings growth, but that concept is "highly unrealistic" according to research. (Tr. Vol. 6 p 624) Furthermore, Dr. Woolridge discussed the inconsistency between Mr. Hevert's high long-term EPS-based growth rates and significantly lower projections for growth in gross domestic product (GDP). (Tr. Vol. 6 pp 626-638)

Mr. Hevert testified during cross examination that his 13.68% estimate of the long-term expected ROE for the stock market (based on his DCF derived from Bloomberg data) is "well within the range of historical experience" because the historical arithmetic average return on the market is about 12% and the standard deviation is about 19% (which calculates at the high end to a return of 14.28%). (Tr. Vol. 4 p 138) However, assuming that Mr. Hevert's 12% average historical ROE and 19% standard deviation are correct[34], his 13.68% estimate of the long-term ROE derived from Bloomberg data falls within that range, but his 16.88% estimate derived from Value Line data is well in excess of 14.28%. In other words, his own testimony suggests that his higher CAPM results based on the Value Line data are excessive.

Dr. Woolridge testified that Mr. Hevert's market risk premiums of 10.65% and 13.77% are "well in excess of" market risk premiums found in academic studies, the analyses of historic stock and bond returns, and in the surveys of

[34] Dr. Woolridge testified that the compounded annual return is about 10%. (Tr. Vol. 6 p 639)

OFFICIAL COPY

Nov 06 2019

financial professionals. (Tr. Vol. 6 p 623) The Bloomberg-derived market risk premium produced by Mr. Hevert is almost double the 5.5% market risk premium that Dr. Woolridge found in his review of published studies and surveys, and the Value-Line-derived market risk premium produced by Mr. Hevert is substantially more than double. (Tr. Vol. 6 p 603; Exhibit RBH-4; Off. Ex. Vol. 4 p 39)

The criticism of Mr. Hevert's methodology is by no means limited to Dr. Woolridge's expert observations. The same concerns about Mr. Hevert's CAPM methodology are reflected in this Commission's finding in the Final Order in the most recent Duke Energy Progress rate case. The Commission explained that, due to Mr. Hevert's reliance on projected Treasury bond yields for the risk-free rate his results were "an outlier and upwardly biased."[35] Further, the Commission found the following with respect to his market risk premium calculations:

> Witness Hevert's risk premium component of his CAPM uses a constant growth DCF for the S&P 500 companies, using analyst-projected earnings per share forecasts as the growth component. Witness Hevert's DCF dividend growth component, based solely on analysts' earnings per share growth projections without consideration of any historical results, is upwardly biased and unreliable.[36]

Mr. Hevert's DCF analysis that he incorporates into his CAPM model in this case suffers from the exact same problem: it uses only analysts' projected earnings growth estimates with no historical results. (Tr. Vol. 4 p 140)

---

[35] Order Accepting Settlement, Deciding Contested Issues and Granting Partial Rate Increase, issued 23 February 2018 in Docket No. E-2, Sub 1142 at 85.
[36] *Id.*

OFFICIAL COPY

Nov 06 2019

The Virginia Corporation Commission found the same flaws in Mr. Hevert's CAPM analysis presented to establish the cost of capital in a Virginia Electric and Power Company case;

> [T]he Company's Capital Asset Pricing Model ("CAPM") analysis is …flawed. For example, the Company's highest ROE estimates result from the use of a 2019 projected 30-year Treasury bond yield of 4.2% and a 2021 projected 30-year Treasury bond yield of 4.4%. The Commission has explicitly rejected the use of such projected interest rates in prior cases, stating that inclusion of these projected rates inflates the results of the utility's risk premium analysis. In addition, the Company exclusively used earnings per share as the measure of long-term growth to develop the market risk premium component of its CAPM analysis, which results in an overstatement of the cost of equity.

