COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183
	)	

COLUMBIA GAS OF KENTUCKY, INC.'S
REBUTTAL TESTIMONY

FILED: October 22, 2021

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183
	)	

VERIFICATION OF JUDY COOPER

COMMONWEALTH OF KENTUCKY)
)
COUNTY OF FAYETTE)

Judy Cooper, Director of Regulatory Affairs of Columbia Gas of Kentucky, Inc., being duly sworn, states that she has supervised the preparation of her Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of her knowledge, information and belief, formed after reasonable inquiry.

Judy Cooper
Judy Cooper

The foregoing Verification was signed, acknowledged and sworn to before me this 19th day of October, 2021, by Judy Cooper.

Evelyn Long Durr

Notary Commission No. 600778

Commission expiration: 05/15/2022

EVELYN LONG DURR
Notary Public
Commonwealth of Kentucky
Commission Number 600778
My Commission Expires May 15, 2022

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF COLUMBIA	)	
GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT	)	
OF RATES; APPROVAL OF DEPRECIATION	)	
STUDY; APPROVAL OF TARIFF REVISIONS;	)	Case No. 2021-00183
ISSUANCE OF A CERTIFICATE OF PUBLIC	)	
CONVENIENCE AND NECESSITY; AND OTHER	)	
RELIEF	)	
	)	

VERIFICATION OF VINCENT REA

STATE OF NORTH CAROLINA	)
	)
COUNTY OF MOORE	)

Vincent Rea, Managing Director of Regulatory Finance Associates, LLC, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that he has supervised the preparation of his Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of his knowledge, information and belief, formed after reasonable inquiry.

Vincent V. Rea

Vincent Rea

The foregoing Verification was signed, acknowledged and sworn to before me this 14 day of October, 2021, by Vincent Rea.

Stephen W Sikes

Notary Commission No.

____

STEPHEN W SIKES
Notary Public, North Carolina
Moore County
My Commission Expires
October 21, 2023

Commission expiration:
10-21-23

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF) Case No. 2021-00183

VERIFICATION OF CHUN-YI LAI

STATE OF OHIO)
)
COUNTY OF FRANKLIN)

Chun-Yi Lai, Financial Planning Manager for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that she has supervised the preparation of her Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of her knowledge, information and belief, formed after reasonable inquiry.

____
Chun-Yi Lai

The foregoing Verification was signed, acknowledged and sworn to before me this 18 day of October, 2021, by Chun-Yi Lai.

____

NOTARY PUBLIC ★ STATE OF OHIO ★

MICHAEL SHUMATE
Notary Public, State of Ohio
My Commission Expires
January 24, 2024

Notary Commission No. 2019-RE-765767

Commission expiration: 1-24-2024

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

VERIFICATION OF SUSAN TAYLOR

STATE OF OHIO	)
	)
COUNTY OF FRANKLIN	)

Susan Taylor, Director of Financial Planning for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that she has supervised the preparation of her Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of her knowledge, information and belief, formed after reasonable inquiry.

Susan Taylor

Susan Taylor

The foregoing Verification was signed, acknowledged and sworn to before me this 19th day of October, 2021, by Susan Taylor.

NOTARIAL SEAL
STATE OF OHIO

John R Ryan III
Attorney At Law
Notary Public, State of Ohio
My commission has no expiration date
Sec. 147.03 R.C.

Notary Commission No. N/A

Commission expiration: N/A

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)
	)
THE ELECTRONIC APPLICATION OF	)
COLUMBIA GAS OF KENTUCKY, INC. FOR AN	)
ADJUSTMENT OF RATES; APPROVAL OF	)
DEPRECIATION STUDY; APPROVAL OF	) Case No. 2021-00183
TARIFF REVISIONS; ISSUANCE OF A	)
CERTIFICATE OF PUBLIC CONVENIENCE AND	)
NECESSITY; AND OTHER RELIEF	

VERIFICATION OF SUZANNE K. SURFACE

STATE OF OHIO)

)

COUNTY OF FRANKLIN)

Suzanne K. Surface, Senior Vice President for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that she has supervised the preparation of her Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of her knowledge, information and belief, formed after reasonable inquiry.

Suzanne K. Surface

The foregoing Verification was signed, acknowledged and sworn to before me this 12th day of October, 2021, by Suzanne K. Surface.

DYLAN COCKERILL, NOTARY PUBLIC
COMM. EXP. SEPT. 01, 2025
STATE OF OHIO

Notary Commission No. ____________

Commission expiration: 09/01/2025

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183
	)	

VERIFICATION OF JEFFERY GORE

STATE OF OHIO)
)
COUNTY OF FRANKLIN)

Jeffery Gore, Regulatory Manager for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that he has supervised the preparation of his Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of his knowledge, information and belief, formed after reasonable inquiry.

____
Jeffery Gore

The foregoing Verification was signed, acknowledged and sworn to before me this 19th day of October, 2021, by Jeffery Gore.

____

John R Ryan III
Attorney At Law
Notary Public, State of Ohio
My commission has no expiration date
[illegible] 147.03 R.C

Notary Commission No. N/A

Commission expiration: N/A

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

VERIFICATION OF JENNIFER HARDING

STATE OF OHIO)
)
COUNTY OF FRANKLIN)

Jennifer Harding, Director, Income Tax Operations for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that she has supervised the preparation of her Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of her knowledge, information and belief, formed after reasonable inquiry.

Jennifer Harding

The foregoing Verification was signed, acknowledged and sworn to before me this 21st day of October, 2021, by Jennifer Harding.

NOTARIAL SEAL STATE OF OHIO

John R Ryan III
Attorney At Law
Notary Public, State of Ohio
My commission has no expiration date
Sec. 147.03 R.C.

Notary Commission No. N/A

Commission expiration: N/A

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF	)	
COLUMBIA GAS OF KENTUCKY, INC. FOR AN	)	
ADJUSTMENT OF RATES; APPROVAL OF	)	
DEPRECIATION STUDY; APPROVAL OF TARIFF	)	Case No. 2021-00183
REVISIONS; ISSUANCE OF A CERTIFICATE OF	)	
PUBLIC CONVENIENCE AND NECESSITY; AND	)	
OTHER RELIEF	)	

VERIFICATION OF KEVIN JOHNSON

STATE OF OHIO)
)
COUNTY OF FRANKLIN)

Kevin Johnson, Lead Regulatory Analyst for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that he has supervised the preparation of his Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of his knowledge, information and belief, formed after reasonable inquiry.

Kevin Johnson

Kevin Johnson

The foregoing Verification was signed, acknowledged and sworn to before me this 18th day of October, 2021, by Kevin Johnson.

Nicholas Staniszewski

NOTARY PUBLIC STATE OF OHIO
NICHOLAS C STANISZEWSKI
Notary Public State of Ohio
My Comm. Expires October 17, 2023

Notary Commission No. N/A

Commission expiration: 10/17/2023

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF	)	
COLUMBIA GAS OF KENTUCKY, INC. FOR AN	)	
ADJUSTMENT OF RATES; APPROVAL OF	)	
DEPRECIATION STUDY; APPROVAL OF TARIFF	)	Case No. 2021-00183
REVISIONS; ISSUANCE OF A CERTIFICATE OF	)	
PUBLIC CONVENIENCE AND NECESSITY; AND	)	
OTHER RELIEF	)	

VERIFICATION OF KIMBERLY CARTELLA

STATE OF OHIO	)
	)
COUNTY OF LORAIN	)

Kimberly Cartella, Director Compensation for NiSource Corporate Services Company, on behalf of Columbia Gas of Kentucky, Inc., being duly sworn, states that she has supervised the preparation of her Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of her knowledge, information and belief, formed after reasonable inquiry.

Kimberly Cartella

Kimberly Cartella

The foregoing Verification was signed, acknowledged and sworn to before me this 13th day of October, 2021, by Kimberly Cartella.

Emily L. Brady

Notary Commission No. Emily L. Brady, Attorney at Law Resident Summit County ~~Notary Public, State of Ohio~~ My Commission Has No Expiration Date Sec 147.03 RC

Commission expiration: NO EXP.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
THE ELECTRONIC APPLICATION OF	)	
COLUMBIA GAS OF KENTUCKY, INC. FOR AN	)	
ADJUSTMENT OF RATES; APPROVAL OF	)	
DEPRECIATION STUDY; APPROVAL OF TARIFF	)	Case No. 2021-00183
REVISIONS; ISSUANCE OF A CERTIFICATE OF	)	
PUBLIC CONVENIENCE AND NECESSITY; AND	)	
OTHER RELIEF	)	
	)	

VERIFICATION OF DAVID ROY

COMMONWEALTH OF KENTUCKY)
)
COUNTY OF FAYETTE)

David Roy, Vice President of Operations and Construction of Columbia Gas of Kentucky, Inc., being duly sworn, states that he has supervised the preparation of his Rebuttal Testimony in the above-referenced case and that the matters and things set forth therein are true and accurate to the best of his knowledge, information and belief, formed after reasonable inquiry.

David Roy

David Roy

The foregoing Verification was signed, acknowledged and sworn to before me this 19th day of October, 2021, by David Roy.

Evelyn Long Durr

Notary Commission No. 600778

Commission expiration: 05/15/2022

EVELYN LONG DURR
Notary Public
Commonwealth of Kentucky
Commission Number 600778
My Commission Expires May 15, 2022

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF	)	Case No. 2021-00183
COLUMBIA GAS OF KENTUCKY,	)	
INC. FOR AN ADJUSTMENT OF	)	
RATES; APPROVAL OF	)	
DEPRECIATION STUDY; APPROVAL	)	
OF TARIFF REVISIONS; ISSUANCE	)	
OF A CERTIFICATE OF PUBLIC	)	
CONVENIENCE AND NECESSITY;	)	
AND OTHER RELIEF	)	

PREPARED REBUTTAL TESTIMONY OF
JUDY M. COOPER
ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

Mark David Goss
David S. Samford
L. Allyson Honaker
GOSS SAMFORD, PLLC
2365 Harrodsburg Road, Suite B-325
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Attorneys for Applicant
COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Judy M. Cooper and my business address is Columbia Gas of Kentucky, Inc., 2001 Mercer Road, Lexington, Kentucky, 40511.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. I will respond to the testimony served in this proceeding by the Office of the Attorney General ("AG") Witness Dittemore.

Q. What issues will you be addressing in your rebuttal testimony?

A. I will address just one issue, AG Witness Dittemore's removal of 100 percent of association dues from Columbia's forecasted test period resulting in a $49,271 reduction to Columbia's proposed revenue requirement.

Q: Please summarize AG Witness Dittemore's proposed adjustment to association dues.

A: AG Witness Dittemore's proposed adjustment would remove Columbia's total amount of association dues to the American Gas Association ("AGA") and to the Southern Gas Association ("SGA"). His basis for the adjustment is that the Commission has denied recovery of Edison Electric

Institute ("EEI") dues in prior electric cases because EEI engages in legislative advocacy, regulatory advocacy and public relations; he views both organizations as very similar to EEI; and he finds there is insufficient evidence in the record to establish that the dues are not used for legislative advocacy, regulatory advocacy, and/or public relations.

Q. Do you agree with the reduction proposed by AG Witness Dittemore?

A. No, I do not agree with the reduction to eliminate association dues.

Q: Why do you disagree with the reduction proposed by AG Witness Dittemore to eliminate association dues entirely?

A: I disagree with the total elimination of association dues because I do not agree that AGA and SGA are both very similar organizations to EEI. I disagree with the generalization that the Commission has entirely eliminated EEI dues in past electric rate cases <u>solely</u> because the organization engages in legislative advocacy, regulatory advocacy and public relations. Further, I will provide additional explanation to clarify that the dues to AGA and SGA are used to support services that benefit natural gas customers and those dues are reasonable and should be included for recovery as part of the revenue requirement in this case. The proposed adjustment to eliminate all association dues from the revenue requirement should be rejected.

Q: What is the amount of Columbia's annual dues to AGA?

A: Columbia witness Gore provides Columbia's allocated amount of AGA dues in the response to the AG's First Request for Information No. 204. The amount for the forecasted test period is $49,600. Columbia made a rate making adjustment to exclude AGA associated lobbying expenses of $2,338. AGA dues in the amount of $47,262 are included in the forecasted test period.

Q: What benefits does AGA provide to Columbia and its customers?

A: AGA membership is of significant benefit to customers as it provides a forum for Columbia employees to have access to industry platforms which assist us to keep our customers and systems safe and reliable. These include:

- Peer Review Programs for pipeline safety, damage prevention and occupational safety.
- SOS Program which allows member companies to ask specific questions of peer companies, which has been utilized to help Columbia address safety issues within our Corrective Action Program. Additionally, the SOS program provides a forum for protocols around COVID response including work practices to

keep customers and employees safe, vaccination protocols, and other COVID related process changes.

- Operations Discussion Groups are useful as peers discuss best practices as we move forward in a new working environment.
- Safety Data Benchmarking as provided by AGA, allows us to benchmark our safety metrics against our industry peers over and above the standard OSHA metrics to help Columbia provide safe service to customers.

AGA's facilitation of the exchange of this information allows its members to access best practices for both safety and operational processes in an efficient manner. This includes the development of energy codes and standards that help enhance natural gas safety. These are member-only services that Columbia would not be able to access if it were not an AGA member.

Q: What is the amount of Columbia's annual dues to SGA?

A: Columbia witness Gore provides Columbia's allocated amount of SGA dues in the response to the AG's First Request for Information No. 204. The amount for the forecasted test period is $1,700. All of this amount is included in Columbia's forecasted test period expense because none of

SGA's membership dues are attributed to lobbying expense and therefore no amount was removed as a rate making adjustment.

Q: What benefits does SGA provide to Columbia and its customers?

A: The SGA is specifically focused on training, sharing best practices, leadership development and peer networking. SGA does not conduct legislative industry lobbying. The SGA was formed to help natural gas companies improve their individual programs, practices and procedures in all areas of their operations. SGA forums provide natural gas employees a venue in which they can exchange information with their peers in order to better serve their customers. This has been essential as natural gas companies have navigated through COVID protocols.

SGA provides significant training for member companies in the areas of:

- Pressure Regulation, Control & Odorization
- Mains & Services Construction
- Gas Control
- Distribution System Maintenance
- Damage Prevention
- Engineering Design & Integrity Management
- Pipeline Safety & Stakeholder Engagement
- LNG Operations

- Emergency Preparedness and Response

The training and facilitation services of SGA allow Columbia's employees to continue to be well educated on the most current practices to keep our employees, systems and customers safe.

Q: Can you identify the past electric cases that OAG Witness Dittemore mentions as the precedent for the elimination of association dues?

A: Yes, in his testimony on page 9 OAG Witness Dittemore references two cases. The cases are identified as Orders in Case No. 2003-00433 at 51-52, and in Case No. 2003-00434 at 44-45. The first case is an electric and natural gas base rate case of Louisville Gas & Electric Company ("LG&E). The second case is an electric base rate case of Kentucky Utilities Company ("KU"). The witness for the OAG, in the LG&E case, proposed to eliminate 72.16 percent of EEI dues based on a claim that there was no benefit to ratepayers from that portion of EEI dues. LG&E agreed that the portion of EEI dues associated with legislative advocacy and public relations should be removed for rate-making purposes but the portion of dues associated with other activities was reasonable to include for ratemaking purposes. The Commission found that the portion of dues associated with legislative advocacy, regulatory advocacy and public relations should be excluded for ratemaking purposes and determined that amount to be 45.35 percent of LG&E's EEI dues. The Commission found a like percentage of KU's dues should be excluded for ratemaking purposes. In both of these past electric cases, 54.65 percent of EEI dues were included for ratemaking purposes. The entire amount of association dues was not removed and it is incorrect to reference these two cases as supporting elimination of the total amount of association dues.

Q: What other cases did AG Witness Dittemore address?

A: Two more recent cases of LG&E and KU were addressed in his testimony. In both of those cases, the Commission determined that the utilities had not demonstrated that EEI dues were properly recoverable from the respective customers because LG&E and KU had not provided any benefits to customers from the company's participation in EEI.

Q. **What amount of association dues should be reasonably recoverable from Columbia's customers?**

A. The fair, just and reasonable amount of association dues that are incurred by Columbia for membership in AGA and SGA that provide the most efficient avenue and access to current industry practices and training materials is $ 47,262. This amount is for appropriate activities of AGA and SGA that provide Columbia information, data, education, and insight that would not be available without membership in these organization. The experience and knowledge provide by AGA and SGA is utilized for training programs in-house and in the development and refinement of operating standards and policies. The ultimate beneficiaries are Columbia's customers from a well-informed workforce that is capable and trained to deliver safe, reliable service in a cost efficient manner.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)))))))))	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF
VINCENT V. REA
ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

Mark David Goss
David S. Samford
L. Allyson Honaker
GOSS SAMFORD, PLLC
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Lexington, Kentucky 40504
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Attorneys for Applicant
COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

TABLE OF CONTENTS

I. Introduction

Q. Please state your name and business address.

A. My name is Vincent V. Rea. My business address is 80 Blake Boulevard, #4572, Pinehurst, NC 28374.

Q. Are you the same Vincent V. Rea who submitted Direct Testimony in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony in this proceeding?

A. The purpose of my testimony is to rebut and otherwise respond to the direct testimony of Richard A. Baudino, who has been retained by the Kentucky Office of the Attorney General (the "AG") in connection with Columbia's pending request for a base rate adjustment.

Q. Please provide an overview of the principal conclusions you have arrived at within your rebuttal testimony.

A. Within my rebuttal testimony, I present arguments and direct evidence which demonstrate that the recommendations of AG witness Baudino are flawed, and should therefore be rejected by the Commission. In forming his recommendations, Mr. Baudino has relied upon assumptions, analyses and conclusions which suffer from a number of infirmities. Specifically, the various approaches and input assumptions that Mr. Baudino has applied to the DCF model and CAPM are significantly flawed, which I will discuss further herein. Mr. Baudino has also failed to properly assess the risk differences between Columbia and the proxy group he referenced, and also to evaluate a broader group of proxy companies with comparable risks, which ultimately cause his cost of equity recommendations to be unreliable.

In the process of reviewing the testimony and analyses of Mr. Baudino in this proceeding, I have revisited my original cost of equity evaluation, which concluded that Columbia's cost of equity is in the range of 10.30 – 10.80 percent, with a midpoint value of 10.55 percent. Based upon my review, I did not come across any information or evidence that would cause me to revise my original recommendations. Therefore, consistent with the Company's preference to propose a cost of equity at the lower end of the range of reasonableness indicated by my evaluation, I continue to support Columbia's proposed cost of equity of 10.30 percent in the instant proceeding.

Q. Please explain why you are revising the Company's proposed weighted average cost of capital and overall fair rate of return in this proceeding.

