

STATE OF VERMONT
PUBLIC UTILITY COMMISSION

Case No. 18-0974-TF

Tariff filing of Green Mountain Power Corporation requesting a 5.45% increase in its base rates effective with bills rendered January 1, 2019, to be fully offset by bill credits through September 30, 2019

PREFILED SURREBUTTAL TESTIMONY OF

RICHARD A. BAUDINO

ON BEHALF OF THE

VERMONT DEPARTMENT OF PUBLIC SERVICE

OCTOBER 8, 2018

Summary: Mr. Baudino responds to the rebuttal testimony of James Coyne regarding GMP's proposed cost-of-capital. Mr. Baudino disagrees with portions of Mr. Coyne's rebuttal testimony, but the Department maintains its recommendation that the Commission approved an authorized rate of return on equity ("ROE") of 9.3%.

Surrebuttal Testimony
Of
Richard A. Baudino

1 **Q1. Please state your name and business address.**

2 A1. My name is Richard A. Baudino. My business address is J. Kennedy and Associates,
3 Inc. (“Kennedy and Associates”), 570 Colonial Park Drive, Suite 305, Roswell,
4 Georgia 30075.

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6 **Q2. Did you submit direct testimony in this proceeding?**

7 A2. Yes. I submitted direct testimony on behalf of the Vermont Department of Public
8 Service (the “Department”).

9
10 **Q3. What is the purpose of your surrebuttal testimony?**

11 A3. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Mr.
12 James Coyne, witness for Green Mountain Power Corporation (“GMP” or
13 “Company”).

14
15 **Q4. Please summarize Mr. Coyne’s response to your direct testimony.**

16 A4. In his rebuttal testimony, Mr. Coyne noted on page 1 that GMP and the Department
17 are in agreement regarding the return on equity “(ROE)” in this proceeding and that
18 “[b]ecause of this general agreement between the parties, my rebuttal testimony is
19 limited.” Mr. Coyne summarized the main differences in our respective approaches
20 to estimating GMP’s cost of equity in his Exhibit GMP-JMC-13.

1 **Q5. Please summarize your response to Mr. Coyne's rebuttal testimony.**

2 A5. Like Mr. Coyne, and as discussed in more detail in my direct testimony, I
3 acknowledge that the Department and GMP agree on the allowed ROE in this
4 proceeding. Given this agreement on ROE and the more limited nature of Mr.
5 Coyne's rebuttal testimony, my response to Mr. Coyne's rebuttal testimony will also
6 be more limited than it otherwise would have been absent such an agreement.

7

8 As a general matter, Mr. Coyne pointed out the areas of disagreement between us
9 that led to our differing conclusions regarding our recommended ROE absent the
10 agreement between the Department and GMP. Mr. Coyne's rebuttal testimony does
11 not change any recommendations or conclusions I made in my direct testimony and
12 so I will not simply restate those recommendations in my surrebuttal testimony. For
13 purposes of my surrebuttal testimony, I will address and reply to the following major
14 areas of disagreement between Mr. Coyne and myself:

- 15 • The use of current vs. forecasted interest rates.
- 16 • Reliance on the Discounted Cash Flow ("DCF") model.
- 17 • The expected market return for the Capital Asset Pricing Model ("CAPM").
- 18 • GMP risk analysis.

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1 **Q6. Regarding current interest rates, please describe recent actions by the Federal**
2 **Reserve (“Fed”) regarding short-term interest rates.**

3 A6. On September 26, 2018 the Fed announced another increase to its target range for the
4 federal funds rate to 2% - 2.25%. In its press release on September 26, the Fed
5 stated the following:

6 Information received since the Federal Open Market Committee met
7 in August indicates that the labor market has continued to strengthen
8 and that economic activity has been rising at a strong rate. Job gains
9 have been strong, on average, in recent months, and the
10 unemployment rate has stayed low. Household spending and
11 business fixed investment have grown strongly. On a 12-month basis,
12 both overall inflation and inflation for items other than food and
13 energy remain near 2 percent. Indicators of longer-term inflation
14 expectations are little changed, on balance.