AGO Hevert Cross Examination Exhibit 1 at 5; Off. Ex. Vol. 4 p 74.[37]

The flaws in Mr. Hevert's CAPM analysis are amplified in his empirical CAPM analysis ("ECAPM"). Mr. Hevert testified that the CAPM tends to under-estimate the cost of equity for companies that have low Beta coefficients, such as utilities, and his ECAPM model responds to that tendency by applying the Beta factor to only 75% of the market risk premium and does not apply the Beta to the remaining 25%. (Tr. Vol. 4 p 149) As a result, the ECAPM is guaranteed to drive the ROE estimates higher when applied to the low risk stocks including the utilities in his proxy group. (Tr. Vol. 4 pp 148-50) As such, if the Commission finds in this case, as it has in the past, that Mr. Hevert's CAPM model is upwardly biased, that finding would apply equally to his ECAPM as well. (*Id.*)

If the Commission excludes as upwardly-biased Mr. Hevert's results using projected 30 year Treasury yields, the Value Line-derived market risk premium,

---

[37] Final Order, issued 29 November 2017 in Case No. PUR-2017-00038.

and the ECAPM results, what remains are ROEs of 8.25% and 9.29% (using the Bloomberg-derived market risk premium and actual thirty-year Treasury bond yields, with two different beta coefficients). These values are consistent with Mr. Hevert's median DCF results, which were in the range of 9.24 – 9.39%. (Tr. Vol. 4 p 45)

3. The other approaches used by Mr. Hevert are problematic.

Other studies performed by Mr. Hevert also should not be given weight by the Commission, as they rely on upwardly-biased data or on factors forbidden by our Supreme Court.

Mr. Hevert performed another risk premium analysis that he called the Bond Yield Plus Risk Premium, and it has two flaws. (Tr. Vol. 6 pp 641-44) First, his use of projected interest rates causes the results of the study to be higher and is reason to question the results for reasons discussed in connection with the CAPM study. (Tr. Vol. 6 pp 641-42) Second, his use of regulators' *authorized* returns in lieu of basing his analysis on current market data is not permissible in fixing ROEs in North Carolina.[38] (Tr. Vol. 6 pp 642-44) Thus, as was discussed in Part I.A, his study relies on improper factors.

Finally, Mr. Hevert's Expected Earnings approach should be given no weight. As the Commission observed in its recent rate case order for Piedmont Natural Gas, there are two problems with Mr. Hevert's Expected Earnings analysis. First, it uses projected earnings for years far beyond the date rates will be effective in this case; i.e., the years 2021-2023 or 2022-2024 (Exhibit RBH-6; Off. Ex. Vol.

[38] *See* Part I.A.2; *Public Staff 2,* 331 N.C.at 224, 415 S.E.2d at 360-61; *see also Cooper 2,* 367 N.C. at 443, 758 S.E.2d at 643.

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

4 p 61).[39] Second, the Commission has previously stated that it does not favor future earnings projections based solely on analysts' projections.[40]

In addition, the Expected Earnings approach relies on projected actual earnings on book value of investment for each of the companies in the proxy group as a basis for estimating the cost of capital. (Tr. Vol. 4 pp 56-57) The analysis does not include a component to measure investor return requirements, however, and so does not reflect changes in expectation affected by existing economic conditions such as increases or decreases in interest rates. (Tr. Vol. 6 pp 644-48) Investors do not purchase stock at book value, so the market information about stock prices is not considered. (Tr. Vol. 6 p 646)

In short, Mr. Hevert's cost of equity analyses are upwardly-biased and erroneous and should not be given weight in the Commission's determination. Once the extreme inputs to his models are eliminated, the results of his analysis are suggested ROEs of between 8.25% and 9.39%. These results do not come close to supporting the stipulated ROE of 9.75%.