A. Since the time that Columbia filed its case-in-chief on May 28, 2021, the Company has completed two additional long-term debt issuances, and the interest cost rates associated with those debt issuances differ from the projected cost rates that were reflected in the Company's original filing. In addition, the Company has also revised its projected interest cost rates for two future long-term debt issuances that are expected to occur during March 2022 and June 2022, respectively. Lastly, the Company has also updated its projected interest cost rate for short-term debt based on the 13-month average for the period ending December 31, 2022. As a result of making the aforementioned changes to Columbia's embedded cost of long-term debt and its short-term debt cost rate, the Company's proposed overall fair rate of return has been revised from 7.48 percent to 7.39 percent, as further discussed herein.

Q. Are you sponsoring any attachments as part of your rebuttal testimony in this proceeding?

A. Yes. I am sponsoring Attachment Rebuttal VVR-2R, Attachment Rebuttal VVR-5R, and Attachment Rebuttal VVR-6R, which correspond to the same numbered attachments to my direct testimony, and which reflect the Company's proposed updates to Columbia's overall fair rate of return, embedded cost of long-term debt, and short-term debt cost rate. I will further discuss these attachments in Section IX of my rebuttal testimony.

II. Overview of AG Witness Baudino's Recommendations

Q. Please provide an overview of Mr. Baudino's cost of equity and capital structure recommendations in this proceeding.

A. Mr. Baudino's range estimate of the cost of equity for Columbia is 8.40 percent – 9.40 percent, and he has recommended a 9.10 percent cost of equity for the Company in this proceeding. Mr. Baudino has further recommended that the Commission should impute a hypothetical capital structure for Columbia consisting of 51.75 percent common equity, 44.25 percent long-term debt, and 4.00 percent short-term debt.[1] In conducting his cost of equity evaluation, Mr. Baudino applied a constant growth DCF model analysis ("Discounted Cash Flow" or "DCF" analysis), and a Capital Asset Pricing Model ("CAPM") analysis to the same proxy group (the "Gas LDC Group") that I referenced, which consists of seven publicly-traded gas utility holding companies. In regard to his constant growth DCF model analysis, Mr. Baudino evaluated both average growth rates (Method 1) and median growth rates (Method 2), and then combined these values with the applicable expected dividend yield. In regard to his CAPM analyses, Mr. Baudino conducted both a forward-looking and a historical evaluation of the expected market return and expected market risk premium. Mr. Baudino based his forward-looking market return estimate entirely upon the expected market return data reported by the Value Line Investment Analyzer. However, it is unclear which particular market index is being referenced within the Value Line market return data presented by Mr. Baudino, and whether the projected market

[1] *Direct Testimony of Richard A. Baudino,* Case No. 2021-00183 (September 8, 2021), at 3-4, and 29-33.

return data is based upon the geometric mean or the arithmetic mean, the former of which is not an appropriate basis for estimating the market risk premium. In the AG's response to Columbia's data request No. 5, Mr. Baudino was not able to answer either of these two questions. With respect to both Mr. Baudino's forward-looking CAPM analysis and his historically based CAPM analysis, he evaluated recent historical 30-year U.S. Treasury bond yields as a proxy for the risk-free rate of return, as well as the Duff & Phelps "normalized" risk-free rate of return. Based upon his application of the aforementioned analytical models to the market and financial data of the Gas LDC Group companies, Mr. Baudino's cost of equity results were determined to be as reflected in Table VVR-1R below:[2]

[2] Also see Table 2 (p. 29) in Mr. Baudino's direct testimony.

Table VVR-1R AG Witness Baudino's Cost of Equity Estimates and Recommendations Gas LDC Group	
Method / Analytical Model	Model Result
Constant Growth DCF Model - Average	9.49%
Constant Growth DCF Model - Median	9.20%
CAPM – Forward-Looking Market Return	
Current 30-Year Treasury	8.70%
Duff & Phelps Normalized Risk-Free Rate	8.73%
CAPM – Historical Risk Premium	
Current 30-Year Treasury	7.58%-8.75%
Duff & Phelps Normalized Risk-Free Rate	7.90%-9.07%
Cost of Equity Range Estimate for Columbia Gas of Kentucky (Baudino)	8.40% - 9.40%
Cost of Equity Recommendation for Columbia Gas of Kentucky (Baudino)	9.10%

As reflected in Table VVR-1R above, Mr. Baudino's evaluation yielded a cost of equity estimate of between 9.20 percent and 9.49 percent under his constant growth DCF analyses, and a cost of equity estimate of between 7.58 percent and 9.07 percent under his CAPM analyses. Based on his evaluation, Mr. Baudino has recommended a point estimate of the cost of equity of 9.10 percent in this proceeding. Additionally, as reflected in Table 3 (p. 33) in his direct testimony, Mr. Baudino has recommended an overall weighted average cost of capital for Columbia of 6.69 percent, which is based on Mr. Baudino's proposed hypothetical capital structure consisting of 51.75 percent common equity, 44.25 percent long-term debt, and 4.00 percent short-term debt.

Q. What is your initial reaction to Mr. Baudino's recommended cost of equity for Columbia?

A. After reviewing Mr. Baudino's testimony and supporting exhibits, I have concluded that his estimates of Columbia's cost of equity are flawed, and are the product of a misapplication of the cost of equity analytical models that he has referenced. I will further discuss the infirmities that I found in Mr. Baudino's cost of equity recommendations later in the DCF and CAPM sections of my rebuttal testimony. Meanwhile, it is important to note that while Mr. Baudino maintains that he relied entirely upon the results of his DCF analyses to support his overall cost of equity recommendation in this proceeding,[3] his cost of equity recommendation of 9.10 percent does not comport with the actual results of his DCF analysis.[4] I will discuss this matter in greater detail later in the DCF section of my rebuttal testimony, but Mr. Baudino essentially ignored his own DCF analysis, which generated an average DCF-based cost of equity estimate of 9.49 percent,[5] while he has recommended a cost of equity of just 9.10 percent in this proceeding.

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[3] *Direct Testimony of Richard A. Baudino,* Case No. 2021-00183 (September 8, 2021), at 3 and 29.
[4] Id. at 21 and Table 2 (p. 29)
[5] See, Exhibit RAB-3 (p. 2).

Q. As a preliminary matter, how does Mr. Baudino's ROE recommendation of 9.10 percent compare to the most recently authorized ROE granted to a gas utility in Kentucky by the Commission?

A. Mr. Baudino has recommended a cost of equity that is significantly below the most recently authorized ROE granted by the Commission to Louisville Gas & Electric's ("LG&E") gas utility operations. On June 30, 2021, in Case No. 2020-00350, the Commission authorized an ROE of 9.425 percent for LG&E's gas utility operations, which was based upon a 53.19 percent equity capitalization layer.[6] Considering that Mr. Baudino has recommended a 9.10 percent cost of equity for Columbia, his recommendation is approximately 33 basis points below the 9.425 percent ROE granted by the Commission in the aforementioned LG&E case, and is therefore inconsistent with the comparable earnings standard. This is particularly the case because Columbia, with 135,000 gas utility customers, is a much smaller gas utility as compared to LG&E, which provides gas utility services to approximately 332,000 customers in the Commonwealth of Kentucky. As I discussed at length in my direct testimony,[7] the finance literature has demonstrated that smaller companies possess a higher level of both business risk and financial risk as compared to larger companies, and therefore have a higher cost of equity.

[6] See, Order, Case No. 2020-00350 (June 30, 2021), *Electronic Application of Louisville Gas and Electric Company for an Adjustment of Its Electric and Gas Rates,* at 25, and Appendix D.
[7] See, Direct Testimony of Vincent V. Rea, Case No. 2021-00183 (May 28, 2021), at 25-26, and 80-81.

Additionally, Columbia has proposed a ratemaking capital structure in the instant proceeding which includes an equity capitalization ratio of 52.64 percent, which reflects a slightly higher level of financial risk as compared to the 53.19[8] percent equity capitalization layer that the Commission adopted in the LG&E gas proceeding. For these reasons, Columbia's market-based cost of equity would be expected to be somewhat higher than LG&E's cost of equity. Therefore, Mr. Baudino's recommended cost of equity of 9.10 percent understates Columbia's cost of equity in the current market environment, particularly when compared to the recently authorized ROE granted to LG&E. Again, not only is Mr. Baudino's proposed cost of equity of 9.10 percent approximately <u>33 basis points</u> <u>below</u> the 9.425 percent ROE authorized by the Commission in LG&Es 2020 gas rate proceeding, but it is also <u>52 basis points</u> <u>below</u> the <u>9.62</u> percent national average of authorized ROEs for gas utility companies during the first two quarters of 2021.[9]

III. <u>The ROE Recommendation of AG Witness Baudino Would Not Allow Columbia the Opportunity to Earn a Fair Rate of Return as Compared to Other Gas Distribution Companies</u>

Q. Would Mr. Baudino's ROE recommendation allow Columbia the opportunity to earn a fair return as compared to other gas distribution companies?

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[8] <u>*See,*</u> Order, Case No. 2020-00350 (June 30, 2021), *Electronic Application of Louisville Gas and Electric Company for an Adjustment of Its Electric and Gas Rates,* Appendix D.

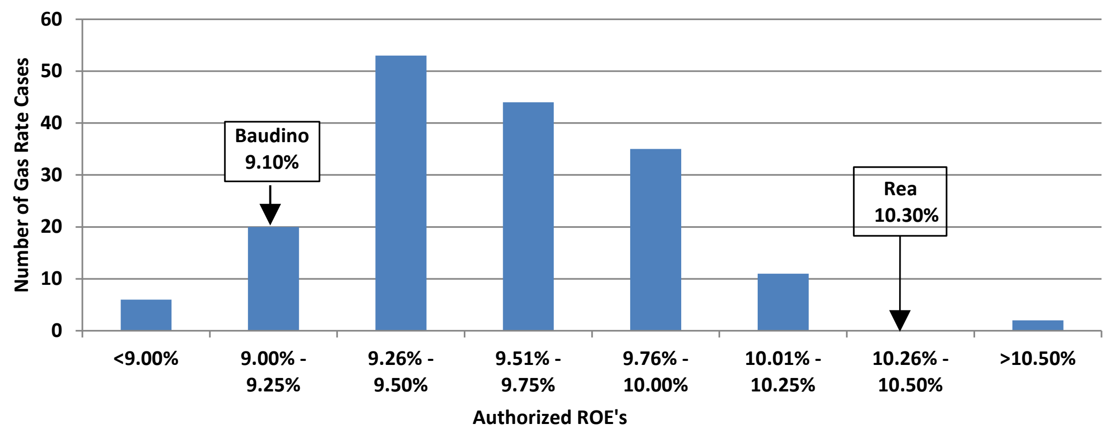
[9] *RRA Regulatory Focus, Major Rate Case Decisions - January - June 2021* (S&P Global Market Intelligence) July 27, 2021, at 1.

A. No. To thoroughly investigate this matter, I evaluated Mr. Baudino's ROE recommendation against: (1) recent ROE determinations for other gas distribution companies nationwide, as ROE decisions represent the culmination of an often protracted deliberation process undertaken by state commissions to determine what constitutes a fair rate of return; and (2) currently authorized ROEs for the companies comprising the Gas LDC Group. Employing the above comparative approaches, I will demonstrate that Mr. Baudino's ROE recommendation would not allow Columbia the opportunity to earn a fair return as compared to other gas distribution companies nationwide.

Q. How does Mr. Baudino's ROE recommendation compare to the ROEs authorized by state commissions across the U.S. during the past five years?

A. To facilitate such a comparison, I present Table VVR-2R below, which summarizes the distribution of ROE determinations (in 0.25 percent increments) from 171 gas utility rate proceedings over the past five and one-half years (January 2016 - June 2021).

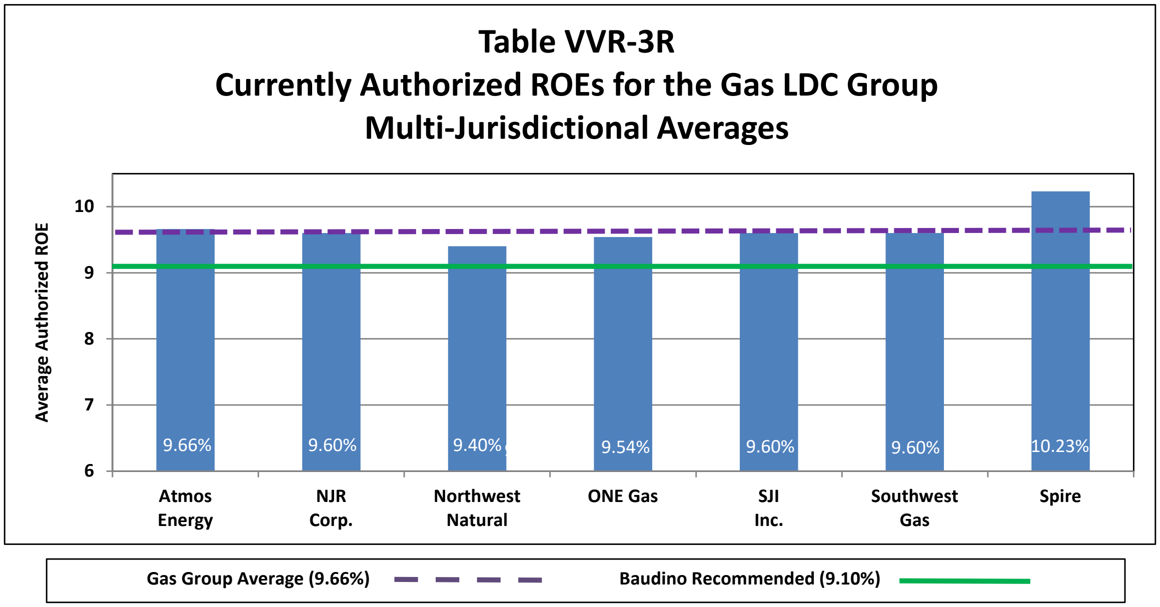
Table VVR-2R
Distribution of Authorized ROEs for U.S. Gas Utilities
January 1, 2016 - June 30, 2021



As Table VVR-2R above illustrates, out of a total of 171 gas utility ROE determinations during the January 2016 - June 2021 period, Mr. Baudino's recommended ROE of 9.10 percent falls near the very bottom of the range. In fact, during this period, only <u>15 decisions</u> were at or below Mr. Baudino's recommended ROE of 9.10 percent, and 13 of those decisions occurred in a single regulatory jurisdiction - New York State. Stated alternatively, over <u>91 percent</u> of the ROE determinations during this five-year plus period were higher than Mr. Baudino's recommended ROE of 9.10 percent.

Q. How does Mr. Baudino's ROE recommendation compare to the ROEs currently authorized by the respective state commissions for the Gas LDC Group companies?

A. I present this analysis in Table VVR-3R below, which compares the average authorized ROEs for each of the Gas LDC Group companies against Mr. Baudino's recommended ROE.



***Source: Company 10-K filings.**

As Table VVR-3R above illustrates, the overall average authorized ROE for the companies comprising the Gas LDC Group, based on multi-jurisdictional averages, is currently 9.66 percent, while the ROE recommended by Mr. Baudino is below this level, at 9.10 percent. Therefore, if the Commission were to adopt Mr. Baudino's recommendation, the Company's authorized ROE would be set significantly below the average authorized ROE for the Gas LDC Group companies.

Q. Based upon on the recently authorized ROEs of gas utilities nationwide, as reflected in Table VVR-2R and Table VVR-3R above, is Mr. Baudino's ROE recommendation consistent with the concept of the opportunity cost of capital?

A. No. The opportunity cost of capital is classically defined as the highest available return on an alternative investment of comparable risk. Mr. Baudino's ROE recommendation is significantly below the average of recently authorized ROEs for gas utilities nationwide, demonstrating that Mr. Baudino's recommendation does not recognize the concept of the opportunity cost of capital. Paradoxically, Mr. Baudino would in fact appear to recognize the concept of opportunity cost, at least theoretically, and this is borne out by the fact that Mr. Baudino makes the following statement in his direct testimony:

> From an economist's perspective, *the notion of "opportunity cost" plays a vital role in estimating the ROE. One measures the opportunity cost of an investment equal to what one would have obtained in the next best alternative*. For example, let us suppose that an investor decides to purchase the stock of a publicly-traded regulated gas utility. That investor will make the decision based on the expectation of dividend payments and perhaps some appreciation in the stock's value over time; however, *that investor's opportunity cost is measured by what she or he could have invested in as the next best alternative. That alternative could have been another utility stock*, a utility bond, a mutual fund, a money market fund, or any other number of investment vehicles (emphasis added).[10]

[10] Direct Testimony of Richard A. Baudino, Case No. 2021-00183, at 5.

Therefore, recommending a cost of equity of 9.10 percent when the recently authorized ROEs for other gas utilities in both Kentucky and nationwide have been in the range of 9.425 percent to 9.70 percent, is clearly inconsistent with the concept of the opportunity cost of capital.

Q. How would the financial community respond if the Commission were to authorize an ROE at the level recommended by Mr. Baudino?

A. If the Commission were to authorize an ROE at the level proposed by Mr. Baudino, the decision would not be well-received in the financial community for a number of reasons. It is important to note that equity investors derive their return expectations for utility stocks on the basis of the authorized ROEs of similarly situated utilities in the same jurisdiction, and also nationwide. In contrast, Mr. Baudino's cost of equity recommendation is significantly below the ROEs authorized by the Commission in recent years[11] for other gas utilities in Kentucky, which have ranged from 9.425 percent to 9.73 percent. Moreover, according to Regulatory Research Associates, during the first two quarters of 2021, the average authorized ROE granted to gas utilities nationwide was 9.62 percent,[12] which reflects a significant increase over the 9.46 percent national average for gas utilities

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[11] During the 2019-2021 period.

[12] *RRA Regulatory Focus, Major Rate Case Decisions - January - June 2021* (S&P Global Market Intelligence) July 27, 2021, at 1.

during 2020. Therefore, if Mr. Baudino's ROE recommendation were adopted, this would actually create a disincentive for investors to commit new investment capital to Kentucky's regulated utility companies, since significantly higher returns could be found in utility stocks with similar risk profiles in other jurisdictions.

While the Commission is certainly not bound by the decisions of other state regulatory bodies, it is nonetheless important to recognize that if Kentucky utilities are offering equity returns which are significantly lower than the returns offered by utilities in other jurisdictions, they will find it increasingly difficult to compete for investor capital with these other utilities. This in turn could jeopardize the utility's ability to make critical infrastructure investments required for safety and reliability purposes, or to do so without a significant impact on its costs, which are ultimately borne by ratepayers. Columbia is firmly committed to maintaining a safe, dependable pipeline system, but it would be in an undesirable position to effectively compete for investor capital - whether it be external capital, or capital allocated by NiSource among its six utility operating companies - based upon the ROE proposed by Mr. Baudino.