15
16 Consistent with its statutory mandate, the Committee seeks to foster
17 maximum employment and price stability. The Committee expects
18 that further gradual increases in the target range for the federal funds
19 rate will be consistent with sustained expansion of economic activity,
20 strong labor market conditions, and inflation near the Committee’s
21 symmetric 2 percent objective over the medium term. Risks to the
22 economic outlook appear roughly balanced.

23
24 In view of realized and expected labor market conditions and
25 inflation, the Committee decided to raise the target range for the
26 federal funds rate to 2 to 2-1/4 percent.”
27

28 The Fed also supplied an update to its economic projections for growth in gross
29 domestic product (“GDP”), the unemployment rate, inflation, and the federal funds
30 rate. The Fed’s projections show a 3.0% federal funds rate for the longer run. This
31 was a slight increase from the 2.9% projection in June 2018.

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1 **Q7. How did the Fed's increase in the target range for the federal funds rate affect**
2 **long-term interest rates?**

3 A7. As of September 26, 2018, the yield on the 30-year Treasury bond was 3.20% per
4 data on the Federal Reserve's web site. The yield on the average utility bond was
5 4.43% on that date according to Moody's Credit Trends. Comparing these bond
6 yields to the June 2018 yields I reported in my direct testimony, the 30-year Treasury
7 bond yield rose slightly from 3.05% and the average utility bond yield rose a few
8 basis points from 4.37%.

9
10 **Q8. Does the recent increase in the target range for the federal funds rate affect**
11 **your recommended ROE?**

12 A8. No. The slight increases in the long-term bond yields I just cited are not significant
13 enough to change my recommendation of 9.1% for GMP. I note that the 30-year
14 Treasury bond yield rose as high as 3.13% during the 6-month period I used for
15 Treasury Bond yields in my exhibit PSD-RAB-4. The small increase to 3.2% on
16 September 26 is simply not enough to warrant any change in my recommendation
17 now.

18
19 **Q9. Has the yield on the 30-year Treasury Bond continued to rise in October?**

20 A9. Interest rates continued to rise in October, with the yield on the 30-year Treasury
21 bond rising from 3.19% on September 29 to 3.30% on October 3. Once again, this
22 very recent increase in the long-term Treasury bond yield does not change my
23 recommendation in this proceeding.

1 **Q10. What is the most recent Value Line Investment Survey opinion regarding**
2 **interest rates and utility stock prices?**

3 A10. Value Line noted the following in its September 14, 2018 report on the Electric
4 Utility (Central) Industry:

5 As of September, electric utility equities had turned in a mixed
6 performance in 2018. In most cases, company specific drivers are
7 influencing share prices more than any theme in this Industry.
8 Among the utility issues covered in Issue 5, OGE Energy has been
9 the top performer, having risen 12%. The company is performing
10 well, and the market's expectation of a 10% dividend hike is
11 appealing for investors. Vectren has also fared well, up about 10%,
12 thanks to the aforementioned takeover agreement with CenterPoint.

13
14 *Although interest rates have risen this year and are expected to climb*
15 *further, this has not hampered the stocks in this group. Their average*
16 *dividend yield is just 3.4%, which is low (by historical standards).*
17 *Many of these stocks' recent prices are within the 2021-2023 Target*
18 *Price Range. This means that total return potential over that time*
19 *frame is low. (italics added)*
20

21 **Q11. Is the DCF a reliable model to use to estimate the ROE for GMP given the**
22 **recent increase in the target federal funds rate?**

23 A11. Yes, most definitely. Value Line pointed out that even though interest rates have
24 risen this year, that increase did not hamper the regulated utility stocks it follows.
25 Current stock prices are still relevant indicators of investor preferences and return
26 requirements and continue to be reliable indicators of the required ROE for investors
27 in regulated utility stocks.