4. <u>Other issues that Mr. Hevert took into consideration do not affect the results.</u>

Mr. Hevert also testified that he took into consideration the magnitude of Dominion's capital expenditures when he recommended an ROE higher than the mean results of is models. (Tr. Vol. 4 p 57-60) However, as Dr. Woolridge explained in response, capital expenditures are already considered a risk factor in the credit-rating process, and Dominion's credit ratings from S&P and Moody's

[39] 2019 Piedmont Rate Order at 43.
[40] *Id.*

indicate that the Company has an investment risk that is below the average for the proxy groups. As such, an adjustment is not supported. (Tr. Vol. 6 pp 648-49)

Mr. Hevert also contended that a flotation cost adjustment is appropriate and was considered in his recommendation to fix a 10.75% ROE. (Tr. Vol. 6 p 649) However, as Dr. Woolridge observed, Mr. Hevert did not identify any flotation costs for Dominion. (Tr. Vol. 649-52) The North Carolina Supreme Court has held that flotation costs should not be allowed.[41]

D. Public input has raised concerns about the rate increase.

In setting the rate of return, consumer interests are not a mere afterthought; accordingly, the North Carolina Supreme Court has held that the Commission must make findings of fact about the impact of changing economic conditions upon consumers when it considers what rate of return to establish pursuant to N.C. Gen. Stat. § 62-133(b)(4).[42]

Although the unemployment rate in North Carolina overall has fallen since the peak in 2009-2010, the rate in Dominion's service territory remains over 100 basis points higher than the national unemployment rate. (Tr. Vol. 6 p 654) The residential electric rates are below the national average, but at the same time, the median household income has grown slower in North Carolina than the national average and is more than 10% below norm. (*Id.*)

Cost is an important factor to consider in determining a reasonable ROE because even small increases or decreases in the ROE make a large difference in the utility's revenue requirement, particularly when the cost of income taxes is

---

[41] *Public Staff 2*, 331 N.C. at 221, 415 S.E.2d at 358-59.
[42] *State ex rel. Utilities Comm'n v. Cooper*, 367 N.C. 644, 650, 766 S.E.2d 827, 830 (2014).

OFFICIAL COPY

Nov 06 2019

taken into account. Here, over $6 to 8 million would be shaved from Dominion's annual revenue requirement if the Commission were to establish an ROE in the range recommended by Dr. Woolridge of 8.75% to 9.0% instead of the 9.75% ROE proposed in the Stipulation. (AGO-Johnson Cross Exhibit 1; Off. Ex. Vol. 6 p 4) This $ 6 to 8 million will be charged to Dominion's customers year after year.

Customers testified about the impact of the proposed rate increase at public hearings held in Halifax, Williamston, and Manteo, (Tr. Vol. 1 – Tr. Vol. 3), and identified the following key concerns:

- Low income, senior citizens or disabled individuals who live on a fixed income and currently have difficulty paying their utility bill will have even more difficulty paying their bills if there is an increase in the utility rates. (Tr. Vol. 1 pp 9-10, 19-20; Tr. Vol. 2 pp 12, 14-15, 22-24, 27-28; Tr. Vol. 3 pp 12-15, 26)
- Rate increases are burdensome on all residents and businesses. (Tr. Vol. 1 pp 12-14, 16-17; Tr. Vol. 2 pp 13-14, 16-19, 21, 23; Tr. Vol. 3 p 19)
- Some think the rate increase serves to increase profits, benefit shareholders, and CEO salaries. (Tr. Vol. 2 pp 11-15, 22-23; Tr. Vol. 3 pp 22-23, 30)

The budgetary concerns of these customers are equally as valid as the desire of Dominion's shareholders to reap more return on their investment.

OFFICIAL COPY

Nov 06 2019

OFFICIAL COPY

Nov 06 2019

The legislature intended for the Commission to set the rate of return as low as "may be reasonably consistent" with Constitutional requirements.[43] Here, Mr. Hevert's opinion patently fails to meet this standard. His models were demonstrably unreliable and upwardly-biased and his original recommendation and the stipulated ROE were not supported by evidence and should also be rejected. There is no credible and legally-valid expert opinion supporting the Stipulation ROE of 9.75% ROE. Therefore, for the reasons stated in Dr. Woolridge's testimony, the Commission should set the ROE between 8.75% and 9.0%.

