



Before the South Dakota Public Utilities Commission
State of South Dakota

In the Matter of the Application of Otter Tail Power Company
For Authority to Increase Rates for Electric Utility
Service in South Dakota

Docket No. EL18-021

Exhibit ____

COST OF CAPITAL

Rebuttal Testimony and Schedules of

Kevin G. Moug

March 15, 2019

TABLE OF CONTENTS

I. INTRODUCTION..... 1

II. SUMMARY OF REBUTTAL TESTIMONY 1

III. MR. COPELAND’S RECOMMENDATIONS 2

 A. Mr. Copeland’s Recommendation 2

 B. Probable Effects on Market Perceptions of OTP 3

 C. Possible Effects on Perceptions of the South Dakota Regulatory Environment..... 6

IV. CONCLUSION..... 7

1 **I. INTRODUCTION**

2 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

3 A. My name is Kevin G. Moug. My business address is 4150 19th Avenue S. Suite 101
4 Fargo, ND 58103.

5

6 Q. BY WHOM ARE YOU EMPLOYED AND WHAT IS YOUR POSITION?

7 A. I am the Chief Financial Officer and Senior Vice President of Otter Tail Corporation
8 (OTTR) and the Treasurer for Otter Tail Power Company (OTP). OTP is a wholly-owned
9 subsidiary of OTTR.

10

11 Q. DID YOU PREPARE DIRECT TESTIMONY IN THIS PROCEEDING?

12 A. Yes. I filed Direct Testimony on behalf of OTP addressing financial soundness, and
13 supporting the OTP capital structure and cost of capital for the 2017 Test Year.

14 **II. SUMMARY OF REBUTTAL TESTIMONY**

15 Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

16 A. The decision of the South Dakota Public Utilities Commission (Commission) in setting the
17 Return on Equity (ROE) for OTP will send signals to the capital markets in regards to
18 investing in South Dakota utilities. An ROE set well below the national average and the
19 average for other South Dakota utilities will cause concern for rating agencies and the debt
20 and equity markets that the Commission is not supportive of utilities who are looking to
21 make investments in South Dakota to improve reliability and customer service.

22 Adopting the cost of equity analysis, ROE range or specific ROE recommendation
23 of Mr. Basil L. Copeland, Jr. would likely reduce capital markets' interest in investing in a
24 utility doing business in South Dakota and reduce utilities' interest in investing in South
25 Dakota. Those results would be likely because Mr. Copeland's cost of equity analysis,
26 ROE range, and specific ROE recommendation are so far outside and below the
27 mainstream of ROEs awarded by other regulatory commissions. For example, the average

1 ROE for vertically integrated electric utilities authorized in 2018 was 9.68 percent. Mr.
2 Copeland’s cost of equity analysis, ROE range, and specific ROE recommendation are also
3 far below what OTP estimates to be the currently authorized ROE for other South Dakota
4 electric utilities, as discussed in more detail by OTP witness Mr. Bruce G. Gerhardson.

5 As discussed by OTP witness Mr. Robert B. Hevert, far better returns would be
6 available from investing in virtually any other state in the United States. The result would
7 be an increase to the cost of capital for utilities doing business in South Dakota, reduced
8 investments in South Dakota or both.

9 An ROE for OTP below the national mainstream or below the authorized ROE of
10 other utilities in South Dakota would send more pronounced signals because of the context
11 of this case. OTP has made, and is making, extensive investments in South Dakota,
12 providing exceptionally high-quality service and cost savings over many years, and filing
13 very infrequent general rate cases in South Dakota. Lack of support for those results would
14 be particularly unsettling.

15 **III. MR. COPELAND’S RECOMMENDATIONS**

16 **A. Mr. Copeland’s Recommendation**

17 Q. HOW DOES THE RESULT OF MR. COPELAND’S COST OF EQUITY ANALYSIS
18 COMPARE TO ROES APPROVED BY OTHER COMMISSIONS?

19 A. Mr. Copeland asserts that OTP’s cost of equity “is presently about 7 percent.”¹ Mr. Hevert
20 explains that Mr. Copeland’s asserted cost of equity is far below the lowest ROE for a
21 vertically integrated electric utility authorized by any regulatory commission since at least
22 1980.² It is also more than 250 basis points below the average ROE authorized in 2018.

¹ Copeland Direct, p. 3.

² Hevert Rebuttal, Section II.