IV. Current U.S. Economic and Capital Markets Trends

Q. Please provide an overview of recent trends in the U.S. economy and the capital markets.

A. As the U.S. continues to make steady progress towards putting the COVID-19 pandemic in the rearview mirror, there is mounting evidence that the U.S. economy is rebounding from the pandemic even faster than previously anticipated. Indeed, U.S. economic growth thus far during 2021 has been robust. Nevertheless, the recent emergence of the Delta variant of the COVID-19 virus has cast some degree of uncertainty as to whether the strong U.S. economic recovery will continue into the fourth quarter of 2021. As of early-October 2021, U.S. economic growth continues to be fueled by a number of factors, including: (1) the reemergence of pent-up demand, which had been suppressed for over a year as a result of governmental lock-down orders, as well as a general apprehension among Americans of contracting or spreading the COVID-19 virus; (2) actual or proposed stimulus measures that have been championed by the Biden administration, which thus far has included the $1.9 trillion American Rescue Plan, and could ultimately result in trillions of dollars of additional fiscal stimulus spending by the federal government in the coming years; and (3) the ongoing extraordinary monetary policy interventions of the Fed, which includes the Fed's targeting of short-term interest rates at essentially zero (i.e., the Federal Funds target rate), as well as the Fed's recent re-initiation of its quantitative easing or bond-buying programs, both of which are designed to stimulate U.S. economic growth.

As evidence mounts that the U.S. economy is now beginning to return to a more solid footing, the Fed has recently started discussing the possibility of reducing or "tapering" the central bank's $120 billion of monthly purchases of U.S. Treasury and agency securities, quite possibly during the fourth quarter of 2021. More specifically, during the Federal Reserve Board's press conference after the September 21-22, 2021 FOMC Meeting, Fed Chair Jerome Powell stated the following:

> So the test for beginning our taper's [sic] that we've achieved substantial further progress toward our goals of inflation and maximum employment. *And for inflation we appear to have achieved more than significant progress, substantial further progress. So that part of the test is achieved, in my view and in the view of many others*. So the question is really on the maximum employment test. Many on the Committee feel that the substantial further progress test for employment has been met. Others feel that it's close, but they want to see a little more progress. There's a range of perspectives. *I guess my own view would be that the test, the substantial further progress test for employment is all but met. And so once we've met those two tests, once the Committee decides that they've met, and that could come as soon as the next meeting, that's the purpose of that language is to put notice out there <u>that could come as soon as the next meeting</u>.* The Committee will consider that test, and we'll also look at the broader environment at that time and make a decision whether to taper.[13]

Consistent with Chair Powell's comments after the September 21-22, 2021 FOMC meeting, there is a high likelihood that the Fed will announce its decision to begin the process of tapering its bond-buying program at the Fed's upcoming FOMC

[13] Transcript of Chair Powell's Press Conference (FOMC Meeting) September 22, 2021 (federalreserve.gov), at 5-6.

meeting on November 2-3, 2021. In the event that the Fed elects to begin the tapering process later this year, this would begin the process of removing the "artificial"[14] downward pressure on long-term interest rates that the Fed's bond-buying programs have exerted in the U.S. bond market, and for this reason, it is reasonable to conclude that long-term interest rates would then begin to trend upward. Meanwhile, the strong GDP growth rates and higher actual and anticipated inflation rates recently witnessed in the U.S. economy are expected to put additional upward pressure on long-term interest rates going forward, which is consistent with a higher cost of equity.

Q. Can you please elaborate further on how the U.S. economic recovery from the earlier stages of the COVID-19 pandemic is now being reflected in key macroeconomic indicators?

A. Yes. As noted earlier, the recent release of pent-up consumer demand, which is attributable to the largely successful COVID-19 vaccine roll-outs and the corresponding moderation of governmental restrictions, has recently been a key contributor to robust U.S. economic growth. After a clearly challenging 2020, which registered negative real GDP growth rates during the first and second

[14] "Artificial" from the standpoint that it has been demonstrated by the Fed's own economists that the Fed's recent monetary policy interventions have interfered with normal supply and demand dynamics in the U.S. debt capital markets.

quarters of 2020, real GDP growth during the first two quarters of 2021 averaged a very healthy 6.45 percent.[15] Moreover, the *Blue Chip Financial Forecasts*[16] consensus projections currently reflect an average real GDP growth rate of 6.18 percent for the four quarters of calendar year 2021, which is a very robust growth rate by recent historical standards.

Meanwhile, as the U.S. economy continues to emerge from the worst of the COVID-19 pandemic, the U.S. unemployment rate, which reached a pandemic high level of 14.8 percent during April 2020, has continued to decline in recent months, and reached a new pandemic low of 5.2 percent during August 2021. The recent strengthening in the U.S. labor market is clearly manifested in the strong wage gains made by U.S. workers over the past year, as U.S. wages increased by 4.30 percent on a year-over year basis between August 2020 and August 2021. These strong wage gains, coupled with the release of pent-up consumer demand and supply chain disruptions as a result of COVID-19, have all contributed to the recent increases seen in the U.S. inflation rate. Along these lines, the Wall Street Journal recently reported the following:

> Disrupted supply chains, temporary shortages and a rebound in travel have pushed inflation to its highest reading in decades. Core inflation, which excludes volatile food and energy prices, rose 3.6% in July from a year earlier, according to the Fed's

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[15] See, *Blue Chip Financial Forecasts*, Volume 40, No. 9, September 1, 2021, at 2.
[16] Id. at 2.

> preferred gauge. A difference gauge of overall prices, the consumer-price index, rose 5.3 percent in July.[17]

Notably, in recent years leading up to the COVID-19 pandemic, the U.S. inflation rate had generally fluctuated at or below the Fed's targeted inflation rate of 2.0 percent. It is therefore clear that today's significantly higher U.S. inflation rate is unusual by recent historical standards and will therefore likely put additional upward pressure on long-term interest rate over the near-to-intermediate term horizon.

Q. Can you please summarize the key factors that you believe will have the effect of raising long-term interest rates over the near-to-intermediate term horizon?

A. Yes. The key factors that will continue to put upward pressure on U.S. interest rates over the near-to-intermediate term horizon include: (1) robust U.S. economic growth, as reflected in the real GDP growth rates discussed earlier, which has the potential to put upward pressure on the "real" component of long-term interest rates; (2) actual and anticipated rates of U.S. inflation, which are markedly higher than the "sub-2.0 percent" inflation rates seen prior to the COVID-19 pandemic; (3) strong wage gains for U.S. workers over the past year as noted earlier, which has a significant influence on actual and anticipated rates of inflation, as reflected in item (2) above; (4) continued monetary policy stimulus from the Fed with regard

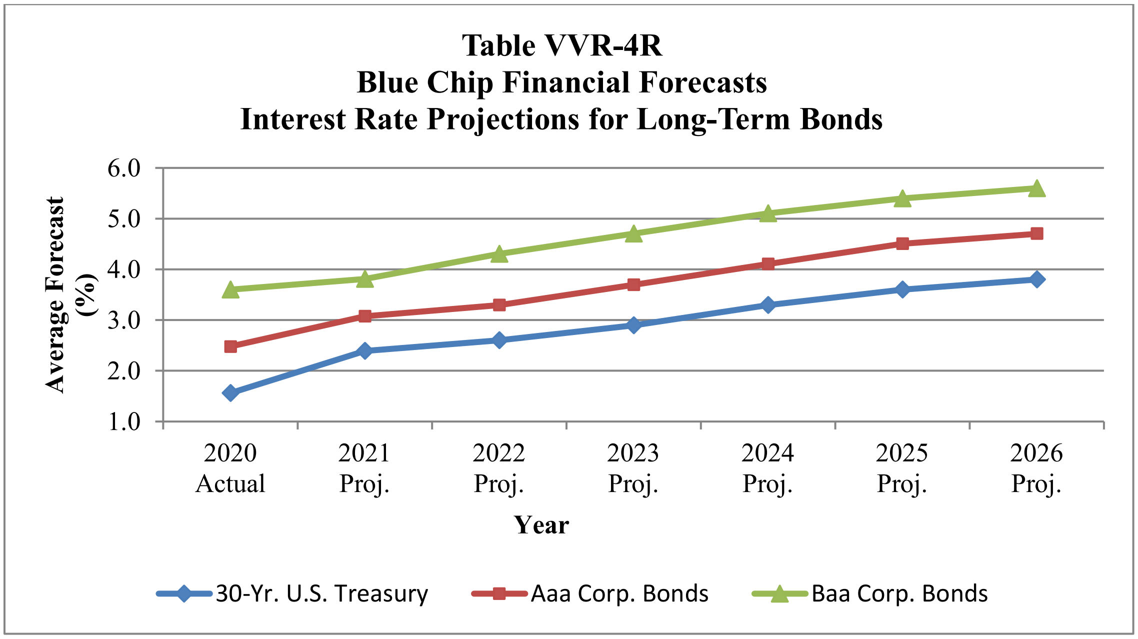
[17] *The Wall Street Journal Weekend*, August 28-29, 2021, at A2.

to the Fed's zero interest rate policy (i.e. Federal Funds rate); (5) the increasingly likely tapering of the Fed's colossal bond-buying programs, which the Fed is currently preparing to commence, and which will have the effect of putting upward pressure on long-term interest rates; and (6) the large fiscal stimulus measures currently being proposed by the Biden Administration and Congress, which would exceed upwards of $5.0 trillion, and could potentially ignite even higher levels of inflation than is currently being witnessed in the U.S. economy. Each and all of these factors will have the effect of putting additional upward pressure on long-term interest rates over the near-to-intermediate term horizon.

Q. Recognizing that multiple economic and sociopolitical factors currently suggest that long-term interest rates will trend materially higher over the near-to-intermediate term, are economists also projecting that U.S. Treasury and corporate bond yields will increase over the next several years?

A. Yes. Both prominent economists and capital market participants widely-expect that intermediate and longer-term interest rates will continue to trend higher over the next several years, as the U.S. economy continues to expand in the post-COVID-19 environment. As reflected in Table VVR-4R below, the consensus estimates of prominent economists, as reflected in the Blue Chip Financial

Forecasts,[18] are currently projecting material increases in long-term interest rates over the near-to-intermediate term horizon.



In view of the expected continuing upward trend in long-term capital costs, it is critical to incorporate reputable interest rate forecasts, such as those reported by the Blue Chip publication, into the cost of equity estimation process. This is because interest rate forecasts are widely-referenced by the investment community and therefore influence the investment decisions and valuation analyses of equity investors.

Q. Have you seen any recent evidence that long-term interest rates in the U.S. have already started to trend upward?

[18] *Blue Chip Financial Forecasts*, Volume 40, No. 6 (June 1, 2021).

A. Yes. Over the past several months (between August 2021 and October 2021) the 30-year U.S. Treasury bond yield has increased by approximately 15 basis points, from the range of 1.90 - 1.95 percent to the range of 2.05 – 2.10 percent.

Q. Have you seen any other recent evidence in the U.S. capital markets which suggests that long-term capital costs are higher now than they were at the time of the Company's 2016 general rate proceeding?

A. Yes, implied volatility has increased markedly in the U.S. equity market in recent months, which may be partially attributable to the fiscal spending and debt ceiling controversies that have recently occurred in Washington, D.C. Specifically, over the past several months (between mid-August 2021 and mid-October 2021), the CBOE "VIX" implied volatility index has been fluctuating in the range of approximately 17-26. The average of this recent trading range is significantly higher (approximately two times higher) than the trading range for the VIX during the time that the Commission issued its December 22, 2016 Order in the Company's last general rate proceeding.[19] Specifically, the VIX index closed at 11.43 on December 22, 2016, while, as noted above, the VIX has recently been trading in the range of 17-26. Thus, while Mr. Baudino has accurately pointed out that the VIX index, and therefore implied volatility, has declined since the

[19] *Order,* Kentucky Public Service Commission, Application of Columbia Gas of Kentucky, Inc., for an Increase in Base Rates, Case No. 2016-00162.

beginning of the COVID-19 crisis,[20] he has failed to recognize that the level of implied volatility is significantly higher now than it was at the time that the Commission issued in Order in the Company's 2016 general rate case proceeding. This is an important observation, since increased implied volatility is consistent with a higher level of investment risk, which in turn is consistent with higher long-term capital costs.

V. <u>DCF Methodologies are Flawed and the Results are Understated</u>

<u>Discussion of Mr. Baudino's Testimony</u>

Q. What significant infirmities did you identify in Mr. Baudino's DCF analysis?

A. The significant infirmities that I identified in Mr. Baudino's DCF analyses include: (1) reliance upon dividend-per-share (DPS) growth projections, which are not nearly as widely-referenced by investors as earnings-per-share (EPS) growth estimates, which has been demonstrated by the finance literature; (2) incorporating DCF estimates which do not pass threshold tests of reasonableness and economic logic; (3) failure to incorporate DCF estimates which reference the market and financial data of a broader group of comparable companies in order to improve the statistical reliability of his results; and (4) failure to adopt a financial leverage adjustment to recognize the higher level of financial risk associated with

[20] Direct Testimony of Richard A. Baudino, Case No. 2021-00183, at 14-15.

the book value based capital structure used for rate-setting purposes. Collectively, these infirmities caused Mr. Baudino's cost of equity range estimate under the DCF method, which ranged from 9.20 percent[21] to 9.49 percent[22], to be significantly understated.

Q. Do you agree with Mr. Baudino's use of the DPS growth projections reported by Value Line in his constant growth DCF analyses?

A. No. DPS growth projections are not widely-referenced by institutional investors, and to my knowledge, very few, if any, of the sell-side equity analysts that work for the major U.S. banks and brokerage firms disseminate DPS growth estimates to their investor clients. Mr. Baudino concedes this very point in his direct testimony, where he states: *"….Value Line is the only source of which I am aware that forecasts dividend growth.*[23] It is important to note that the most relevant measure of growth for purposes of the constant growth DCF model is the growth rate that investors actually expect, and therefore incorporate into their investment decisions. Contrary to the implicit assumption made by Mr. Baudino, which is that investors place a significant emphasis on the DPS growth estimates reported by Value Line, a substantial body of evidence indicates otherwise. Additionally,

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[21] Median growth rate estimate.
[22] Average growth rate estimate.
[23] Direct Testimony of Richard A. Baudino, Case No. 2021-00183, at 20-21.

substantial academic research[24] has also demonstrated that it is actually the *earnings estimates* of equity analysts that exert a significant influence over stock valuations, and therefore on the return expectations of investors. Morin discusses the propriety of referencing the EPS growth estimates of equity analysts in *New Regulatory Finance,* where he states:

> Because of the dominance of institutional investors and their influence on individual investors, analysts' forecasts of long-run growth rates provide a sound basis for estimating required returns. Financial analysts exert a strong influence on the expectations of many investors who do not possess the resources to make their own forecasts, that is, *they are a cause of g* (emphasis added).[25]

This was further demonstrated in a widely-referenced article published in the *Financial Analysts Journal* which surveyed professional investment analysts, and which determined that a company's earnings and cash flow estimates are the factors that are most heavily referenced by investment analysts in forming their

[24] See, Robert S. Harris, *Using Analysts' Growth Forecasts to Estimate Shareholder Required Rates of Return*, Financial Management, (Spring 1986), at 59, 66; James H. Vander Weide and William T. Carleton, *"Investor Growth Expectations: Analysts vs. History,"* The Journal of Portfolio Management (Spring 1988), at 4; Eugene F. Brigham, Dilip K. Shome, and Steve R. Vinson, *The Risk Premium Approach to Measuring a Utility's Cost of Equity,* Financial Management (Spring 1985), at 36; E.J. Elton, M.J. Gruber and J. Gultekin, "*Expectations and Share Prices"*, Management Science (September 1981) at 975-981; K.L. Stanley, W.G. Lewellen, and G.G. Schlarbaum, *"Further Evidence on the Value of Professional Investment Research"*, Journal of Financial Research (Spring 1981), at 1-9; Roger A. Morin, *New Regulatory Finance* (Public Utility Reports, Inc., 2006), at 298; Jing Liu, Doron Nissim and Jacob Thomas, *Equity Valuation Using Multiples*, Journal of Accounting Research, Vol. 40, No. 1, March 2002; Cristi A. Gleason, W. Bruce Johnson, Haidan Li, *Valuation Model Use and the Price Target Performance of Sell-Side Equity Analysts*, Contemporary Accounting Research (Volume 30, Issue 1, Spring 2013).

[25] Roger A. Morin, *New Regulatory Finance* (Public Utility Reports, Inc., 2006), at 298.

valuation opinions.[26] In contrast, dividends ranked at the *very bottom* of the list of the factors that investment analysts consider in forming their valuation opinions. Specifically, the authors stated the following with regard to the importance of dividends:

> The respondents were also asked to determine the relative importance of other inputs in analyzing securities. Table 6 shows how the survey participants ranked the importance of earnings, cash flow, book value, and dividends.
>
> …
>
> Earnings and cash flow are considered far more important than book value and dividends. *The lack of importance these respondents assigned to dividends is interesting. As reported in Table 6, only 3 of the 297 respondents considered dividends to be the most important variable in valuing a security* (emphasis added).[27]

The conclusion drawn from this survey of professional analysts is only logical, as a company's earnings are the very source of both its dividend payments and retained earnings, and for this reason, EPS growth estimates provide a more complete picture of the future growth expectations of investors. Considering that the finance literature has clearly demonstrated that the EPS growth estimates of "sell-side" equity analysts have a significant influence on the investment decisions of both institutional and individual investors, they represent the most appropriate

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[26] Stanley B. Block, "A Study of Financial Analysts; Practice and Theory", Financial Analysts Journal, (July-August, 1999), at 88.

[27] Id. at 88.

measure of expected earnings and dividend growth for purposes of the constant growth DCF model.

Q. Are the DPS growth rates referenced in Exhibit RAB-3 (p. 2) of Mr. Baudino's testimony reasonably consistent with the EPS growth rates he references in the same exhibit?

A. No. Mr. Baudino's DPS growth rate assumptions are as much as *250 basis points* lower than the EPS growth rate assumptions reflected in Exhibit RAB-3 (p. 2). For example, while Mr. Baudino references a 7.00 percent median EPS growth rate estimate from Value Line, he also references a 4.50 percent median DPS growth rate from Value Line. As noted earlier, a company's earnings are the very source of both its dividend payments and retained earnings, and for this reason, EPS growth estimates provide a more complete picture of the future growth expectations of investors. This is particularly the case, because the Gas LDC Group companies are currently projecting a compound average rate base growth rate of 8.98 percent over the next five years, which strongly suggests that gas utilities will maintain lower dividend growth rates over (at least) the next five years, in order to fund future rate base growth. For this reason, unlike EPS growth estimates, the DPS growth estimates of the Gas LDC Group companies do not likely reflect the future growth rate expectations of equity investors. This is further demonstrated in Table VVR-5R below, which illustrates the large disparities between the dividend growth rates that Mr. Baudino referenced in his DCF analyses, and the anticipated levels of rate base growth and earnings growth for the Gas LDC Group companies.