II. IF DOMINION IS ALLOWED TO RECOVER COAL ASH COSTS FROM RATEPAYERS, IT SHOULD NOT BE ALLOWED TO ADD A RATE OF RETURN TO THOSE COSTS.

Dominion's proposed increase includes not only the costs of closing coal ash ponds, but *also* adds a rate of return to those costs as they are deferred and again as they are amortized. (Tr. Vol. 4 pp 271, 337-38) Assuming *arguendo* that Dominion has demonstrated that the coal ash costs are recoverable, it is not appropriate or lawful for the Commission to authorize Dominion to add a rate of return on the costs during deferral and amortization.

Dominion's coal ash proposal includes a rate of return for Dominion on the costs both during deferral and during amortization. Mr. McLeod testified in rebuttal testimony that Dominion seeks to recover $21.9 million from North Carolina retail ratepayers for coal ash closure costs ("CCR") that have been deferred since the last rate case, $2.7 million of which is for the "financing cost" based on the

[43] *See Duke Power,* 285 N.C. 377, 388, 206 S.E.2d 269, 276 (1974).

Company's weighted average cost of capital. (Tr. Vol. 6 p 663 n.1)[44] The Company initially proposed to amortize the cost of coal ash disposal (including the added rate of return during deferral) over a three-year period, and to include the unamortized balance in ratebase so that Dominion will continue to earn a rate of return until the costs are fully recovered. (Tr. Vol. 4 pp 337-38) Under the Stipulation, coal ash cost recovery issues were not resolved and the Company did not withdraw its request for a return on coal ash costs. However, in conjunction with the Stipulation, the Company did propose a longer amortization period for cost recovery, changing from a three-year period to a five-year period. (*Id.*)

Dominion asks the Commission to add the rate of return amount during deferral and amortization based on the rationale that was applied in Commission orders in recent Duke Energy rate cases.[45] The AGO has appealed from the portion of those orders that granted Duke Energy a rate of return on coal ash disposal costs attributable to past service and costs relating to retired plants.[46]

It is not fair or lawful for Dominion be allowed to profit from its coal ash closure activities by earning a rate of return as it spends to close impoundments and dispose of waste that has accumulated for decades.

---

[44] The North Carolina retail jurisdictional share is based on system-wide deferred costs of $376.7 million. (*Id.*)

[45] Duke Energy Progress Order Accepting Settlement, Deciding Contested Issues and Granting Partial Rate Increase, issued 23 February 2018 in Docket No. E-2, Sub 1142; Duke Energy Carolinas Order Accepting Settlement, Deciding Contested Issues and Requiring Revenue Reduction, issued 22 July 2018 in Docket No. E-7, Sub 1146.

[46] *See* N.C. Supreme Court Case Nos. 271A18 and 401A18.

OFFICIAL COPY

Nov 06 2019

Two categories of expenditures may be captured in rates: those that make up a utility's rate base, and those that make up its operating expenses.[47] Only the utility's rate base, not its operating expenses, is eligible to be multiplied by a rate of return.[48] Our Supreme Court has enforced the distinction between rate bases and operating expenses. On at least three earlier occasions, it has reversed the Commission for putting property that was not used and useful into a utility's rate base.[49]

Here, Dominion must show that its coal ash costs meet the test for inclusion in rate base, and it has failed to do that because it has not shown that the costs are for property that is used and useful for providing current service to consumers.

A. <u>Coal ash costs were not spent on property that is used and useful for providing current utility service.</u>

The North Carolina Supreme Court has noted that "[t]here is but one rate base," namely, the rate base defined by the ratemaking statute.[50] In *Thornburg II,* this Court explained that, for everything other than construction work in progress, a two-part test decides what goes into a utility's rate base:

---

[47] *See, e.g.*, *State ex rel. Utilities Com. v. Thornburg*, 325 N.C. 463, 467 n.2, 385 S.E.2d 451, 453 n.2 (1989) ("*Thornburg I")*; N.C. Gen. Stat. § 62-133(b).