1 Q. HOW DOES MR. COPELAND’S RECOMMENDED ROE COMPARE TO OTHER
2 ROES APPROVED BY THE COMMISSION?

3 A. Mr. Copeland’s recommended 8.25 percent ROE is 100 basis points or more below OTP’s
4 estimate of the Commission-approved ROEs now in effect for other South Dakota utilities,
5 as further explained in the Rebuttal Testimony of Mr. Gerhardson.
6

7 Q. HOW DOES MR. COPELAND’S RECOMMENDED ROE COMPARE TO ROES
8 GRANTED BY OTHER STATE COMMISSIONS?

9 A. As Mr. Hevert also further explains in his Rebuttal Testimony, an 8.25 percent ROE would
10 be approximately 155 basis points lower than the average ROE granted in 2017 and 143
11 basis points lower than the average ROE granted in 2018. If adopted, Mr. Copeland’s
12 recommended ROE would be the lowest ROE awarded a vertically integrated electric
13 utility in the United States since at least 1980.³

14 **B. Probable Effects on Market Perceptions of OTP**

15 Q. WHAT ARE THE PROBABLE EFFECTS ON MARKET PERCEPTIONS OF OTP IF
16 THE COMMISSION WERE TO ADOPT A HISTORICALLY LOW ROE FOR OTP?

17 A. Adopting an ROE for OTP at or below the lowest ROE awarded since at least 1980 and far
18 below those awarded in recent history (since 2014, as discussed by Mr. Hevert) would send
19 a signal that OTP’s regulatory environment in South Dakota was deteriorating. The effect
20 could be significant and long lasting.
21

22 Q. WHY DO YOU THINK SUCH IMPACTS WOULD OCCUR?

23 A. One of the factors rating agencies and investors use in evaluating a utility is the regulatory
24 environment in which a utility does business. Predictability of regulatory decisions is an
25 important part of the regulatory environment. A decision by the Commission to grant the
26 lowest ROE since at least 1980, as recommended by Mr. Copeland, would be viewed by
27 rating agencies as an unpredictable outcome, virtually coming out of nowhere, and a
28 significant deterioration from prior Commission decisions.

³ Hevert Rebuttal, Section II.

1 Q. WHY WOULD THAT BE SEEN AS A SIGNIFICANT DETERIORATION FROM
2 PRIOR COMMISSION DECISIONS?

3 A. It is generally understood by capital markets that South Dakota has consistently awarded
4 ROEs that are low, but remain within the low end of the mainstream of ROEs across the
5 country. There has also been a reasonable degree of consistency in the authorized ROEs
6 among utilities doing business in South Dakota, as discussed by Mr. Gerhardson. Ordering
7 an ROE for OTP that was significantly below the mainstream and below other utilities in
8 South Dakota would be seen as an indication that this pattern is no longer in effect.

9
10 Q. WHY WOULD IT BE SEEN AS BEING SO UNPREDICTABLE?

11 A. Such a decision would be seen as being particularly unpredictable because of OTP's
12 superior performance in terms of saving costs, maintaining low rates, and filing rate cases
13 less frequently than other utilities. Specifically, capital markets would view a low ROE
14 for OTP as coming out of nowhere because it would be:

15 (1) Without any justification based on OTP's performance record of
16 consistently superior customer service, low rates, and infrequent rate cases,
17 as Mr. Gerhardson has explained in his Direct Testimony and Rebuttal
18 Testimony; and

19 (2) Unsupportive of OTP's extensive capital expenditure program, which
20 includes the installation of the Big Stone Area Transmission–Ellendale
21 Transmission Project, the Lake Norden Area Transmission Project and the
22 Astoria Generating Station, as explained by Mr. Gerhardson.

23 Granting a low ROE to OTP in the context of this combination of factors would create
24 significant concerns for capital markets about the South Dakota regulatory climate for OTP
25 and the regulatory environment in South Dakota in general.

26

1 Q. DO RECENT OTP CREDIT ANALYSES CONFIRM THE IMPORTANCE OF
2 REGULATORY ENVIRONMENT AND SUPPORT FOR COST RECOVERY?

3 A. Yes. Moody's most recent Credit Opinion for OTP underscored the importance of
4 regulatory environment and support for cost recovery, and expressly noted that lower
5 authorized returns can result in a ratings downgrade:

6 OTP's stable rating outlook incorporates our expectation that OTP's
7 regulatory environments will remain credit supportive and financial policies
8 will remain consistent. ... A rating upgrade could be considered if OTP's
9 regulatory environments improve materially, further shortening regulatory
10 lag and improving rates and returns. ... A rating downgrade is possible if
11 its regulatory environment wanes and becomes less credit supportive, such
12 that regulatory lag increases or there are lower rates and returns.⁴

13 Fitch's August 30, 2018 ratings release said that OTP's credit ratings reflect "a balanced
14 regulatory environment across its three state jurisdictions."⁵