Table VVR-5R
Anticipated Rate Base and Earnings Growth Rates for the Gas LDC Group Companies Compared to Mr. Baudino's DPS Growth Rate Assumption

Gas LDC Group Company	Rate Base Growth 2020-2025	Projected EPS Growth Yahoo Finance (1)	Projected EPS Growth Zacks (1)	Projected EPS Growth Value Line (2)
Atmos Energy	12.90%	7.70%	7.40%	7.00%
New Jersey Resources	11.00%	6.00%	7.10%	2.00%
Northwest Natural Gas	5.00%	5.50%	4.90%	5.50%
ONE Gas	n/a	5.00%	5.00%	6.50%
South Jersey Industries	10.00%	4.80%	5.40%	11.50%
Southwest Gas	7.50%	4.00%	5.50%	8.00%
Spire Inc.	7.50%	7.31%	5.50%	10.00%
Avg. Growth Rate for Gas LDC Group Companies	8.98%	5.76%	5.83%	7.21%
Mr. Baudino's DPS Growth Rate Assumptions	4.50% (median) 4.86% (average)	4.50% (median) 4.86% (average)	4.50% (median) 4.86% (average)	4.50% (median) 4.86% (average)

(1) Data accessed August 26, 2021.
(2) Value Line Investment Survey, August 27, 2021

Q. To what degree would Mr. Baudino's DCF-based cost of equity estimates change if he had focused his analysis on the EPS growth estimates of equity analysts, which is the approach supported by the finance literature?

As reflected in Table VVR-6R below, if Mr. Baudino had appropriately referenced the EPS growth estimates of equity analysts, which is the approach supported by the finance literature, his DCF estimates of the cost of equity would have been substantially higher. Specifically, Mr. Baudino's DCF estimate under his average growth rate approach would have been 9.86 percent, rather than 9.49 percent, while his DCF estimate under the median approach would have been 9.58 percent, rather than 9.20 percent. This provides further evidence that Mr. Baudino's recommended cost of equity of 9.10 percent is significantly understated, particularly since Mr. Baudino has relied entirely upon the DCF model in developing his cost of equity recommendations.

Table VVR-6R Mr. Baudino's DCF Estimates of the Cost of Equity Based on the EPS Growth Estimates of Equity Analysts				
DCF Model Component	**Value Line EPS Growth**	**Zack's EPS Growth**	**Yahoo! EPS Growth**	**Average of EPS Growth Rates**
Method 1:				
Dividend Yield	3.48%	3.48%	3.48%	3.48%
Average Growth Rate	7.21%	5.83%	5.76%	6.27%
Expected Div. Yield	3.60%	3.58%	3.58%	3.59%
DCF Return on Equity	**10.81%**	**9.41%**	**9.34%**	**9.86%**
Method 2:				
Dividend Yield	3.48%	3.48%	3.48%	3.48%
Median Growth Rate	7.00%	5.50%	5.50%	6.00%
Expected Div. Yield	3.60%	3.57%	3.57%	3.58%
DCF Return on Equity	**10.60%**	**9.07%**	**9.07%**	**9.58%**

Q. Does Mr. Baudino's DCF-based cost of equity estimates incorporate estimates that do not pass threshold tests of reasonableness and economic logic?

A. Yes. Mr. Baudino's DCF-based cost of equity estimates incorporate a DPS growth rate of just 0.50 percent for Northwest Natural Holding Co., which, when combined with Mr. Baudino's expected dividend yields of 3.56 percent (average approach) and 3.55 percent (median approach), yield cost of equity estimates of just <u>4.06 percent</u> and <u>4.05 percent</u>, respectively. Therefore, Mr. Baudino has essentially "blended-in" these illogical DCF results into his DCF estimates. This is not proper, as the exercise of informed judgment is critical under such circumstances, and consistent with FERC precedent,[28] investors cannot reasonably be expected to invest in common stocks if the expected return on a given stock is lower, or only marginally higher, than the returns available on corporate fixed-income securities. Likewise, DCF estimates on the extreme high-side of the spectrum should also be evaluated for reasonableness through the exercise of informed judgment. Therefore, as a result of Mr. Baudino's failure to properly evaluate the reasonableness and economic logic of his DCF results through the exercise of informed judgment, his results incorporate a further downward bias, and should therefore be rejected.

Q. Mr. Baudino maintains that referencing the median value from a DCF analysis can "normally" mitigate the impact of both high-end and low-end DCF results, which is the approach he took in this proceeding. Do you agree with this approach?

A. No. Simply referencing a median value does not involve the application of informed judgment in evaluating each of the individual results from the DCF analysis, and therefore may result in grossly inappropriate DCF results being included in the analyst's overall ROE recommendation. For example, consider

[28] See, *Association of Businesses Advocating Tariff Equity, et al., v. Midcontinent Independent System Operator, Inc., et al.*, 169 FERC ¶ 61,129, Opinion No. 569, at P 387 and P 388 (November 21, 2019); Southern California Edison Co., 131 FERC ¶ 61020 at P 55 (April 15, 2010); ISO New England, Inc. et al., 109 FERC ¶ 61,147 at P 205 (November 3, 2004).

the following sequence of cost of equity estimates from a DCF analysis of seven gas distribution companies:

Sequence of DCF estimates: 2.5%, 2.9%, 3.3%, 3.5%, 9.0%, 9.5%, 10.0%

Under Mr. Baudino's recommended approach, the median value of the above sequence of cost of equity estimates is 3.5 percent, which Mr. Baudino would argue obviates the effects of outlier results, and he would therefore blindly rely upon the 3.5 percent median value in developing his cost of equity recommendations. This is not a proper approach, as the proper application of informed judgment would have instead concluded that a rational investor would not commit capital to an equity investment which only promised a total return that is commensurate with that of fixed income securities such as utility bonds.

Q. Is Mr. Baudino's overall cost of equity recommendation in this proceeding consistent with the results of his DCF analysis?

A. No. Mr. Baudino essentially ignored his own DCF analysis, which generated an average DCF-based cost of equity estimate of <u>9.49</u> percent,[29] while he has recommended a cost of equity of 9.10 percent. Mr. Baudino attempts to justify this readily apparent disconnect between his actual DCF results and his overall cost of equity recommendation on the basis of his decision to reject two EPS growth rate estimates reported by Value Line (10.0 percent for Spire Inc., and 11.5

[29] See, Exhibit RAB-3 (p. 2).

percent for South Jersey Industries), which Mr. Baudino characterizes as "unsustainable double digit growth rates". Mr. Baudino's decision to eliminate the EPS growth estimates of Spire Inc. and South Jersey Industries essentially amounts to cherry-picking the data, particularly since he has not cited any regulatory precedent or other objective basis for determining an appropriate threshold test for the elimination of outlier results.

These matters notwithstanding, what is even more concerning is that Mr. Baudino chose to eliminate *all* of his DCF cost of equity estimates that were based on Value Line's projected EPS growth rates. This is clearly inappropriate, since even if Mr. Baudino could provide a justifiable basis for eliminating both high-end and low-end outlier results, the remaining four projected EPS growth estimates reported by Value Line (which are perfectly legitimate growth estimates)[30] would have resulted in an average EPS growth rate estimate of 6.75 percent.[31] Based upon the expected dividend yield assumptions presented by Mr. Baudino in Exhibit RAB-3 (p. 2), the 6.75 percent average EPS growth rate estimate would have yielded an average DCF cost of equity estimate of 10.35 percent, rather than the 10.81 percent estimate reflected in Exhibit RAB-3 (p. 2). <u>Accordingly, Mr.</u>

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[30] Mr. Baudino eliminated <u>all</u> of the Value Line projected EPS growth rate estimates, which included a 7.00 percent EPS growth estimate for Atmos Energy, a 5.50 percent EPS growth estimate for Northwest Natural Gas, a 6.50 percent EPS growth estimate for ONE Gas, and an 8.00 percent EPS growth estimate for Southwest Gas Holdings.

[31] After eliminating an 11.50 percent EPS growth estimate for South Jersey Industries, a 10.00 percent EPS growth estimate for Spire, Inc., and a 2.00 percent EPS growth estimate for New Jersey Resources.

Baudino's *overall* average DCF cost of equity estimate would have only declined from 9.49 percent[32] to 9.40 percent, had he not eliminated all of the remaining Value Line EPS growth rate estimates. Therefore, considering that Mr. Baudino has relied entirely upon his constant growth DCF analysis to develop his overall cost of equity recommendation in this proceeding, Mr. Baudino's decision to inappropriately eliminate perfectly legitimate EPS growth estimates from Value Line, ultimately causes his overall cost of equity recommendation to be unreliable.

Q. Did Mr. Baudino cite to any regulatory precedent, or provide any other supporting basis for the high-end outlier test he applied to his DCF analysis?

A. No. Mr. Baudino did not cite any regulatory precedent or provide any other supporting basis for his decision to eliminate the Value Line EPS growth estimates for Spire Inc. and South Jersey Industries. However, as I discussed earlier, there is well-established regulatory precedent at FERC which provides a reasonable basis for establishing both low-end and high-end outlier thresholds that can be applied to DCF analyses. Notably, the high-end outlier test that Mr. Baudino applied to his DCF analysis does not comport with the regulatory precedent established by FERC. Moreover, while Mr. Baudino readily eliminated two alleged high-end outlier results, he chose *not* to take a symmetrical approach in

[32] As reflected in Exhibit RAB-3 (p. 2).

the elimination of other outlier results, which would have also entailed eliminating low-end outlier results.

Q. Did Mr. Baudino employ a symmetrical approach, and also eliminate low-end outlier results from his DCF analysis?

A. No. Mr. Baudino did not eliminate two growth rate estimates at the lower-end of the range of Value Line's growth estimates, including a DPS growth estimate of 0.50 percent for Northwest Natural Gas, and an EPS growth estimate of 2.00 percent for New Jersey Resources.

Q. Mr. Baudino maintains that your market value financial risk adjustments are unwarranted because market prices can deviate from book value for any number of reasons. How do you respond?

A. I disagree. Mr. Baudino would appear to imply that the market value financial risk adjustment I included in my DCF analyses amounts to a so-called market-to-book adjustment, which it is not. Rather, it is a financial risk adjustment that recognizes, in accordance with the finance literature, that companies with different capital structures will by definition have different financial risk profiles. Mr. Baudino fails to recognize that when the market-based cost of equity analytical models were originally developed, the creators of these models did not specifically contemplate that the market-based cost of equity estimates derived from these models would be applied to a book value based capital structure for utility ratemaking purposes, which almost invariably has a different financial risk profile. Therefore, the financial risk adjustments I have proposed are necessary to recognize the increase in financial risk which results when a market-based cost of equity estimate, which corresponds to a market-value based capital structure, is applied to a utility's book value based regulatory capital structure. The finance literature has long recognized that, to properly analyze the effects of financial leverage on the cost of capital, current market values must be considered, not historically focused book values. For example, both M&M's classic financial theorems[33] and Hamada's research[34] on the effects of financial leverage on systematic risk evaluated market value capital structures, not book value based capital structures.

Q. Mr. Baudino alleges that you have not provided any evidence that investors assess financial risk based on the market value of common equity. How do you respond?

A. Appendix C to my direct testimony discusses the relationship between financial risk and the cost of equity and cites to well-respected research conducted by

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[33] *See,* Franco Modigliani and Merton H. Miller, "Taxes and the Cost of Capital: A Correction," *American Economic Review,* 53 (June 1963), 433-443; Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investments, American Economic Review* 48 (June 1958) at 261-297.

[34] Robert S. Hamada, The Effect of the Firm's Capital Structure on the Systematic Risk of Common Stocks," *The Journal of Finance,* 27 (May 1972) at 435-452.

Modigliani and Miller[35], as well as Morin.[36] Furthermore, while discussing the effects of financial risk on the cost of equity in their widely-referenced textbook *Principles of Corporate Finance*, Brealey, Myers and Allen make it abundantly clear that market value based capital structures must be examined, not book value based capital structures.[37] In fact, when discussing the proper approach to calculating a company's WACC in *Principles of Corporate Finance*, the authors present both a book value and a market value based balance sheet for the hypothetical company they evaluate in this section of their textbook. The authors then observe:

> Why did we show the book balance sheet? Only so you could draw a big X through it. Do so now. When estimating the weighted-average cost of capital, you are not interested in past investments but in current values and expectations for the future.[38]

Thus, while Mr. Baudino maintains that a market value leverage adjustment is not necessary because investors are aware that utilities are regulated on the basis of their book values, he fails to acknowledge that investors and stock analysts evaluate *both* risk and return on an equivalent valuation basis. In fact, the implication of Mr. Baudino's position is that while investors evaluate investment

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[35] *See,* Franco Modigliani and Merton H. Miller, "Taxes and the Cost of Capital: A Correction," *American Economic Review,* 53 (June 1963), 433-443; Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investments, American Economic Review* 48 (June 1958) at 261-297.

[36] Roger A. Morin, New Regulatory Finance (Public Utility Reports, Inc., 2006), at 463-464.

[37] Richard A. Brealey, Stewart C. Myers, and Franklin Allen. *Principles of Corporate Finance, Concise Edition,* McGraw Hill / Irwin, 2011, pp. 332-333.

[38] Id. pp. 378-379.

returns on the basis of the market value of their investments, they inexplicably choose to evaluate investment *risk* on a book value basis. This is not only illogical, but is also inconsistent with fundamental investment principles, which state that an investment's risk and return are closely interrelated, suggesting that the basis upon which both risk and return are evaluated should be consistent and inseparable. Therefore, Mr. Baudino fails to acknowledge the fact, as aptly stated by Morin, that *"the capital structure used to estimate the cost of equity is an integral inseparable part of that estimate."*[39]

VI. <u>CAPM Methodologies are Flawed and the Results are Understated</u>

Q. What significant infirmities did you identify in Mr. Baudino's CAPM analysis?

A. The significant infirmities that I identified in Mr. Baudino's CAPM analysis include: (1) relying upon recent historical U.S. Treasury security yields as a proxy for the risk-free rate of return, thereby failing to recognize that the CAPM is a forward-looking ex-ante model that requires forward-looking expectational inputs; (2) relying upon a market risk premium estimate from Value Line which is based on geometric averages and which should not be relied upon exclusively in estimating the expected market risk premium (3) improper reliance upon a *modified* historical market risk premium estimate, which is based on a single academic study that is subject to bias, and therefore does not likely reflect the

[39] Roger A. Morin, *New Regulatory Finance* (Public Utility Reports, Inc., 2006), at 463-464.

future return expectations of investors; (4) failure to recognize that the beta coefficients referenced in the CAPM should reflect the higher level of financial risk associated with a utility's book-value based regulatory capital structure; (5) failure to recognize substantial empirical evidence supporting the use of both the CAPM with size adjustment and the ECAPM; and (6) failure to also apply his CAPM analysis to a broader group of comparable risk companies, which would have ensured a higher degree of statistical reliability in his cost of equity results.

Q. In his CAPM analysis, Mr. Baudino references a risk-free rate of return assumption of 2.18 percent, which is based on the average historical yield for the 30-year U.S. Treasury bond over the past 6 months. Is this the appropriate risk-free rate to employ in the CAPM?

A. No. Mr. Baudino has failed to acknowledge that the CAPM is an ex ante model which requires expectational inputs. Mr. Baudino's risk-free rate of return assumptions are retrospectively focused and are clearly inconsistent with the recent consensus forecasts of prominent economists, which I presented earlier in my rebuttal testimony.

Q. Is it widely-accepted that forward-looking, ex ante models such as the CAPM require expectational inputs?

A. Yes. Proper application of the CAPM requires expectational inputs rather than backward-looking model inputs, which is particularly critical in view of the recent capital markets environment due to the COVID-19 pandemic. Morin discusses the need for expectational inputs in *New Regulatory Finance,* a widely-referenced authoritative guide on utility cost of capital matters, where he observes:

> At the conceptual level, given that ratemaking is a forward-looking process, interest rate forecasts are preferable. Moreover, the conceptual models used in the determination of the cost of equity, such as the CAPM, are prospective in nature, and require expectational inputs.[40]

Indeed, the use of expectational inputs is particularly important in view of the recent U.S. capital markets environment resulting from the COVID-19 crisis. Notably, intermediate and long-term U.S. Treasury yields have declined since the COVID-19 crisis first began in the U.S. during February-March 2020. This decline in interest rates has been widely-attributed to the recent investor "flight to quality", or to the safety of U.S. Treasury securities, which was largely the result of the COVID-19 crisis. In addition, the Fed's monetary policy interventions, and in particular the re-initiation of the Fed's quantitative easing (QE) programs (as a direct result of the COVID-19 crisis), has continued to put downward pressure on long-term interest rates.

These circumstances notwithstanding, both market observers and economists generally believe that as the U.S. economy continues to recover over the next few years, long-term interest rates will once again begin to trend upward.

[40] Roger A. Morin, *New Regulatory Finance* (Public Utility Reports, Inc., 2006), at 172.

This is particularly the case because Federal Reserve Board (the "Fed") Chairman Jerome Powell has recently indicated that the Fed may begin unwinding or tapering its quantitative easing ("QE", or bond buying) programs by as early as the next Federal Open Markets Committee meeting ("FOMC), which is scheduled for November 2-3, 2021.[41] Considering that the Fed's QE programs have been highly successful in keeping intermediate and long-term interest rates low ever since the 2008-2009 financial crisis and Great Recession, it is widely-anticipated that as the Fed begins to unwind its QE programs, interest rates will begin to trend upward. For these reasons in particular, Mr. Baudino has incorrectly referenced backward-looking U.S. Treasury security yields, while at the same time he has referenced a forward-looking projected market return reported by Value Line. This approach results in a misspecification (or mismatch) among the input variables that Mr. Baudino has referenced in his prospectively focused CAPM analysis. This misspecification results in a significant downward bias in Mr. Baudino's CAPM-based cost of equity estimates.

Q. In his CAPM analyses, Mr. Baudino derives a range of estimated market risk premium values of 6.92 percent - 7.24 percent on a forward looking basis, and 6.00 percent - 7.30 percent on a historical basis. In your opinion, are Mr.

[41] *Fed Prepares to Pull Back on Stimulus,* The Wall Street Journal, September 21, 2021, at A1-A2

Baudino's estimates of the market risk premium an accurate reflection of the market risk premium in the current market environment?

A. No, they are not. I will first address Mr. Baudino's forward-looking or prospective market risk premium assumptions, which he derived from information contained in the Value Line Investment Analyzer.[42] As reflected in Exhibit RAB-4 (p. 1), Mr. Baudino has referenced forward-looking market risk premium assumptions of 7.24 percent and 6.92 percent, based upon the recent historical 30-year U.S. Treasury bond yield, and the Duff & Phelps normalized risk-free rate of return, respectively. In developing these market risk premium assumptions, Mr. Baudino has relied upon a forward-looking total market return estimate of 9.42 percent, which he derived from the Value Line Investment Advisor. As noted earlier, my concern with this approach is that Mr. Baudino was unable to identify[43] which particular market index is being referenced within the Value Line market return data, and whether the projected market return is based upon the geometric mean or the arithmetic mean, the former of which is not an appropriate basis for estimating the market risk premium. Multiple academic studies and finance publications[44] have made clear that the arithmetic mean (not the geometric mean)

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[42] Direct Testimony of Richard A. Baudino, Case No. 2021-00183, at 25-26 and Exhibit RAB-4 (p. 2).