[48] *Thornburg I*, 325 N.C. at 475, 385 S.E.2d at 458; N.C. Gen. Stat. § 62-133(b)(5).

[49] *State ex rel. Utilities Comm'n v. Carolina Water*, 335 N.C. 493, 507-08, 439 S.E.2d 127, 135 (1994) ("*Carolina Water*") (reversing Commission's decision to put retired wastewater treatment plant into ratebase); *State ex rel. Utils. Comm'n v. Pub. Staff-N.C. Utils. Comm'n*, 333 N.C.195, 202, 424 S.E.2d 133, 137 (1993) (*Carolina Trace*) (reversing Commission's order that put into rate base a wastewater connection that a utility was no longer using); *State ex rel. Utilities Com. v. Thornburg*, 325 N.C. 484, 495, 385 S.E.2d 463, 469 (1989) ("*Thornburg II*") (reversing Commission's decision to put costs to construct excess nuclear facilities into rate base); *see also State ex rel. Utils. Comm'n v. Morgan*, 277 N.C. 255, 273, 177 S.E.2d 405, 417 (1970) (holding that it was erroneous, before statutory amendment that authorized the practice, to put construction work in progress into rate base because the work in progress did not produce income during the test period).

[50] *Morgan*, 277 N.C. at 268, 177 S.E.2d at 414.

OFFICIAL COPY

Nov 06 2019

- First, the Commission must "determine the reasonable original cost of the property."[51]
- Second, the Commission must determine whether the property is "used and useful, or to be used and useful within a reasonable time after the test period."[52]

"If the costs in question do not meet both parts of the test, the costs may not be included in the rate base for ratemaking purposes."[53]

The Court's *Carolina Trace* opinion illustrates what it means for property to be used and useful for providing current utility service.[54] One issue in *Carolina Trace* was whether the Commission had properly included in a utility's rate base the entire cost of a sewer connection that had been used for a time, but was abandoned by the time the rate case was filed.[55] The Court reversed the Commission's order, because it was erroneous to allow the utility's rate base to include any completed facility that is not used and useful for providing current service.[56]

Here, Dominion has failed to show which (if any) of its deferred coal-ash disposal costs were *property used and useful* for providing current service. Coal ash costs do not fit any definition of *property*. Black's Law Dictionary defines property as "[c]ollectively the rights in a valued resource such as land, chattel, or an intangible" and as "[a]ny external thing over which the rights of possession, use,

---

[51] 325 N.C. at 491, 385 S.E.2d at 466-67 (citing N.C. Gen. Stat. § 62-133(b)(1)).
[52] *Id.*
[53] *Id.*
[54] 333 N.C. 195, 424 S.E.2d 133.
[55] *Id.* at 197-99, 424 S.E.2d at 134-35.
[56] *Id.* at 202-03, 424 S.E.2d at 137.

OFFICIAL COPY

Nov 06 2019

and enjoyment are exercised."[57] Dominion's coal-ash costs, in contrast, mainly involve expenditures made in preparing closure plans for coal-ash impoundments, treating contaminated groundwater, excavating coal ash, transporting it to other locations, and disposing of it. (Tr. Vol. 6 pp 229-30; Tr. Vol. 5 pp 89-93; Late-Filed Exhibit 5, MDM-1) Those costs are typically accounted for as operating expenses. (Tr. Vol. 6 pp 229-30) Further, most or all of the costs are not expenditures for property "used and useful . . . in providing the service rendered to the public within the State." (Tr. Vol. 6 pp 230-32)[58] Indeed, the evidence indicates that the costs were related to disposal of waste from power generation for electrical service that was provided in the past, instead of for property that is used and useful for providing electric service to current customers. (Tr. Vol. 5 pp 89-93) To the extent that Dominion is allowed to recover the costs to dispose of coal ash that has accumulated for decades, the Company should not additionally be given an opportunity to turn the circumstances into an opportunity for profit-making from current customers.