15

16 Q. IS REGULATORY SUPPORT FOR CAPITAL EXPENDITURES ALSO A
17 SIGNIFICANT MATTER TO RATING AGENCIES?

18 A. Yes. S&P's January 8, 2019 Ratings for OTP noted S&P could revise the outlook to stable
19 (currently, the credit outlook is positive) "if rising capital spending continues without
20 adequate and timely recovery of costs."⁶

21

22 Q. ARE ROE AWARDS USED TO MAKE COMPARISONS BETWEEN UTILITIES?

23 A. Yes. As I explained in my Direct Testimony, it is easy for rating agencies and investors to
24 identify and compare ROEs to expectations and to ROEs from other jurisdictions. ROEs
25 are also regarded as an indicator of regulatory support or the lack thereof. As noted above,
26 Moody's expressly identified improving authorized returns as a factor in considering a
27 ratings upgrade *and* worsening authorized returns as a factor in considering a ratings
28 downgrade.

⁴ Moody's Investors Service, Otter Tail Power Company Credit Opinion, p. 2 (Aug. 8, 2018).

⁵ Fitch Ratings, *Fitch Affirms Otter Tail Corp. and Otter Tail Power's IDRs; Outlooks Stable*, p. 2 (Aug. 30, 2018).

⁶ S&P Global Ratings, Ratings Direct, Otter Tail Power Co., p. 3 (Jan. 8, 2019).

1 Q. ARE THERE ANY RECENT EXAMPLES OF SUBSTANDARD ROE DECISIONS
2 IMPACTING CREDIT RATINGS?

3 A. Yes. As I discussed in my Direct Testimony, Moody's and S&P both took negative credit
4 actions following the Minnesota Public Utilities Commission's (MPUC) decision in the
5 recent Minnesota Power (MP) Minnesota electric rate case.⁷ The MP case underscores the
6 importance of rate case results in general, and ROE's in particular, to utility credit ratings.

7 **C. Possible Effects on Perceptions of the South Dakota Regulatory Environment**

8 Q. COULD RATING AGENCIES AND CAPITAL MARKETS REASSESS THE
9 REGULATORY ENVIRONMENT IN SOUTH DAKOTA IN GENERAL IF OTP IS
10 AWARDED AN ROE BELOW THE MAINSTREAM FLOOR?

11 A. Yes. Mr. Gerhardson explains that Mr. Copeland's formulation of the Commission's duty
12 to establish a fair and reasonable return is unsupported in South Dakota law. Actually
13 adopting such an approach, when combined with a severe and unjustified result that would
14 be totally unexpected, could cause rating agencies and capital markets to interpret such a
15 Commission decision as representing a new and adverse approach to the entire electric
16 industry. That interpretation would be supported by the inconsistency with currently
17 authorized ROEs in South Dakota and with prevailing ROEs throughout the United States.
18 Such an interpretation could have the effect of generally discouraging utility investment in
19 South Dakota.

20

21 Q. ARE THERE OTHER FACTORS THAT WOULD IMPACT PERCEPTION OF SOUTH
22 DAKOTA IF AN UNREASONABLY LOW ROE IS ADOPTED IN THIS CASE?

23 A. Yes. The Commission approved the Settlement Stipulation between OTP and Staff on
24 March 1, 2019. That Settlement Stipulation includes a rate case moratorium. The
25 moratorium, combined with OTP's history of filing infrequent rate cases, means the ROE
26 set in this case is likely to be in effect for quite some time. Locking into an ROE based on
27 current market dynamics would be seen as an additional risk associated with the South

⁷ Moug Direct, p. 11-12.

1 Dakota regulatory environment. Further, as discussed by Mr. Hevert, rate case
2 moratoriums are generally seen as supporting higher, not lower, ROEs.

3
4 Q. WHAT ARE THE LIKELY EFFECTS IF THAT OCCURS?

5 A. The likely effects are that interest in investing in South Dakota utilities could be reduced
6 and the cost of capital for South Dakota utilities would increase, which would lead to higher
7 costs for South Dakota customers.

8 **IV. CONCLUSION**

9 Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

10 A. A decision by the Commission to adopt an ROE for OTP that is significantly below recent
11 ROE awards likely would cause a deterioration in the perception of OTP's regulatory
12 environment and reduce interest in investment in OTP, with a resulting increase in OTP's
13 cost of capital. It could also lead to a deterioration in the perception of the regulatory
14 environment in South Dakota in general, with the same effects on other South Dakota
15 utilities. Accordingly, the Commission should avoid those results by rejecting the cost of
16 equity analysis, ROE range and specific ROE recommendation of Mr. Copeland.

17
18 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

19 A. Yes.