[43] *See*, the Attorney General's response to the Company's Data Request No. 5.

[44] *See,* Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation, 2005 Yearbook, Valuation Edition*, at 75; Brealey, R., Myers, S., and Allen, P. *Principles of Corporate Finance*, International Edition, New York: McGraw-Hill, 2011, at 159; Bodie, Z., Kane, A., and Marcus, A.J. *Investments*, New York: McGraw-Hill Irwin, 8th ed., 2009, at 126-127; Brigham, E.F. and Ehrhardt, M. *Financial Management: Theory and Practice,* 8th ed.,

is the appropriate basis to employ when estimating the forward-looking market return and risk premium expectations of investors. This is attributable to the fact that the arithmetic mean is an unbiased estimate of a security's expected future return, in that it incorporates the variability of historical returns into future return expectations. In contrast, the geometric mean does not incorporate the expected future variability of equity returns into the expected market return. Considering that equity investors would in fact be exposed to potential wide variations in investment returns in the future, these returns would need to revised upward significantly on the basis of arithmetic averages to properly reflect the risk associated with the variability of future returns.

Moreover, the Value Line total market return estimates do not reflect the forward-looking market return expectations of "sell-side" equity analysts, who have a significant influence on market return expectations. In conducting my CAPM evaluation, I determined that based upon the consensus EPS growth estimates of sell-side equity analysts, the market's forward looking annual return expectations for the S&P 500 Index over the 3-5 year horizon is in excess of 13.0

Hinsdale, IL, Dryden Press, 2005; and Bruner, R.F., Eades, K.M., Harris, R.S., and Higgins R.C. "Best Practices in Estimating the Cost of Capital: Survey and Synthesis," *Financial Practice and Education*, Spring/Summer 1998, at 13-28.

percent.[45] In contrast, Mr. Baudino gave no consideration whatsoever to the forward-looking market return expectations of sell-side equity analysts, which is inconsistent with the approach he took in conducting his DCF analyses, where he relied extensively upon the EPS growth estimates of sell-side equity analysts. Therefore, in my judgment, Mr. Baudino erred by not considering the perspective of sell-side equity analysts, particularly since the finance literature has demonstrated that the EPS growth estimates of sell-side equity analysts are a primary driver of stock valuations and the investment decisions of equity investors. In developing my estimate of the market risk premium for purposes of the CAPM, I took a balanced approach and considered both the perspective of the sell-side equity analysts, as well as the Value Line price appreciation potential approach, which yielded a prospective market return expectation of 11.28 percent, and a prospective market risk premium expectation of 8.34 percent.[46] Therefore, considering that Mr. Baudino chose to ignore the perspective of sell-side equity analysts in conducting his CAPM analyses, his prospective market risk premium assumptions of 6.92 percent and 7.24 percent, respectively, are understated by as much as 1.42 percent (142 basis points),[47] which further contributes to the significant downward bias in his CAPM-derived estimates of the cost of equity.

[45] *See*, Attachment Rebuttal VVR-11 (p. 1) to Mr. Rea's direct testimony.
[46] *See*, Attachment Rebuttal VVR-11 (p. 1) to Mr. Rea's direct testimony.
[47] Calculated as 8.34% - 6.92% = 1.42%.

Q. Do you agree with the approach that Mr. Baudino took in developing his estimates of the historically based market risk premium?

A. No, not entirely. While I do agree with the approach that Mr. Baudino took in referencing the 95-year historical average of the market risk premium as reported within the *Duff & Phelps Cost of Capital Navigator (*which reflects a historical annual average market risk premium of 7.30 percent), I do not agree with his alternative approach where he references the Ibbotson-Chen "supply side" expected market risk premium. According to Mr. Baudino, the "supply side" approach to forecasting the equity risk premium essentially subtracts the historical growth rate of the price-to-earnings (EPS) ratio for U.S. stocks from the actual reported historical market risk premium to arrive at an adjusted "supply side" estimate of the market risk premium, which is 6.00 percent. More specifically, the Ibbotson-Chen supply side model "decomposes" the historical U.S. equity returns going back to the year 1926, into "supply factors."[48] These supply factors include: inflation, earnings, dividends, price-to-earnings (P/E) ratios, dividend payout ratios, book value, return on equity and GDP per capita. Next, in order to forecast the expected equity risk premium under the supply side approach, each of the aforementioned variables or supply factors must be estimated for purposes of

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[48] *The Supply of Stock Market Returns*, Roger G. Ibbotson and Peng Chen, Yale International Center for Finance (June, 2001).

input into the supply side model. Therefore, in view of the large number of input variables that must be estimated in order to operationalize the supply side model, the model is subject to forecasting errors, as well as to the subjective bias of the individual analyst implementing the model.

In contrast, the "as-reported" historical annual average market risk premium reported by Duffs & Phelps is not subject to forecasting errors, and most importantly, it reflects an unbiased estimate of the forward-looking market risk premium expectations of investors. In this regard, it is important to note that during the 95-year period (between 1926-2020), the average annual total return for U.S. large-capitalization stocks was 12.20 percent,[49] while during this same period, the average annual market risk premium was 7.30 percent. These are the pertinent benchmark return values to reference in estimating the market risk premium, since over the very long-run (i.e., 95 years), investor expectations are realized, and to my knowledge, there are no particularly compelling reasons to believe that future returns will be significantly different.

Moreover, evaluating the historical returns of large-capitalization stocks, *without any further modifications to the data*, provides an unbiased estimate of future market return expectations. This is because these historical returns reflect repeated observations of a variable that has behaved randomly in the past (U.S.

[49] 2021 SBBI Yearbook, Duff & Phelps, A Kroll Business (April 2021), at 6-17.

stock market returns), and therefore are free of subjective bias. Thus, while I do agree with Mr. Baudino's use of the "as-reported" historical market risk premium of 7.30 percent as reported by Duff and Phelps, his reference to the "supply side" market risk premium of 6.00 percent should be rejected since it incorporates the risk of forecasting errors and subjective bias into what should otherwise be a straightforward calculation of the historical market risk premium. For these reasons, Mr. Baudino's use of the "supply side" market risk premium causes this particular component of his CAPM analysis to understate the cost of equity by at least 1.30 percent (130 basis points).[50]

Q. Do you agree with Mr. Baudino's implicit assumption in his CAPM analyses that the market risk premium is currently equal to, or lower than, the 95-year historical average of 7.30 percent?

A. No, I do not. Numerous academic studies[51] have demonstrated an inverse relationship between the equity risk premium and government interest rates. Specifically, these studies have demonstrated that when government interest rates change by 100 basis points in either direction, the equity risk premium will change

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[50] Based on the difference between the "as-reported" historical market risk premium of 7.30 percent and the "supply side" market risk premium of 6.00 percent referenced by Mr. Baudino.

[51] *See,* Robert S. Harris, "Using Analysts' Growth Forecasts to Estimate Shareholder Required Rates of Return", *Financial Management* (Spring 1986), at 58-67; Robert S. Harris and F. Marston, "Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts," *Financial Management,* 21 (Summer 1992), at 63-70; Farris M. Maddox, Donna T. Pippert and Rodney N. Sullivan, "An Empirical Study of Ex Ante Risk Premiums for the Electric Utility Industry," Financial Management, 24 (Autumn 1995), at 89-95.

by between 37 - 75 basis points in the opposite direction, and therefore that a 50-basis point "inverse relationship" assumption provides a reasonable basis for estimating the prevailing equity risk premium based on current government interest rates (U.S. Treasury security yields). For this reason, when estimating the prevailing equity risk premium, consideration must be given to this well-documented inverse relationship. According to the 2021 SBBI Yearbook, the historical average market risk premium over the past 95 years (1926-2020) has been 7.30 percent, which is calculated on the basis of the arithmetic average of large-capitalization stock returns (12.20 percent), and the arithmetic average of income returns on long-term U.S. government bonds (4.90 percent). Considering that the historical average market equity risk premium of 7.30 percent is calculated on the basis of the historical average income return on government bonds of <u>4.90 percent</u>, it is simply not reasonable for Mr. Baudino to conclude that the prevailing equity risk premium is as much as 130 basis points[52] lower than the 95-year historical average of 7.30 percent.

To the contrary, in view of the recently low interest rate environment and the documented inverse relationship between the market risk premium and government interest rates, it is reasonable to conclude that the market risk

[52] The 130 basis point estimate was determined on the basis of the 7.30 percent historical average market risk premium as reported by the 2021 *SBBI Yearbook*, less Mr. Baudino's lowest estimate of the market risk premium, which is 6.00 percent.

premium is currently *above* the 95-year historical average, and for this reason, it is incorrect for Mr. Baudino to conclude that the market risk premium is currently as low as 6.00 percent. For these reasons, Mr. Baudino's CAPM estimates of the cost of equity, which range from 7.58 percent to 9.07 percent, are significantly understated, and should therefore be rejected.

Q. Mr. Baudino maintains that a small size premium is not appropriate for Columbia because the Decile 4 size adjustment reported by Duff & Phelps[53] which you referenced corresponds to riskier Decile 4 companies, which on average have higher beta coefficients. How do you respond?

I disagree. The fact that the Decile 4 companies have higher beta coefficients on average than the Gas LDC Group companies has no relevance with respect to the impact of size. This is true because the size premiums reported by Duff & Phelps have already been beta-adjusted, which means that the effects of systematic risk have already been fully removed from the calculation of the size premium. Therefore, considering that the effects of systematic risk have already been controlled for in the determination of the size premiums reported by Duff & Phelps, any such differences in beta coefficients are irrelevant, despite Mr. Baudino's misplaced arguments to the contrary.

[53] Notably, Duff & Phelps sources its size premium data by decile ranking from the Center for Research in Security Prices (CRSP) at the University of Chicago's Booth School of Business.

Q. Mr. Baudino further maintains that there is no evidence to suggest that the size premium you have recommended applies to regulated gas utility companies. How do you respond?

A. Once again, I disagree. Support for the use of the size premium in the utility industry comes from at least two studies which have demonstrated that the size effect does in fact apply to utilities. For example, in *Equity and the Small-Stock Effect*, Annin concluded:

> For the traditional CAPM, the large-company composite shows a cost of equity of 12.05 percent; the small company composite, 13.93 percent. However, once the respective small capitalization premium is added in, the spread increases dramatically, to 12.07 and 17.95 percent, respectively. Clearly, the smaller the utility (in terms of equity capitalization), the larger the impact that size exerts on the expected return of that security.[54]

Similarly, in *Utility Stocks and the Size Effect–Revisited*, Zepp concluded:

> New studies based on different size water utilities are presented that do support a small firm effect in the utility industry.[55]

Furthermore, in a recent opinion, the FERC characterized the small size premium as a "generally accepted approach" to CAPM analyses for purposes of utility regulatory proceedings. Specifically, the FERC stated:

> We disagree with Petitioners' argument that the NETOs CAPM analysis is flawed due to the fact that the NETOs applied a size adjustment to account for the difference in size between the NETOs and

[54] Annin, M., *Equity and the Small-Stock Effect*, Public Utilities Fortnightly, October 15, 1995, 133, at 42.

[55] Zepp, T., *Utility Stocks and the Size Effect–Revisited*, The Quarterly Review of Economics and Finance, 43 (2003), at 578-582.

> the dividend-paying companies in the S&P 500. This type of size adjustment is a generally accepted approach to CAPM analyses, and we are not persuaded that it was inappropriate to use a size adjustment in this case. The purpose of the NETOs size adjustment is to render the CAPM analysis useful in estimating the cost of equity for companies that are smaller than the companies that were used to determine the market risk premium in the CAPM analysis.[56]

Therefore, contrary to Mr. Baudino's assertions, there is strong evidence that the size premium does in fact apply to regulated utilities.

Q. Mr. Baudino objects to your evaluation of the Empirical CAPM (ECAPM), stating that the need for an ECAPM adjustment suggests that published betas by sources such as Value Line are incorrect and that investors should not rely upon them in formulating their estimates using the CAPM. How do you respond?

A. I disagree. By way of background, Dr. Roger Morin, who serves as Emeritus Professor of Finance at Georgia State University, developed the ECAPM based upon the large body of empirical research which demonstrated that the CAPM risk-return relationship, as illustrated by the Security Market Line ("SML"), is actually flatter than what is predicted by the traditional CAPM. Dr. Morin's development of the ECAPM was heavily influenced by the research of other well-respected finance academics[57] that similarly developed enhanced CAPM models

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[56] Federal Energy Regulatory Commission, Opinion 531-B, 61,165 at P117 (2015).

[57] See, Fama, E.F. and French, K.R. "The Cross-Section of Expected Stock Returns," *Journal of Finance,* June 1992, 427-465; Fama, E.F. and MacBeth, J.D. "Risk, Returns and Equilibrium; Empirical Tests," *Journal of*

based on many of the same principles and empirical findings which Morin applied in developing the ECAPM. Most notably, the esteemed finance academics Fama and French have also provided additional support for the ECAPM where they have indicated the following:

> The evidence that the relation between beta and average return is too flat is confirmed in time-series tests, such as Friend and Blume (1970), Black, Jensen and Scholes (1972) and Stambaugh (1982).
>
> Confirming earlier evidence, the relation between beta and average return for the ten portfolios is much flatter than the Sharpe-Lintner CAPM predicts. The returns on the low beta portfolios are too high, and the return on the high beta portfolios are too low. For example, the predicted return on the portfolio with the lowest beta is 8.3 percent per year; the actual return is 11.1 percent. The predicted return on the portfolio with the highest beta is 16.8 percent per year; the actual is 13. 7 percent.
>
> The version of the CAPM developed by Sharpe (1964) and Lintner (1965) has never been an empirical success....in the late 1970's, research begins to uncover variables like size, various price ratios and momentum that add to the explanation of average returns provided by beta.
>
> But the empirical work, old and new, tells us that the relation between beta and average return is flatter than predicted by the Sharpe-Lintner version of the CAPM. As a result, CAPM estimates of the cost of equity for high beta stocks are too high (relative to

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Political Economy, September 1972, pp. 607-636; Litzenberger, R.H. and Ramaswamy, K., "The Effect of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empirical Evidence," *Journal of Financial Economics,* June 1979, 163-196; Litzzenberger, R.H., Ramaswamy, K., and Sosin, H. "On the CAPM Approach to the Estimation of a Public Utility's Cost of Equity Capital." *Journal of Finance,* May 1980, 369-383; Pettengill, G.N., Sundaram, S. and Mathur, I. "The Conditional Relation Between Beta and Returns," *Journal of Financial and Quantitative Analysis, Vol.* 30, No. 1, March 1995, at 101-116.

> historical average returns) and estimates for low beta stocks are too low (Friend and Blume, 1970).[58]

Q. Do you agree with Mr. Baudino's contention that the need for an ECAPM adjustment suggests that published betas from sources such as Value Line are incorrect, and therefore need to be adjusted?

A. No. The ECAPM does not represent a risk adjustment to beta (or a horizontal axis adjustment to the SML), but instead represents a return adjustment (or vertical axis adjustment to the SML) for empirically observed differences in actual stock returns versus what is actually predicted by the traditional CAPM. Simply stated, the ECAPM incorporates a return adjustment for empirically observed differences in actual returns, rather than a risk adjustment to beta. Therefore, Mr. Baudino's statements in this regard are simply misplaced.

Q. Mr. Baudino objects to the fact that you re-levered the beta coefficients that you referenced in applying the CAPM. How do you respond?

A. Mr. Baudino has failed to recognize that "as-reported" betas reflect the utility's market-value based capital structure (as based upon the utility's market valuation), and therefore must be adjusted to reflect the higher level of financial risk inherent in a utility's book-value based regulatory capital structure, which is referenced for ratemaking purposes. As discussed at length in my direct

[58] Eugene F. Fama and Kenneth R. French, *The Capital Asset Pricing Model: Theory and Evidence,* The Journal of Economic Perspectives, Vol. 18, No. 3 (Summer, 2004) at 32-33, and 43-44.

testimony (pages 76-79), published betas should not be directly applied to the CAPM, unless the resulting cost of equity estimate will be applied to a market value based capital structure. This is because published betas are derived from the market price movements of individual stocks versus those of total market indices, and therefore reflect the level of financial risk associated with a market value based capital structure. In the utility regulatory setting, published betas must be adjusted to reflect the higher relative financial risk associated with a book value capital structure, which is typically utilized for rate-setting purposes. As has been demonstrated by the classic financial theorems of Modigliani and Miller, and later Hamada, a higher level of financial leverage is consistent with both a higher beta and a higher cost of equity.

With regard to the use of re-levered betas and the Hamada equation in utility regulatory proceedings, a well-regarded authoritative publication on utility cost of capital matters makes the following observation:

> Hamada adjustment procedures are widespread among finance practitioners when using the CAPM to estimate discount rates. They are also utilized by many regulatory bodies. The United Kingdom (UK) Competition Commission as well as other UK regulators and the Western Australian Economic Regulation Authority rely on an unlevering/relevering technique to determine the cost of equity capital for the entities they regulate.[59]

[59] B. Villadsen, M. Vilbert, D. Harris and L. Kolbe, *Risk and Return for Regulated Industries* (Academic Press-Elsevier Inc., 2017), at 152.

Therefore, Mr. Baudino's objection to the use of re-levered betas is simply misplaced.

<u>Risk Premium Method (RPM) Discussion</u>

Q. Mr. Baudino has not conducted a Risk Premium Method (RPM) analysis, but criticizes your RPM analysis because he believes the RPM approach is "imprecise", particularly since historical risk premiums can change substantially over time based on investor preferences and market conditions. How do respond?

A. I disagree. The fact that risk premiums change over time is not a legitimate basis for omitting an RPM analysis from a cost of capital evaluation. This is the case because a proper evaluation of current capital market conditions can provide a reasonable indication as to how the prevailing equity risk premium compares to the historical average equity risk premium. This is the approach that I took in completing my RPM analysis,[60] where I conducted both historical and prospective risk premium analyses, which is absolutely essential since each of these approaches brings different strengths and perspectives into the evaluation process. Therefore, Mr. Baudino's cost of capital evaluation would have been

[60] *<u>See</u>*, Direct Testimony of Vincent V. Rea, Case No. 2021-00183 (May 28, 2021), pp. 84-97.

better informed had he also evaluated the RPM, since in my opinion, any analytical model that augments the scope and scale of different investor perspectives into the cost of equity estimation process should be viewed as a welcome addition to the evaluation. Moreover, while Mr. Baudino argues that the RPM is "imprecise", the finance literature has made clear that the RPM is widely-used in utility regulatory proceedings and also by investment analysts and investors. For example, the finance literature states:

> Risk Premium methods that are in essence simplified precursors to the CAPM discussed in the next chapter have been employed for many years in regulatory proceedings.
>
> ….
>
> Risk premium analyses are widely used by analysts, investors, and expert witnesses and are widespread in investment community reports.[61]

Q. Does Mr. Baudino's assertion that the RPM is too "imprecise" to use in utility regulatory proceedings comport with the recent decisions of the FERC with respect to the RPM?