Investments in facilities that are not used to provide current service, and that will never again be in use, may not, as a matter of law, be included in a utility's rate base. In *Carolina Water*, the North Carolina Supreme Court held that it was an error of law for the Commission to accord rate-base treatment to a utility's investment in a retired wastewater-treatment plant. The Court stressed that "[t]here

---

[57] *Property*, Black's Law Dictionary 1410 (10th ed. 2014).
[58] N.C. Gen. Stat.§ 62-133(b)(1); (b)(3).

OFFICIAL COPY

Nov 06 2019

is no statutory authority for including in rate base costs from a completed plant that is no longer used and useful."[59]

Likewise, in *Carolina Trace*, the property at issue was constructed, used for a time, and then rendered unnecessary before the company's next rate proceeding.[60] Because the property would never again be in use, the Court held that it would not ever be allowed to enter the utility's rate base.[61]

As these cases show, the fact that property might have been used and useful for past service does not make that property used and useful for current service. Current service is the statutory test.[62]

Dominion's coal ash costs are expenditures made to dispose of many decades' worth of coal-ash waste and to close coal ash basins related to electric service provided to customers in the past. (Tr. Vol. 5 pp 85-88) In fact, most of Dominion's expenditures relate to coal stations that have been retired or converted to natural gas and the ash ponds have been retired for years or decades. (*Id.*; Late Filed Exhibit 5 MDM-1)

Thus, Dominion is asking its current customers to pay to dewater, excavate, transport, and dispose of waste generated by coal that was burned as long ago as the 1930s. (Tr. Vol. 5 p 86) That past activity is in no way used and useful for providing current utility service to customers. It is unfair—and unlawful—to make

[59] *Carolina Water*, 335 N.C. at 508, 439 S.E.2d at 135 (citing *Carolina Trace*, 333 N.C. at 202, 424 S.E.2d at 137).
[60] 333 N.C. at 197-98, 424 S.E.2d at 134-35.
[61] *Id.* at 202-03, 424 S.E.2d at 137.
[62] N.C. Gen. Stat. § 62-133(b)(1).

OFFICIAL COPY

Nov 06 2019

today's customers pay Dominion a return on expenditures made now relating to electric service to past customers.

Moreover, the costs to address coal ash do not become investment in rate base simply because the expenditures are useful for environmental compliance. Environmental-compliance costs can be reasonable (and thus recoverable as costs) and still fail the higher standard for generating a return: being used and useful for providing current electric service. There is a difference between the "used and useful" test for inclusion of costs in ratebase and the "reasonableness" test that applies to expenses.

For example, in *Thornburg II*, the Supreme Court affirmed the Commission's conclusion that certain expenditures on facilities were prudent.[63] Even so, the Court held that, as a matter of law, the utility could not receive a return on these expenses, because the facilities at issue were not used and useful for current service.[64]

Indeed, the Commission has previously followed this distinction in a 1994 general rate case for Public Service Company of North Carolina.[65] That case addressed the costs of cleaning up environmental contamination at Public Service Company's manufactured-natural-gas plants.[66] The Commission held that, as a

[63] 325 N.C. at 493, 385 S.E.2d at 468.
[64] *Id.* at 496, 385 S.E.2d at 470.
[65] Order Granting Partial Rate Increase *In the Matter of Application of Public Service Company of North Carolina, Inc., for an Adjustment of its Rates and Charges*, issued 7 October 1994 in Docket No. G-5, Sub 327, at 20-23.
[66] *Id.* at 23.

OFFICIAL COPY

Nov 06 2019

matter of law, the utility could not receive a return on clean-up costs at sites that were not providing current service to customers.[67]

As these decisions illustrate, Dominion's costs for closing its coal ash basins and disposing of the waste are not used and useful for providing current service and it is not appropriate to authorize Dominion to recover a rate of return on the costs.

B. Dominion's creation of an Asset Retirement Obligation does not entitle the Company to a return on expenditures that are not 'property used and useful' in providing utility service.