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1 **Q12. Should the Vermont Public Utility Commission (“the Commission”) still rely on**
2 **current, rather than future interest rates when evaluating the ROE for GMP?**

3 A12. Yes. The recent increase in the target federal funds rate did not significantly affect
4 long-term interest rates. And, with this being the case, it does not affect my
5 recommended ROE. I still strongly recommend that the Commission rely on current
6 interest rates in this proceeding, not the projected interest rates relied upon by Mr.
7 Coyne. I note that the recent 3.2% yield on the 30-year Treasury bond is still far
8 below the 4.1% projected yield recommended by Mr. Coyne in his direct testimony.

9
10 **Q13. On page 9 of Exhibit GMP-JMC-13, Mr. Coyne presented an analysis using the**
11 **median authorized ROE for a vertically integrated utility of 9.63% and your**
12 **historical market risk premium of 7.1% and suggested that either your market**
13 **risk premium or your risk-free, or both, rate are “substantially understated.”**
14 **Please respond to Mr. Coyne’s analysis.**

15 A13. I did not rely on the 7.1% historical market risk premium for my ROE
16 recommendation for GMP. The 7.1% historical market risk premium I used in my
17 exhibit PSD-RAB-5 resulted in a CAPM ROE of 7.92% that was far too low and,
18 thus, it did not factor into my ROE recommendation to the Commission. My DCF
19 analyses all indicated a higher, more reasonable ROE than my CAPM analyses and I
20 continue to recommend an allowed ROE based on the DCF.

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1 **Q14. Did Mr. Coyne address the forward-looking CAPM market returns you**
2 **employed in exhibit PSD-RAB-4?**

3 A14. In my opinion, he did not and simply concluded on page 14, lines 12 through 15 of
4 Exhibit GMP-JMC-13 that the results from my CAPM analyses were too far below
5 the range of a reasonable return to be useful in determining the ROE for GMP.

6
7 I utilized two alternative forward-looking market return estimates from Value Line
8 that resulted in a range of 10.0% - 10.83%, with an average market return of 10.41%.
9 These are valid market return estimates using Value Line projections that are widely
10 available to investors and I continue to stand by them. In this proceeding the CAPM
11 results using those estimates came in significantly below my DCF estimates and I
12 chose not to rely on them, with the DCF model being a stronger and more reliable
13 model overall than the CAPM.

14
15 **Q15. Is it still your position that Mr. Coyne's market return estimate of 14.72% is**
16 **excessive?**

17 A15. Yes. Mr. Coyne's market return estimate significantly exceeds the long-run
18 historical returns on the S&P 500, which range from 10.2% –12.1%. Combining this
19 overstated market return with the inflated forecasted risk-free rate of 4.1% resulted in
20 a CAPM ROE range of 10.33%–11.6% in Mr. Coyne's direct testimony. These
21 CAPM results all exceed Mr. Coyne's recommended ROE range of 9.5%–10.0%.

22

1 **Q16. On page 14, lines 17 through 19 of Exhibit GMP-JMC-13 Mr. Coyne testified**
2 **that you made a risk determination for GMP based on a “high-level**
3 **comparative analysis of credit ratings” of your proxy group. Please respond to**
4 **Mr. Coyne on this point.**

5 A16. Standard and Poor’s, Moody’s, and Fitch all perform detailed risk analyses before
6 they assign credit ratings to their subject companies. These analyses evaluate many
7 aspects of the business and financial risks faced by each company. The credit rating
8 comparison I presented in Table 2 of my direct testimony certainly provides the
9 Commission a sound and reasonable basis for comparing GMP’s risks with those of
10 the companies in the proxy group and I stand by that presentation.

11

12 **Q17. Does this complete your surrebuttal testimony?**

13 A17. Yes.