A. No. Contrary to Mr. Baudino's statements in this regard, it is particularly noteworthy that recently in its *Opinion 569-B,*[62] the FERC modified its previous approach of relying exclusively upon the constant growth DCF model (which is

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[61] Roger A. Morin, *New Regulatory Finance* (Public Utility Reports, Inc., 2006), at 107-108.

[62] *Association of Businesses Advocating Tariff Equity, et al., v. Midcontinent Independent System Operator, Inc., et al.,* 173 FERC ¶ 61,159, Opinion No. 569-B, at PP. 113-122 (November 19, 2020).

the approach that Mr. Baudino has taken in this proceeding) for cost of equity estimation purposes, and now also references both the CAPM and the RPM analytical models.[63] Thus, while Mr. Baudino maintains that the RPM is "imprecise" and even refers to the RPM method as a "blunt instrument", it would appear that the FERC would entirely disagree with this position (as I do), as the FERC made the following statements in *Opinion 569-B*:

> *The Risk Premium Model has a strong theoretical basis.* We continue to find that the defects of the Risk Premium model do not outweigh the benefits of model diversity and reduced volatility resulting from the averaging of more models (emphasis added).[64]

It is therefore clear that Mr. Baudino's failure to also include an RPM analysis in his cost of capital evaluation resulted in a further downward bias in his overall cost of equity recommendation of as much as 134 basis points.[65]

VII. Mr. Baudino Failed to Consider a Broader Group of Comparable-Risk Proxy Companies to Ensure the Statistical Reliability of His Analytical Results

[63] Id. at PP. 113-122.

[64] Id. at P. 113.

[65] As reflected in Table VVR-2 (p. 9) in Mr. Rea's direct testimony, Mr. Rea's RPM evaluation yielded an average RPM-based cost of estimate of 10.44 percent, and a median RPM-based cost of equity estimate of 10.33 percent. Therefore, Mr. Baudino's 9.10 percent overall cost of equity recommendation in this proceeding is 1.34 percent (134 basis points) lower than the average cost of estimate yielded by my RPM analysis.

Q. Mr. Baudino has based his cost of equity recommendations in this proceeding on the market data of just seven proxy group companies. Do you agree with this approach?

A. No. Considering that the various financial and/or market data inputs into the cost of equity models can be vulnerable to observation error, employing the largest comparable risk proxy group possible can significantly improve the statistical reliability of a study's analytical results. The use of larger proxy groups also ensures that a greater diversity of investor perspectives are incorporated into the cost of capital evaluation process. For the foregoing reasons, I elected to evaluate a total of 28 comparable-risk companies in my evaluation, while Mr. Baudino considered just seven companies. Furthermore, in my direct testimony (pp. 30-42), I discuss at length why complementary proxy groups like the Combination Utility Group and the Non-Regulated Group are: (1) entirely consistent with the comparable earnings standard established in *Hope* and *Bluefield*, and (2) entirely risk-comparable to the Gas LDC Group, thus providing an appropriate complementary basis for estimating Columbia's cost of equity.

Q. Mr. Baudino has rejected the use of your Combination Utility Group in this proceeding. How do you respond?

A. Mr. Baudino has rejected my Combination Utility Group on the basis that *"it could only be considered a very rough complement to the gas distribution proxy group that Mr.*

Rea and I both employed."[66] However, considering that the Combination Utility Group companies derive approximately 30 percent of their consolidated revenues from gas distribution operations, and that my comparative risk assessment demonstrated that the Combination Group is entirely risk comparable to the Gas LDC Group, I find Mr. Baudino's statements in this regard to be without merit. In point of fact, evaluating a group of combination utilities in the form of a complementary proxy group would have better informed Mr. Baudino's cost of capital evaluation, particularly in view of the ever-declining number of gas utility holding companies from which to select and evaluate.

Q. Mr. Baudino has also rejected the use of your Non-Regulated Group on the basis of claiming that non-utility companies face risks that regulated gas utilities do not face, and that as a consequence, non-utility companies will have higher required returns. How do you respond?

A. I disagree. With regard to Mr. Baudino's claim that non-utility (or non-regulated) firms have unique risks, and therefore have higher required returns as compared to regulated utilities, this claim is an unsubstantiated generalization on the part of Mr. Baudino, and assumes that all non-regulated firms are essentially a monolithic entity with identical risk profiles. Notably, Mr. Baudino has not provided any evidence in support of his assertion. The universe of non-rate-regulated

[66] Direct Testimony of Richard A. Baudino, Case No. 2021-00183 (September 8, 2021), at 40.

companies are *not* monolithic and their risk profiles can be very different from one another. Mr. Baudino makes the generalization that non-regulated firms are somehow by definition automatically riskier than regulated utilities, yet he did not conduct an objective comparative risk assessment to validate his assertions.

Q. Do the *Hope and Bluefield* decisions suggest that only regulated utilities should be evaluated for purposes of identifying other enterprises with "corresponding risks", as required by the comparable earnings standard?

No. The regulatory precedent established in *Hope* and *Bluefield* does not require that comparable companies be similar with respect to a firm's business operations, or extent to which they are regulated. Comparable companies need only be similar with respect to their corresponding risks, and I have demonstrated through a number of objective risk measures that the Non-Regulated Group is entirely risk-comparable to the Gas LDC Group.[67] This is further demonstrated by the fact that the Non-Regulated Group is fundamentally comprised of lower-risk consumer staple, transportation and telecommunications companies, including McCormick and Company, J.B. Hunt Transport Services, United Parcel Service, and AT&T.

[67] The summarized findings of my comparative risk assessment can be found in Table VVR-4 (page 42) of my direct testimony.

As further evidence that the Non-Regulated Group is in fact comparable in risk to the Gas LDC Group, it is instructive to evaluate the risk assessments of the major credit rating agencies. The credit rating agencies routinely conduct credit risk assessments across a myriad number of industries, and the end product of their risk assessments is a long-term credit rating that is directly comparable *across industries*, including the regulated utility industry. In other words, if the rating agencies assign the same long-term credit rating to both a regulated utility and a non-rate-regulated industrial manufacturing company, this indicates that the relative investment risk between the two companies is in fact, very similar.

Notably, the average long-term credit ratings (from both S&P and Moody's) assigned to the Non-Regulated Group are equivalent to those of the Gas LDC Group, thus suggesting a very similar investment risk profile for the Non-Regulated Group. This is illustrated in Table VVR-4 (p. 42) in my direct testimony, which I have presented again in Table VVR-7R below. As shown in Table VVR-7R, the average long-term credit rating assigned by S&P for the Non-Regulated Group is "A-", while the average S&P long-term rating for the Gas LDC Group is "A-", thus indicating an equivalent level of investment risk between the Non-Regulated Group and the Gas LDC Group. Table VVR-7R further demonstrates that the average long-term credit rating issued by Moody's for the Non-Regulated Group is "A3", while the average Moody's credit rating assigned to the Gas LDC

Group is "A3", also further indicating that the Non-Regulated Group and the Gas LDC Group have very similar investment risk profiles.

Table VVR-7R Comparative Risk Assessment of Proxy Groups			
Risk Measure	**Gas LDC Group**	**Comb. Utility Group**	**Non-Reg. Group**
Value Line Beta	0.89	0.86	0.87
Value Line Safety Rank	2	2	1
Value Line Fin. Strength Rating	A	A	A+
Value Line Stock Price Stability Rating	86	89	94
S&P Long-Term Debt Rating	A-	A-	A-
Moody's Long-Term Debt Rating	A3	Baa1	A3

Therefore, Mr. Baudino's conclusions regarding the Non-Regulated Group are inconsistent with the risk assessments of the major credit rating agencies, which indicate that the Non-Regulated Group has a very similar risk profile to that of the Gas LDC Group. These conclusions are further supported by my comparative risk assessment, where I also evaluated additional risk indicators that are specific to equity investments. Despite this objective evidence, Mr. Baudino has nevertheless rejected the Non-Regulated Group, and in so doing, have chosen to ignore the market-based information which actually defines the "competitive result" for comparable risk companies.

Q. Is a company's industry classification or line of business the sole or even predominate determinant of the company's investment risk profile?

A. No. A company's investment risk profile is a function of a variety of different risk elements which are generally categorized as either business risks or financial risks. Mr. Baudino ignores the fact that the comparative risk indicators that I have evaluated are objective in nature and already fully incorporate industry specific risk considerations into their comprehensive assessments. It must therefore be emphasized that the risk indicators I have evaluated already incorporate the totality of a company's identifiable risks, so regardless of whether a company happens to be more vulnerable to regulatory risks or to competitive-type risks, the measurement of *total investment risk* is consistent across all industries. Based upon the objectively determined investment risk indicators published by the rating agencies and by Value Line, my comparative risk assessment has clearly demonstrated that the Non-Regulated Group is entirely risk-comparable to the Gas LDC Group.

Q. In your opinion, by rejecting the Non-Regulated Group, are Mr. Baudino's conclusions inconsistent with the fair return standards established in *Hope and Bluefield*?

A. Yes. By rejecting the Non-Regulated Group, Mr. Baudino has effectively ignored the comparable earnings standard established in *Bluefield*, which indicated that firms involved in "other business undertakings" should be considered in applying the comparable earnings standard, while the *Hope* ruling indicated that "other enterprises" should be considered. The U.S. Supreme Court has determined that regulated utilities are entitled to earn a rate of return commensurate with other companies having comparable risks, irrespective of their business activities or the extent to which they are regulated. In *Bluefield*, the Court concluded:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.[68]

It is important to note that in *Bluefield*, the Court specifically stated that public utilities should be permitted to earn a return which is equal to the returns available on "*investments in other business undertakings,*" provided they have corresponding risks. By virtue of its reference to *"other business undertakings,"* the Court implicitly

[68] *Bluefield Water Works and Improvement Company v. Public Service Commission of the State of West Virginia*, 262 U.S. 679, 692 *(1923).*

endorsed the use of non-utility proxy groups in the determination of a fair rate of return for utilities. Moreover, in the *Hope* case, the Court concluded:

> By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.[69]

It is clear then that the Court's directive in *Hope* was that the comparable earnings standard should be applied to "other enterprises" and not just to other regulated utilities, since if the Court had intended otherwise, it could have just as easily referenced "other utilities" in its landmark decision. Therefore, based upon the Court's decisions in the *Hope and Bluefield* cases, the use of non-utility proxy companies in the determination of a utility's cost of equity is a sound practice, and is entirely consistent with the comparable earnings standard established in these cases. After all, utilities do not only compete with other utility companies for investor capital, they must also compete with an entire universe of risk-comparable companies, irrespective of industry classification and level of regulatory oversight.

Phillips has provided further guidance on this topic in *The Regulation of Public Utilities,* an authoritative guide on utility regulatory matters, where he states:

> The comparable earnings approach, further, requires that comparisons be made with both regulated and nonregulated alternatives, if the results are to have any validity, for two basic reasons. First, the alternatives confronting investors include both regulated and

[69] *Federal Power Commission et.al. v. Hope Natural Gas Company*, 320 U.S. 591, 603 *(1944).*

> nonregulated enterprises. There is active competition for investor capital; no company enjoys a monopoly of the capital markets. Investors will seek the opportunity that provides the greatest profit, commensurate with the risks involved. Second, returns of regulated firms must always be used with extreme caution, At best, they reflect what the informed judgments of regulatory commissions have permitted such utilities to earn and may not be indicative of what could have been earned in the competitive market.[70]

Therefore, consistent with both judicial precedent and the opportunity cost concept, in order to attract sufficient capital to support its public service obligations, Columbia must be afforded a reasonable opportunity to provide a return to its investors which is similar to the returns offered by non-rate-regulated companies of comparable risk.

VIII. Updates to Columbia's Capital Structure Cost Rates and Proposed Overall Fair Rate of Return

Q. Please discuss the updates that Columbia is proposing with respect to the Company's capital structure cost rates and overall fair rate of return in the instant proceeding.

A. As reflected in Attachment Rebuttal VVR-2R, Attachment Rebuttal VVR-5R and Attachment Rebuttal VVR-6R, the Company has updated the cost rates associated with both Columbia's long-term debt and short-term debt for actual data available through September 30, 2021. Specifically, as reflected in Attachment Rebuttal

[70] Charles F. Phillips, Jr., *The Regulation of Public Utilities* (Public Utility Reports, Inc., 1993), at 398.

VVR-6R, the Company has updated the cost rates associated with four long-term debt issuances, one of which occurred on June 30, 2021, another which occurred on September 30, 2021, while the other two debt issuances will occur in the first and second quarter of 2022, respectively. As reflected in Attachment Rebuttal VVR-6R, the actual cost rate for the June 30, 2021 debt issuance was 3.272 percent, which is lower than the originally projected debt cost rate of 3.90 percent as per the Company's original rate case filing. As also reflected in Attachment Rebuttal VVR-6R, the actual cost rate for the September 30, 2021 debt issuance was 3.2777 percent, which is also lower than Company's originally projected debt cost rate of 3.90 percent. In addition, the Company has also updated the projected cost rates for two future debt issuances that are planned for March 2022 and June 2022. As further reflected in Attachment Rebuttal VVR-6R, based upon the Company's interest rate forecast, it currently anticipates that Columbia will assign a debt cost rate of 3.30 percent to both the Company's March 2022 debt issuance and its June 2022 debt issuance.

Q. Based upon the updates that the Company has applied to the debt cost rates for Columbia's recent debt issuances and its future debt issuances, is the Company now proposing an updated embedded cost rate for long-term debt in this proceeding?

A. Yes. As reflected at the bottom of Attachment Rebuttal VVR-6R, after applying the aforementioned changes to the cost rates for the Company's recent debt issuances and future planned debt issuances, Columbia is now proposing an overall embedded cost of long-term debt of 4.37 percent,[71] which reflects a 19 basis point reduction from the Company's originally proposed cost rate of 4.56 percent. The Company's updated cost of long-term debt of 4.37 percent is consistent with the proposal that AG witness Baudino has made regarding the embedded cost of long-term debt in this proceeding.

Q. Do you agree with Mr. Baudino's proposal to reduce the Company's short-term debt cost rate from 1.40 percent to 1.175 percent?

A. No. Mr. Baudino's proposal is based entirely on the *current* LIBOR rate, which is not forward-looking, and which therefore currently understates the LIBOR rate that is anticipated during the Company's fully forecasted test period. This is particularly the case because the projections released by the Federal Reserve Board after its September 2021 FOMC meeting indicated that the Fed could begin the process of raising short-term interest rates (i.e., the Federal Funds target rate) by as early as 2022, which would be consistent with upward trending LIBOR rates.

The Company's historical practice with regard to projecting Columbia's short-term debt costs has been to reference the forward LIBOR curve data, which

[71] As based upon the 13-month average through December 31, 2022.

is accessible through Bloomberg L.P. The forward LIBOR curve currently reflects a gradual upward trend in the 1-month LIBOR rate over the next 5 quarters, through the fully forecasted test year, ending December 31, 2022. Based upon the expected gradual upward trend, the Company currently anticipates that Columbia's short-term debt cost rate will average 1.30 percent over the 13-month period ending December 31, 2022. Therefore, as reflected in Attachment Rebuttal VVR-2R, the Company has updated its proposed short-term debt cost rate to 1.30 percent, which reflects a 10 basis point reduction from the 1.40 percent cost rate proposed by the Company in its original filing.

Q. Based upon the updates that the Company has applied to the cost rates for both its long-term debt and short-term debt, is Columbia proposing a revised overall fair rate of return in this proceeding?

A. Yes. As reflected in Attachment Rebuttal VVR-2R, the Company is proposing an overall fair rate of return of 7.39 percent in this proceeding, which represents a 9 basis point reduction from the overall fair rate of return of 7.48 percent that Columbia originally proposed in this proceeding.

IX. <u>AG Witness Baudino's Proposal to Impute a Hypothetical Capital Structure is Unsupported and Would Penalize Columbia for Maintaining a Capital Structure that is Consistent with other Gas Utilities in Kentucky</u>

Q. Mr. Baudino has proposed that the Commission impute a hypothetical capital structure for Columbia of 51.75 percent common equity, 44.25 percent long-term debt, and 4.00 percent short-term debt, claiming that the Company has historically *"utilized a greater percentage of short-term debt in its capital structure than the 3.11% amount included by Mr. Rea in his ratemaking capital structure…"*[72] How do you respond?

A. Mr. Baudino asserts that the Company has historically maintained a greater percentage of short-term debt in its capital structure than the 3.11 percent amount included in Columbia's proposed capital structure, and references both Exhibit RAB-7 (p. 1) and the Company's response to data request AG 1-040, to support his position. Notably, in data request AG 1-040, part (g), the AG, on behalf of Mr. Baudino, requested the Company's historical capital structure balances for the years 2015-2020, which the Company provided in the form of KY PSC Case No. 2021-00183, AG 1-040, Attachment AL. While Mr. Baudino maintains that Columbia's 5-year average short-term debt ratio is 3.88 percent,[73] and that the Company has historically maintained a short-term debt ratio higher than 3.11 percent, this is not entirely correct. In fact, there have been years in the not-to-distant past, where the Company actually maintained short-term *investment*

[72] Direct Testimony of Richard A. Baudino, Case No. 2021-00183, at 31.
[73] *See*, Exhibit RAB-7 (p. 1).

balances throughout the year, with no short-term borrowing balances, which resulted in an average short-term debt ratio for the year of zero percent. Therefore, Mr. Baudino's arguments in this regard are not borne out by the historical record, and for this reason, his proposal to increase the Company's short-term debt ratio to 4.00 percent should be rejected.

Q. Mr. Baudino has proposed that the Commission impute a 51.75 percent equity capitalization ratio for Columbia, which essentially reduces the Company's proposed equity capitalization ratio of 52.64 percent by the same amount as Mr. Baudino's proposed increase to the Company's short-term debt ratio, which is 0.89 percent.[74] How do you respond?

A. I have already addressed the reasons why Mr. Baudino's proposal to increase the Company's short-term debt ratio for ratemaking purposes is not supported by the facts and should therefore be rejected. Since Mr. Baudino's proposed to reduce the Company's equity capitalization ratio is essentially in form an "offset" to his proposal to increase the Company's short-term debt ratio, his proposed equity capitalization ratio of 51.75 percent should also be rejected.