When Dominion records an asset retirement obligation ("ARO") for financial accounting purposes the information is pertinent to *investors,* but does not change how the costs must be accounted for in ratemaking. Indeed, the creation or existence of an ARO does not require that Dominion's coal-ash removal costs are "property used and useful, or to be used and useful within a reasonable time after the test period, in providing the service rendered to the public,"[68] and no exception to the used and useful requirement is provided for an ARO in the ratemaking statute.[69]

Rather, the accounting treatment adopted by a utility—even when approved by the Commission—cannot and does not "create a liability upon the company's customers or establish the company's right to recover from its customers the amounts so entered."[70]

---

[67] *Id.*
[68] N.C. Gen. Stat. § 62-133(b)(1).
[69] *Id.*
[70] *State ex rel. Utilities Com. v. Edmisten*, 291 N.C. 451, 464, 232 S.E.2d 184, 191 (1977); accord *State ex rel. Utilities Comm'n v. North Carolina Power*, 338 N.C. 412, 421-22, 450 S.E.2d 896, 901-02 (1994); *Carolina Trace*, 333 N.C. at 203, 424 S.E.2d at 138.

OFFICIAL COPY

Nov 06 2019

The Commission itself has recognized this principle in other cases, including in the context of ARO costs. In 2004, the Commission authorized the use of deferral accounting for asset retirement obligations created by utilities to address financial accounting requirements, but specified that the net effect of the deferral accounting must be to continue the Commission's currently existing accounting and ratemaking practices.[71] The Order granted the deferral request but required in particular that "the effect of the deferral accounting allowed shall be to reset [the Company's] retail rate base, net operating income, and regulatory return on common equity to the same levels as would have existed had [the ARO financial accounting requirements] not been implemented."[72]

This distinction – which the Commission itself drew in 2004 – is the same one that applies here. Dominion's accounting treatment of its coal ash costs does not control the Commission's treatment of those costs for ratemaking purposes.

C. The rate of return Dominion proposes to recover on coal ash expenditures is not "working capital" that may be included in rate base simply because the expenditures were made from utility funds.

Dominion also argues that the rate of return it proposes to recover on coal ash costs is "working capital" that may be included in rate base under reasoning discussed by our Supreme Court in *VEPCO.* (Tr. Vol. 7 pp 668-69)[73] In that case, our Supreme Court held that working capital may be included in a utility's rate

[71] Order Allowing Utilization of Certain Accounts issued 6 August 2004 in Docket No. E-22, Sub 420 ("2004 ARO Accounting Order"), Ordering paragraph 2; AGO-McLeod Cross Exhibit 1 at 5, Off. Ex. Vol. 4 p 198.
[72] *Id.*
[73] *State ex rel. Utilities Commission v. Virginia Electric & Power Co.*, 285 N.C. 398, 206 S.E.2d 283 (1974) ("*VEPCO*").

OFFICIAL COPY

Nov 06 2019

base.[74] The Court defined working capital as "the utility's own funds reasonably invested in . . . materials and supplies and its cash funds reasonably so held for the payment of operating expenses, as they become payable."[75]

However, this holding does not state nor does it signify that all capital supplied by investors must be included in the utility's rate base.[76] Under North Carolina law, the provision of capital by investors is a necessary condition, but not a sufficient basis, for putting assets into a utility's rate base. For an asset to get rate-base treatment, it must not only have been funded by the utility's investors, but must also be used and useful for providing current utility service.

In *Morgan*, the Court made clear that the mere fact that investors have funded certain expenses is not enough to allow a utility to put those expenses in its rate base.[77] There, the Court held that the Commission erred by giving a utility a return on its investments in a facility that was still under construction and not yet in use. If all capital supplied by investors were entitled to be treated as working capital the *Morgan* Court would have allowed the investments at issue to go into the utility's rate base. The Court, however, did the opposite. *Morgan* is instructive, because in that case, the Court also decided whether the utility could include working capital in its rate base, and noted that rate base should include working capital supplied by the company, but not funds supplied by its customers.[78] Taken as a whole, the lesson of *Morgan* is that the Court's admonition that working capital

[74] *Id.* at 414-15, 206 S.E.2d at 295-96.
[75] *Id.*
[76] *Id.*
[77] 277 N.C. at 273, 117 S.E.2d at 417.
[78] *Id.* at 273-74; 177 S.E.2d at 417.

OFFICIAL COPY

Nov 06 2019

can be placed into rate base if it is supplied by investors is intended as a reminder that investor-supplied funds are a necessary—but not sufficient—precondition to putting property into rate base.

The Supreme Court has applied this same analysis in multiple other cases. Again and again, it has held that a utility's rate base excluded property that was presumably funded by investors, but that failed the additional requirement of being used and useful:

- In *Thornburg II*, the issue was whether a utility's rate base could include the parts of common facilities that served three abandoned units at the Shearon Harris nuclear plant.[79] This Court held that as a matter of law, these excess facilities were not used and useful.[80]
- In *Carolina Water*, a utility was facing unrecovered costs that resulted from the early retirement of a wastewater-treatment plant.[81] The Court held that including these costs in the utility's rate base was erroneous. That outcome, the Court held, would allow the utility "to earn a return on its investment at the expense of the ratepayers."[82]
- In *Carolina Trace*, as noted earlier, the Court barred a utility from receiving a return on any part of its investment in a sewer connection that was constructed and abandoned during the time between the

---

[79] 325 N.C. at 486, 385 S.E.2d at 464.
[80] *Id.* at 495, 385 S.E.2d at 469.
[81] 335 N.C. at 507, 439 S.E.2d at 135.
[82] *Id.* at 508, 439 S.E.2d at 135.

OFFICIAL COPY

Nov 06 2019

utility's rate cases.[83] Because of that timing, the property never qualified as used and useful. [84]

As such, our Supreme Court has never recognized any exceptions to the "used and useful" requirement. There is no working-capital exception. There is no exception for funds supplied by investors. There is no statutory authority for the Commission to grant a return on expenditures that are not used and useful for service during the test year.[85] Dominion has not shown that its coal ash expenses meet the used-and-useful requirement, and the "working capital" argument must fail.

In sum, it is beyond the Commission's authority to allow Dominion to receive a return on its coal ash costs and Dominion should not be allowed to profit from current customers for actions taken now to dispose of coal ash that has accumulated for decades and to close ash ponds no longer in use.

CONCLUSION

For the reasons stated above, the Commission should set Dominion's Return on Common Equity at between 8.75% and 9.0%. Additionally, the Commission should eliminate the rate of return that Dominion seeks on deferred and amortized coal ash closure costs.

---

[83] 333 N.C. at 203, 424 S.E.2d at 137.
[84] *Id.*
[85] *Carolina Trace*, 333 N.C. at 203, 424 S.E.2d at 137; accord *Carolina Water*, 335 N.C. at 508, 439 S.E.2d at 135 (citing *Carolina Trace*).

OFFICIAL COPY

Nov 06 2019

Respectfully submitted this the 6th day of November, 2019.

JOSHUA H. STEIN
ATTORNEY GENERAL

__/s/______________________

Jennifer T. Harrod
Special Deputy Attorney General
N.C. Department of Justice
Post Office Box 629
Raleigh, N.C. 27602-0629
Telephone: (919) 716-6692
Facsimile: (919) 716-6050
jharrod@ncdoj.gov

__/s/______________________

Margaret A. Force
Assistant Attorney General
N.C. Department of Justice
Post Office Box 629
Raleigh, N.C. 27602-0629
Telephone: (919) 716-6053
Facsimile: (919) 716-6050
pforce@ncdoj.gov

CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing BRIEF OF THE ATTORNEY GENERAL'S OFFICE has been served upon the parties of record in this proceeding by email or by depositing a copy of the same in the United States Mail, postage prepaid, this the 6th day of November 2019.

__/s/______________________

Margaret A. Force
Assistant Attorney General

OFFICIAL COPY

Nov 06 2019