Q. Have you evaluated whether or not the Company's proposed equity capitalization ratio of 52.64 percent is consistent with other recently adopted

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[74] Calculated as 4.00 percent minus 3.11 percent, equals 0.89 percent. The 4.00 percent value reflects Mr. Baudino's proposed short-term debt weighting in this proceeding, while the 3.11 percent value reflects the Company's proposed short-term debt weighting in this proceeding.

equity capitalization ratios for gas utility operating companies in Kentucky?

A. Yes. As reflected in Table VVR-8R below, over the past four years (2018-2021), the average equity capitalization ratio adopted by the Commission for gas utilities in Kentucky has been 53.25 percent,[75] which is well-above the 52.64 percent equity capitalization level proposed by the Company in the instant proceeding. Moreover, the Company's proposed equity capitalization ratio is only slightly higher than the 52.42 percent equity capitalization layer adopted by the Commission in the Company's most recent AMRP proceedings.

Table VVR-8R
Equity Capitalization Ratios Recently Adopted by the Kentucky PSC for Gas Utilities vs. Columbia's Proposed Equity Capitalization Ratio

Company	Case No.	PSC Order Date	Equity Capital. Ratio Adopted
Atmos Energy Corp.	2018-00281	5/7/2019	58.06%
Atmos Energy Corp.	2017-00349	5/3/2018	52.57%
Columbia Gas of KY (AMRP)	2019-00383	12/20/2019	52.42%
Columbia Gas of KY (AMRP)	2018-00341	12/5/2018	52.42%
Duke Energy Kentucky	2018-00261	3/27/2019	50.76%
Average (2018-2021)	-	-	53.25%
CKY Proposed Equity Ratio	-	-	52.64%

[75] Based upon completed gas utility rate proceedings during 2018-2021, where the equity capitalization ratio was explicitly identified and adopted in the Commission's final order. The data does not include "implied" equity capitalization ratios from black box settlements.

Accordingly, Table VVR-8R above provides further evidence that the Company's proposed equity capitalization ratio of 52.64 percent is entirely consistent with the equity capitalization ratios adopted for other gas utility operating companies in Kentucky.

X. AG Witness Baudino's Proposal to Reduce the Authorized ROE for the Company's SMRP Rider is Inconsistent with the Manner in which the Cost of Equity is Determined in Utility Regulatory Proceedings

Q. Mr. Baudino has proposed a reduction to the authorized ROE for the Company's SMRP rider by as much as 10-20 basis points below the Company's overall authorized ROE in the instant proceeding. How do you respond?

A. I disagree. Mr. Baudino's proposal to make a downward adjustment to the authorized ROE for the Company's SMRP rider entirely ignores the manner in which the cost of equity is determined in utility regulatory proceedings. While Mr. Baudino's proposal would appear to suggest that authorized ROE decisions in utility rate proceedings are determined in a vacuum, or in total isolation, the fact of the matter is that the cost of capital witnesses offering testimony in utility rate proceedings rely almost entirely on *proxy group analyses* in making their cost of equity recommendations. As discussed at length in my direct testimony (pp. 42-46), the gas utility operating companies comprising the Gas LDC Group already benefit from many of the same types of infrastructure cost recovery mechanisms that Columbia benefits from with respect to the SMRP rider. For this reason, the market data of these proxy companies, *including their stock prices and embedded cost of equity,* will already reflect any risk reducing effects of these cost recovery mechanisms, to the extent such risk reduction actually occurs. Accordingly, the authorized ROE established in utility base rate proceedings will already reflect any such risk reducing effects of infrastructure cost recovery mechanisms such as the SMRP rider, since many of these same types of cost recovery mechanisms are already reflected in the stock price and embedded cost of equity of the proxy group companies. Therefore, if Mr. Baudino's proposal to reduce Columbia's authorized ROE for its SMRP rider by as much as 10-20 basis points were adopted by the Commission, this would essentially constitute a double-counting of any risk reduction effects, since any such effects would already be reflected in the Company's cost of equity and authorized ROE.

Q. Can you offer any additional evidence that the authorized ROEs decided in utility rate proceedings already incorporate any potential risk-reducing effects of infrastructure cost recovery mechanisms such as the SMRP rider?

A. Yes. As discussed in my direct testimony, I conducted a comprehensive evaluation to determine the extent to which the proxy group companies I referenced utilize infrastructure cost recovery mechanisms that are similar in form to Columbia's SMRP rider. In conducting my evaluation, I employed the same approach that investors typically employ in conducting their relative risk assessments among various investment alternatives. That is, I reviewed each company's SEC public filings (i.e. 10-Ks and 10-Qs) and investor conference presentations. This is an important observation since investors will generally form their risk perceptions with respect to the impacts of infrastructure cost recovery mechanisms largely on the basis of the information contained within a company's public filings and/or other publicly-disseminated information.

As presented in Attachment Rebuttal VVR-4 to my direct testimony, I determined that three-quarters of the utility proxy group companies (12 out of 16) employ infrastructure cost recovery mechanisms that are comparable to Columbia's SMRP program. More specifically, within the Gas LDC Group that I evaluated in my direct testimony, six of the seven proxy group companies employ infrastructure cost recovery mechanisms that are similar in form to Columbia's SMRP program. Therefore, the market-based data of the Gas LDC Group companies would already capture any risk-reducing effects resulting from the reduced regulatory lag associated with such cost recovery mechanisms. For the above stated reasons, it would be inappropriate to apply a downward adjustment to the authorized return for Columbia's SMRP rider, since any such adjustment would be redundant to the effects that would already be incorporated into the Company's overall authorized ROE, as determined in the instant proceeding.

Q. Can you offer any additional explanations as to why it would be inappropriate to apply a downward adjustment to the authorized ROE for Columbia's SMRP rider?

A. Yes. With regard to the matter of assured cost recovery, the risks associated with the SMRP rider are essentially no different than the overall risks associated with the distribution utility and its traditional investments in rate base, as the Company's SMRP investments must also pass prudency reviews by the Commission, and the revenue requirement associated with the SMRP rider will ultimately be rolled-into base rates. This is particularly the case because Columbia's use of 13-month average balances for the fully forecasted test period in the instant proceeding offers many of the same benefits as the SMRP rider with regard to the reduction of regulatory lag. This is further borne out by the fact, that, as noted in the direct testimony of Company witness Cooper, since Columbia is utilizing a forecasted test year per KRS 278.192, there will likely not be an SMRP Rider filing for October 2021 or a March 2023 Balancing Adjustment filing. Accordingly, there is no basis for the suggestion that Columbia's authorized ROE for its SMRP rider should be lower than the overall authorized ROE for the Company's distribution operations. This is further demonstrated by the fact, that, as can be seen in Exhibit VVR-4 to my direct testimony, the overriding majority of the gas proxy group companies that I evaluated in deriving my ultimate ROE recommendations already employ infrastructure cost recovery mechanisms that are similar in form to Columbia's SMRP program. For this reason, any risk-reducing effects of infrastructure cost recovery mechanisms (such as the SMRP rider), if actually present, would already be reflected in the market data of the proxy group companies, and would therefore already be reflected in my cost of equity estimates and recommendations. Accordingly, if the Commission were to reduce Columbia's authorized ROE for the SMRP rider on the basis of an alleged reduction in investment risk, this downward adjustment would in fact be double-counting any risk-reducing effects that are already reflected in Columbia's overall authorized ROE.

Q. Does this conclude your prepared Rebuttal testimony?

A. Yes, it does.

ATTACHMENTS ARE EXCEL SPREADSHEETS AND UPLOADED SEPARATELY

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)))))))))	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF
CHUN-YI LAI
ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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October 22, 2021

I. <u>INTRODUCTION</u>

Q. Please state your name and business address.

A. My name is Chun-Yi Lai. My business address is 290 West Nationwide Blvd., Columbus, Ohio 43215.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. Subsequent to the filing of my Prepared Direct Testimony, Mr. Dittemore filed Direct Testimony on behalf of the Attorney General related to the revenue requirement for Columbia Gas of Kentucky ("Columbia"). This testimony will address the following topics: (1) the O&M indexing adjustment and 2) the alternative labor adjustment proposed by Mr. Dittemore.

II. AG Testimony – O&M Indexing Adjustment

Q. Please explain the O&M indexing adjustment proposed by Mr. Dittemore.

A. Mr. Dittemore argues that Columbia's O&M expenses are excessive and therefore, proposes an indexing adjustment of $4,058,340, based on a three-year average of 2016 through 2018 adjusted for inflation, as a reduction to O&M expense.

Q. Do you agree with Mr. Dittemore's methodology?

A. No, I do not agree with the methodology used by Mr. Dittemore in two parts. First, Columbia filed a rate case in 2016 with an approved revenue requirement increase of $13.086 million effective January 2017. Calendar year 2016 is not relevant in this proceeding as it does not reflect the increase in revenue requirement approved in the last rate case. Therefore, a three-year average of 2016 through 2018 would not be appropriate. Second, Mr. Dittemore does not appropriately account for the fact that certain elements in Columbia's direct O&M expenses are driven by Columbia's work plan or industry events that are outside of Columbia's control.

Q. Please further explain.

A. As mentioned above, there are certain cost categories that are driven by Columbia's work plan or industry events outside of Columbia's control. The key drivers in the increase in Columbia's direct O&M expenses since 2017 are labor, medical insurance, corporate insurance and outside services. This was also discussed in my direct testimony[1].

[1] Company Exhibit No. 26 for Witness Lai's testimony, pages 13 through 15.

Category	Actual 2017	Actual 2018	Actual 2019	Actual 2020	Unadjusted Budget 2021 Rate Case 2022
Labor	$9.4	$10.1	$11.8	$11.5	$13.0
Medical Insurance	$1.0	$1.1	$1.2	$1.0	$1.9
Corporate Insurance	$0.7	$0.8	$1.3	$1.8	$2.3
Outside Services	$5.6	$5.7	$6.9	$6.8	$7.8

1. **Labor** costs reflect the salaries and wages for Columbia employees that report and charge their time directly to Columbia. The increase is driven by Columbia's increase in headcounts over the period to support its ongoing operational activities to provide safe, reliable service to customers. The headcount level increased due to the hiring of additional employees in Construction Services to support Columbia's capital program, and System Operations to comply with additional operational requirements, and Field Operations. While employees in Construction Services charge most of their time to capital, any training associated with onboarding and ongoing education is charged to O&M. The increase also includes the transfer of NiSource Corporate Service employees to Columbia in Large Customer Relations and Safety Compliance & Risk Management.

2. **Medical Insurance** costs in the Forecasted Test Period are based on the information provided by NiSource's independent actuary, AON. The underlying assumptions for the current AON study were based upon the 2018 and 2019 experience, coupled with the headcount growth from 2019 to 2020 and annual medical trends.
3. **Corporate Insurance** costs across the industry have increased significantly over the past few years. Beginning in late 2018 and through 2019 the insurance market has seen significant rate increases. This is due to several factors, including mergers and acquisitions amongst insurers, higher frequency and severity of events, including natural catastrophes, and high jury awards well beyond historical averages that have resulted in underwriting losses. Many insurers who have historically underwritten in the utility space are either significantly reducing available capacity or withdrawing from the market entirely. Due to the high risk exposure of the utility industry, there are very few new carriers willing to write U.S. utility insurance and, those that are, have very limited capacity. The decrease in available capacity has significantly impacted insurance premiums.

4. **Outside Services** costs reflect the payments made to consultants and contractors for various services. One service performed that has increased over the period is locates and turnbacks. The number of ticket volumes with locating has increased over the last years. This has a substantial impact to Columbia's O&M over the period due to the resource requirements to meet locate timing requirements.

Q. Did Mr. Dittemore propose an alternative adjustment if the Commission declines to accept his O&M indexing adjustment?

A. Yes, Mr. Dittemore is proposing an alternative adjustment of labor reduction for Columbia direct and NCSC if the Commission does not accept his O&M indexing adjustment.

Q. Do you agree with Mr. Dittemore's labor adjustment for Columbia direct? Please explain.

A. No, I do not. Columbia indicated plans to fill eight positions which were existing vacancies, with seven of those positions residing in gas operations. The number of vacancies in gas operations has increased from seven to thirteen positions which were planned to be filled by September 12, 2021.[2] I would like to specify that the additional six vacancies were

[2] PSC 2021-00183 AG DR Set 2 No. 67.

not newly created positions; but rather, positions vacated by employee departures or transfers to NCSC.

Positions supporting ongoing operations are most often filled from within Columbia's existing employee ranks, and bargaining unit agreement provisions can affect the bidding and selection process so that vacancies are held open for certain periods while applicants temporarily occupy a position before making a final decision. Once the new positions are filled by existing employees, the employees' former positions are then filled by new hires.

Q. Please explain Columbia's hiring process to fill gas operations positions.

A. For hiring of gas operations employees, the Company utilizes a "wave hiring" process. Wave hiring is built upon creating "pools" of applicants, and then offering a job to an applicant in the "pool".

Q. Were the thirteen vacancies filled during the most recent wave hire?

A. Yes, the thirteen vacancies were filled with new hires in the most recent wave hiring process.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF
SUSAN TAYLOR
ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Susan Taylor. My business address is 290 W Nationwide Blvd, Columbus, Ohio 43215.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to respond to adjustments proposed by Witness Dittemore related to NCSC forecasted test year.

Q. Do you agree with the approach by Witness Dittemore using an average of 2016 – 2018 as a starting point to apply a 2017 inflation factor?

A. No. As stated previously in Columbia's responses to the Attorney General's First Request for Information, No. 50 and Second Request No. 27, I do not agree with using 2016 nor 2018 as part of the starting point to apply a 5 year inflation factor adjustment. As stated in Columbia's Response to the Attorney General's First Request for Information, No. 50, the engagement of NCSC employees in the Merrimack Valley event's recovery efforts in 2018 contributed largely to lower billings to Columbia Gas of Kentucky. Thus 2018 NCSC billings are vastly understated compared to other periods and not representative of base year and forecasted period as demonstrated on Witness Dittemore's DND-2.9 schedule. Further, the inflation methodology for NCSC O&M costs in this base case is consistent with that used by the Office of the Attorney General in its rebuttal testimony Case No. 2013-00167, p.33 and Case No. 2016-00162, p.21. In that rebuttal testimony, inflation is calculated starting with the pro-forma adjusted test year from the previous base case. I employed a consistent inflation methodology, starting with a pro-forma NCSC base test period of 2017 from the 2016-00162 case, to illustrate the costs are just and reasonable. I did not use merit in the calculation for labor increases which is approximately 40% of NCSC costs; otherwise the cumulative growth amount would have been higher. Witness Dittemore is now deploying a new methodology not consistent with the last base rate case to inflate his adjustment, and uses a 2017 inflation factor even though he includes 2016 in his starting point average. Even if using 2016 as the starting point would be appropriate, doing so would yield a 12% inflation factor, and not the 9.94% I used with a starting point of 2017.

Table - Rebuttal ST-1	
Description	Factor **%**
Calculation of Inflation Rate	
GDPIPD Index - Average 2016	1.0572
GDPIPD Index - Average FTY 2022	1.1841

Inflation Factor % (Line 3 divided by Line 2 Less 100%)	**12.00%**

Gross Domestic Product Implicit Price Deflator (GDPIPD)
Source for GDPIPD Index is IHS Global Insight
As of March 2021

Q. Do you agree with the statement by Witness Dittemore that he believes it is not coincidental that the pro-forma adjusted 2022 forecasted test year is in alignment with inflation from pro-forma adjusted 2017 used in the last base case 2016-00162?

As noted in my Direct Testimony, the NCSC budget process is grounded in a trailing 12-month historical spend, removing/adding one-time items, and then applying merit increases and inflation adjusted for each year thereafter. Therefore, it would be reasonable to assume that after removing one-time items, inflation from 2017 to 2022, is in line with a compound annual growth rate. Further stated, adjustments were not merely quantified in ST-3 to equal the inflation-adjusted values as implied.

Q. Have you used this method of walking forward pro-forma adjusted from previous test year to current test year before?

A. Yes. As noted previously in Columbia's Response to the Attorney General's Second Request for Information, No. 78, the approach to take pro-forma adjusted costs from the previous base rate case test year and apply inflation factor to demonstrate reasonableness has been similar in other base rate filings in other jurisdictions. And it should be noted, the adjustments made are very similar: incremental initiative savings not identified during the budget process, Corporate Incentive Plan and pension adjustments in line with historical averages, and removal of one-time costs. This is not a new methodology and has been used to support operation & maintenance costs in other jurisdictions.

Q. Do you agree with the alternate operating income adjustment on p. 29-30 of Witness Dittemore rebuttal testimony related to his labor vacancy adjustment?

A. I do not agree with Witness Dittemore's alternate adjustment. As stated in KY PSC Case No. 2021-00183, AG 1-142 Attachment A, dollar adjustments are made for planned vacancies as part of labor saving initiatives. During the budget process, the budget system integrates with the Human Resource ("HR") system; and thus, headcount matches the source system file. Witness Dittemore is correct in his assumption that based on CONFIDENTIAL KY PSC Case No. 2021-00183, AG 2-48, Attachment A, there should be forecasted savings as part of the NiSource Next initiative. There is indeed labor savings built into the forecasted test year for labor savings in the amount of $2,817,118 as shown in Table – Rebuttal ST-2 below for direct and NCS labor savings. The labor savings adjustment included in the forecasted test year of $2,817,118 is well in excess of

Witness Dittemore's proposed labor vacancy adjustment of $1,399,663 and revenue requirement adjustment of $1,408,509.

Table - Rebuttal ST-2	
Labor Savings Summary	**Forecasted Test Year**
CKY Direct - VSP	$ -
CKY Direct - Other Labor	$ 701,449
Total CKY Direct Labor Savings Included in Forecasted Test Year	$ 701,449
NCS Allocated to CKY- VSP	$ 634,614
NSC Allocated to CKY - Other Labor	$ 815,038
Total NCS Allocated	$ 1,449,652
Additional Labor Adj per Attachment ST-3	$ 666,016
Total NCS Labor Savings Included in Forecasted Test Year	$ 2,115,668
Total Labor Savings Included in Forecasted Test Year	**$ 2,817,118**

Q. Are there any other labor adjustments not reflected by Witness Dittemore in his comparisons?

A. Yes, as part of the Safety Plan initiative, employees have been recently hired or will be starting by end of 2021, and 17 of those employees are billing hours to Columbia for a labor impact of $380,710.

Q. In your opinion, are the forecasted NCSC test year costs reasonable based on base year costs and savings initiatives in place?

A. Yes, the forecasted test year is reasonable given the cost saving measures in place, balanced with the Safety Plan initiative. Per Attachment Rebuttal ST-1, actual base year costs, annualized for Safety Plan labor is in line with the forecasted test year.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

ATTACHMENTS ARE EXCEL SPREADSHEETS AND UPLOADED SEPARATELY

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF SUZANNE SURFACE ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Suzanne K. Surface. My business address is 290 W Nationwide Blvd, Columbus, Ohio 43215.

Q. Did you provide Direct Testimony in this proceeding?

A. No, I did not.

Q: What is your current position and what are your responsibilities?

A. I currently serve as the Senior Vice President of NiSource's Enterprise Transformation Management Office. In this role, I develop and execute enterprise-wide initiatives focused on improving business performance.

Q: What is your educational background?

A. I received a bachelor's degree in economics from Wittenberg University and a master's in business administration from Capital University.

Q: What is your employment history?

A. I have spent over thirty years in various roles working for NiSource and Columbia Gas companies in various capacities. Over the course of my NiSource career, I served at various times as the Vice President of Regulatory Strategy, Vice President of Audit, and held various executive roles leading NiSource's efforts for business transformation and continuous improvement. I assumed my current role in June 2020.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. I am responding to the portion of the direct testimony of Attorney General witness David Dittemore relative to the NiSource Corporate Services Company ("NCSC") allocation to Columbia Gas of Kentucky ("Columbia" or the "Company"). Specifically, I will explain why Mr. Dittemore's recommended $4,058,340 adjustment should be rejected, as he has simply applied an indexing adjustment to Columbia's total operations and maintenance expense for the test period, both for direct and for NCSC costs. This adjustment disregards the evidence provided in both Columbia witness Lai and Taylor's testimony supporting direct and NCSC costs, it does not take into account incremental services and safety initiatives supported by Columbia witnesses Gore and Roy, it disregards the savings from the NiSource Next transformational effort, and it is not based on evidence of imprudent or unreasonable costs. Therefore, the adjustment of $4,058,340 proposed by Mr. Dittemore is without merit.

Q. What is the expected level of NCSC costs to be billed to Columbia during the Forecasted Test Period?

A. As detailed in Columbia witness Taylor's testimony, the level of NCSC O&M costs in the Forecasted Test Period to Columbia are $19,320,924, inclusive of adjustments. The noted adjustments include those made for identified efficiencies associated with the NiSource Next initiative.

Q. What is NiSource Next?

A. NiSource Next is a comprehensive, multi-year program designed to deliver long-term, sustainable capability enhancements and cost efficiency improvements that reflect NiSource's commitment to safety, risk mitigation, and customer service. NiSource Next is structured to leverage our scale, use technology, define clear roles and accountability with our leaders and employees, and standardize our processes, all in an effort to create an organization focused on operational rigor and continuous improvement.

Q. Please elaborate.

A. NiSource Next is an enterprise-wide initiative focused on leveraging our company's scale, driving efficiencies, improving our cost structure and capabilities, and enhancing our ongoing commitment to safety. The NiSource Next initiative will focus on the following outcomes:

- An unwavering commitment to safety leadership through our ongoing SMS journey.
- Fostering innovation within teams to rethink outdated processes and drive efficiencies.

- Leveraging technology to make meaningful connections to customers and enhance service levels.
- Streamlining cost structures to drive efficiencies across the organization.
- Standardizing operations management supported by modern technology for improved speed and reliability.

This program of work is already underway and has deepened our focus on driving O&M cost savings and transforming our operations to ensure we are well-positioned to deliver on our commitments to operational excellence and customer value. Through the NiSource Next transformation effort, the company has sought to offset the costs of investing in additional measures to enhance safety and service in Kentucky.

Q. Has Columbia reflected the impact of NiSource Next in this case?

A. Yes. As detailed in the Direct Testimony of Columbia witness Susan Taylor, Columbia has incorporated $3,758,276 of identified savings into forecast periods in this case.

Q. Did Mr. Dittemore address these savings in his testimony?

A. He does. Mr. Dittemore agrees that the Company has engaged in efforts to reduce costs, while improving safety leadership and customer service through NiSource Next. In addition, he acknowledges that the Company has included the nearly $4 million in efficiencies. However, Mr. Dittemore attempts to disregard the effect of the savings, but as addressed below, his arguments should be rejected.

Q. Before you address Mr. Dittemore's specific arguments, would you like to make any initial observations?

A. Yes, I would. Below I explain and respond to the arguments made by Mr. Dittemore in his direct testimony. However, initially I want point out what is missing from Mr. Dittemore's testimony – specific challenges to O&M costs in the case. Specifically, Mr. Dittemore fails to assert or support that any costs included in the Company's O&M costs for this case are unreasonable or imprudent. Instead, he seeks to base a significant adjustment on arguments that are both inappropriate and unsupported.

Q. Can you describe the cost savings that are reducing Columbia's claim in this case?

A. Columbia recognizes there were a number of addressable factors that contributed to higher operation and maintenance expenses relative to its peers in the benchmarking study referenced by Mr. Dittemore. In fact, this benchmarking study was one of several data points used by the company to undergo the significant transformational initiatives addressed by NiSource Next, reducing

Columbia's O&M claim in the case by approximately $3.8 million. NiSource Next identified four major workstreams, each with multiple initiatives designed to drive effectiveness and efficiency. These are listed below, along with a description of the initiatives that were identified to address the Company's cost structure, and the associated savings reflected in Columbia's budget in 2022.

NiNext Transformation Initiative	**2022 Budgeted Savings - Columbia Gas of Kentucky**
Optimize Organization & Talent – This workstream included a voluntary separation program, enforces managerial spans and layers across the organization, simplifies the organizational structure across operating segments, and reduces administrative costs.	[redacted]
Connected Customer Experience – Initiatives creating digital service solutions for customers to enhance convenience and accessibility while reducing call volumes	[redacted]
Operational Work Standardization – Key programs focus on updated Capital Policy and changing our work management system to capture supporting data, modifying the way NiSource performs maintenance operations, and enabling strategies to allow front line leaders to work more effectively.	[redacted]
Evolution of Business Services – Contracted with a third party provider of select finance, supply chain, HR and tax services to drive efficiencies	[redacted]
IT Functional Initiatives – Initiatives to improve cost structures from managed service providers, software and hardware, and moving to a more variable staffing model	[redacted]
Other Functional Initiatives – Initiatives across corporate services (HR, Communications, Legal and Supply Chain)	[redacted]

[1] The contract with Tata Consulting Services (TCS) was signed after the 2021 budget was finalized. The Columbia allocated portion of the 2022 savings was reflected as an efficiency adjustment to reduce CKY's cost of service; see Ms. Taylor's direct testimony.

designed to improve cost structures by managing demand, enhancing technology, and standardizing internal practices	

Q. Does Mr. Dittemore calculate the savings necessary for Columbia to attain an improvement in its cost structure from 4th to 3rd quartile?

A. Yes, Mr. Dittemore estimates that Columbia should achieve a reduction in O&M costs by \$2.7 M and \$9.0 M for Columbia to reach the 3rd quartile and the 2nd quartile. So, taking into account the transformational efficiencies of \$3.8 M, Columbia would no longer be in the 4th quartile. Instead, we believe the Company would now place in the 3rd to 2nd quartile range of its peers.

Q. Are there additional reasons that PSC should reject Mr. Dittemore's conclusion that, even after reflecting transformation savings, Columbia Gas of Kentucky's O&M budget "has not reflected the magnitude of cost savings necessary to bring its costs in line with its peer utilities"?

A. Yes. In Mr. Dittemore's testimony, he compares the 2022 forecast period to 2019 and 2020 actual results. However, in his analysis, he fails to take into account the key variances included in the 2022 budget forecast (as compared to 2019 and 2020 actual results) identified by Columbia Gas of Kentucky witness Chun-Yi Lai in her rebuttal testimony, and the costs of specific safety and customer programs introduced by witnesses Roy and Gore.

Q. What are the key variances?

A. Ms. Lai has identified four cost categories of note: labor, medical insurance, corporate insurance, and outside services that contribute to an increase in budgeted O&M expense in the forecasted year. The total increase in expense for these four costs from twelve months actual ended 2020 to the forecasted period 2022 is $3,806,615. Mr. Gore identified adjustments for incremental services and benefits to the forecasted period of $1,877,800, consisting of training, customer payments, a Picarro leak detection pilot, and an initiative to address cross bores. These are explained further in Mr. Gore and Mr. Roy's direct testimony.

Q. How do these variances and incremental initiatives impact Mr. Dittemore's analysis?

A. Mr. Dittemore seeks to discredit the company's transformation efforts by arguing that even with the transformational savings, costs in 2022 are higher than in 2020 by $5,251,621 ($54,122,430 - $48,870,809 - see Mr. Dittemore's analysis in Table 3 on page 21 of his testimony, in the line titled "Normalized Annual O&M Results"). However, Mr. Dittemore has failed to recognize the $3.9 M in budget increases supported by Ms. Lai, and the $1.9 M in incremental services supported by Mr. Gore. For the period from 2020 to 2022, these differences total $5.8 M, which more than fully explain the increase in O&M expense of $5.3 M. In fact, absent these key variances and incremental safety and customer programs, costs would have decreased from 2020 to 2022, thus proving the inclusion and favorable impact of the transformational savings initiatives.

Q. Did Mr. Dittemore provide any evidence that the key variances supported in Ms. Lai's testimony are imprudent or unreasonable?

A. No, he did not.

Q. Did Mr. Dittemore discuss the incremental services and programs supported by Mr. Gore and Mr. Roy?

A. Yes, Mr. Dittemore explicitly supported the inclusion of the Picarro leak detection pilot.

Q. Did Mr. Dittemore have any other proposals related to Columbia's O&M expenses?

A. Yes. Mr. Dittemore also proposes an "indexing adjustment", supported in his Schedules 2.7.

Q. Do you have any comments on this proposal?

A. Yes, I do. At the outset, I note that Schedule 2.7 has multiple inaccuracies, and should not be relied on for any conclusions. First, Mr. Dittemore "normalizes" 2019 and 2020 for Incentive Compensation by removing it from the O&M results. However, incentive compensation is added to 2022 O&M expense rather than removed. As a result, rather than normalizing O&M, he has doubled the incentive compensation variance for 2022 resulting in an incorrect comparison.

Further, Mr. Dittemore compares historic costs in 2019 and 2020 to 2022 costs which "add back purported efficiency savings already in the budget."[2] Compounding his error from above, the result is to compare historic costs to 2022 costs that are not requested or represented in this case. Mr. Dittemore's attempt to base a cost comparison on costs that might have been, but that are absent in the Company's case, does not support his requested adjustment. While this cost comparison is ultimately not used to calculate his indexing adjustment, these inaccuracies in assessing Columbia's "overall percentage increase Forecast period vs. 2019/2020" should be noted.

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[22] It is interesting that Mr. Dittemore acknowledges the nearly $3.8 million in savings in one section of his testimony, and then characterizes these savings as "purported" in another part of his argument.

Q. Are you able to quantify the impact of Mr. Dittemore's errors?

A. Yes. The net impact of these two errors is to inflate the Nominal amount of increase vs. 2020 shown in Dittemore Schedule DND-2.7, Line 11 by $5,799,264, roughly doubling the true increase from 2020 to 2022.

Q. Do you have any final comments on Mr. Dittemore's proposed O&M adjustment?

A. I do. Again, his testimony contains no challenges to NCSC costs or other O&M costs, as he has not identified any costs that are unreasonable or imprudent. Further, he seeks to rely on a peer benchmarking study to support his claims, but does so while ignoring the Company's efforts to reduce O&M costs. Mr. Dittemore also fails to recognize the key variances that are relevant across industry peers and incremental programs that bring additional value to customers. Finally, Mr. Dittemore's testimony contains inaccuracies that should not be relied upon by the Commission.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF
JEFFERY GORE
ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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Attorneys for Applicant
COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Jeffery T. Gore and my business address is 290 West Nationwide Blvd., Columbus, Ohio 43215.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of this testimony is to provide a summary of changes to the revenue requirement based on new information available.

Q. What is the revised revenue requirement request?

A. The new revenue requirement request is for $25,615,135. This is a reduction of $1,079,851 from the original request of $26,694,986.

Q. Have you provided a summary that details the items causing the decline in the revenue requirement request?

A. Yes. Refer to Attachment Rebuttal JTG-1 for detailed analysis of these items. Page 1 provides the 3 categories of adjustments including changes in expenses (Line 10), rate base adjustments (Line 12) and changes to the requested Capital Structure (Line 15).

Q. Can you provide some explanation regarding the various expense adjustments?

A. Yes. Continuing on Rebuttal Attachment JTG-1, Page 1, the expense adjustments include:

- Line 3 – As noted in response to Staff Set 3 No. 40, the original filing depreciation rates were not aligned with the new depreciation study as prepared by Witness Spanos. This adjustment reflects the reduced depreciation expense for the forecasted test period after updating the depreciation rates.
- Line 5 – Per the Company's September 1, 2021 filing withdrawing its proposed Certificate of Public Convenience and Necessity, the 2022 capital expenditure for safety training facilities was removed from this case. The expense impacts reflect removal of the operating and maintenance costs in 2022 for the facility and removal of depreciation expense related to the capital expenditure no longer included in the forecasted test period.
- Line 8 – As noted in response to AG Set 2 No. 75, the company did not remove $90,000 for Line DE inspections that will not be needed due to the capital work being completed by end of 2022. This adjustment removes the inspection costs from the test year.

Q. Can you explain the rate base adjustments made on Rebuttal Attachment JTG-1, Page 1, Line 12?

A. Yes. Per Attachment Rebuttal JTG-1, Page 2, the rate base adjustments are:

- Line 4 – The lower depreciation expense as noted in the expense adjustments causes a lower accumulated depreciation balance. The adjustment increases rate base to reflect this change.
- Line 5 – the removal of the safety training facilities investment reduces Plant in Service balance included in rate base. Partially offsetting this rate base decline is the impact of removing the applicable depreciation expense associated with this investment.
- Line 8 - As noted in response to Staff Set 3 No. 40, the ADIT balances included in the original filing required adjusting due to a formula issue.
- Line 9 – In addition to the formula change, ADIT balances were also adjusted to reflect the changes in book depreciation included in the various expense adjustments.

Q. Can you provide some explanations regarding the Capital Structure adjustment on Rebuttal Attachment JTG-1, Page 1, Line 15?

A. Yes. Witness Rea's rebuttal testimony supports changes to the Long-term and Short-term interest rates used in the forecasted test year capital structure. Refer to Attachment Rebuttal JTG-1, Page 3 for the calculated impact to the revenue requirement for this change. As the previously described rate base change impacts to the revenue requirement were made based on the originally filed for capital structure, the impact of the capital structure changes are only applied to the revised rate base as calculated on Attachment Rebuttal JTG-1, Page 2.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

ATTACHMENTS ARE EXCEL SPREADSHEETS AND UPLOADED SEPARATELY

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF JENNIFER HARDING ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

TABLE OF CONTENTS

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Jennifer Harding. My business address is 290 W. Nationwide Blvd, Columbus, Ohio 43215.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. I will respond to the testimony served in this proceeding by the Office of the Attorney General ("OAG") Witness Dittemore.

Q. What issues will you be addressing in your rebuttal testimony?

A. I will address the adjustments to the accumulated deferred income tax (ADIT) balance in rate base for the correction of the book/tax difference related to plant in service and elimination for the net operating loss (NOL) carryforward. Additionally, I will be addressing the Company's proposed the Tax Act Adjustment Factor (TAAF).

II. <u>CORRECTED ACCUMULATED DEFERRED INCOME TAX (ADIT)</u>

Q. Please summarize OAG Witness Dittemore adjustment to the ADIT balance in rate base for the correction of the book/tax difference related to plant in service.

A. The Company's initial forecast for accelerated depreciation for both state and federal ADIT remained constant throughout the forecast period. This balance should change monthly as the difference between accelerated tax depreciation and book depreciation is calculated on plant in service balances. The Company indicated an error occurred in the presentation of its ADIT forecast in response to AG discovery request 1-101 of approximately $2.1 million. OAG Witness Dittemore reflected this adjustment in Schedule DND-2.12. The revenue requirement impact of this adjustment based upon the Company's requested rate of return is $196,938.

Q. Do you agree with OAG Witness Dittemore adjustment to the ADIT balance in rate base for the correction of the book/tax difference related to plant in service?

A. Yes, as indicated in OAG Witness Dittemore's direct testimony on page 31, the Company provided an updated schedule in response to the AG discovery request 1-101 for the correction of a formula error causing in an increase in the 13-month ADIT of $2,099,769, resulting in a decrease of the revenue requirement of $196,938. The Company has adjusted for a decrease in book depreciation as identified in Columbia Witness Gore's rebuttal testimony on page 4 and the corresponding impact to the book/tax difference for plant in service was updated in the Company's revenue requirement on WP B-6, WP E-1.1. The decrease in book depreciation caused an increase of the 13-month ADIT to $2,136,606, resulting in a decrease of the revenue requirement of $200,439.

III. <u>ELIMINATION OF FEDERAL NOLC FROM RATE BASE</u>

Q. Please summarize OAG Witness Dittemore adjustment to the ADIT balance in rate base for the elimination of the NOL carryforward.

A. OAG Witness Dittemore acknowledges that he does not take exception with the concept of recognizing the NOL [carryforward] as a rate base component, however, he disagrees with the Company's method to determine the Kentucky jurisdictional NOL balance. Specifically, he asserts that the Company's NOL methodology does not comply with the Commissions' policy of reflecting Income Tax components on a stand-alone basis for ratemaking purposes and therefore, should be removed from Rate Base.

In addition, OAG Witness Dittemore states that Income Tax Expense, the related ADIT liability, and the NOL asset should be computed consistently. He continues that the Company is basing the balances for Income Tax Expense and ADIT Liability (exclusive of the NOL asset offset) on a stand-alone Company basis, Columbia has incorrectly based the NOL asset offset balance on the consolidated results of NiSource Inc. By doing so, OAG Witness Dittemore contends that the Company's proposal breaks the link between the synchronized recognition of Columbia's Income Tax Expense, its ADIT liability and NOL asset offset balance for ratemaking purposes.

Q. Do you agree with OAG Witness Dittemore adjustment to the ADIT balance in rate base for the elimination of the NOLC?

A. No, I do not. Initially, it is important to note that there is a distinct difference between utilization of the Federal net operating loss carryforward ("NOLC") based on future taxable income computed and reported on separate-company pro forma Federal income tax returns recorded in the Company's GAAP financials, and the Internal Revenue Service ("IRS") normalization rules for ratemaking purposes based on the consistent reduction of the NOLC-related balance with the accelerated tax depreciation ADIT balance computed on the "last dollars deducted" basis.

Eliminating the ADIT associated with the Federal NOLC and the Tax Cuts and Jobs Act ("TCJA") Federal NOLC deficient ADIT balance from rate base would result in a normalization violation.

Q. Please explain the nature of Columbia Kentucky's Federal NOLC.

A. An NOL is created when tax deductions exceed taxable income. These deductions can arise from temporary book/tax differences such as accelerated depreciation. For capital intensive businesses like utilities, the temporary bonus depreciation IRS rules often result in tax depreciation deductions so large that they created negative current Federal taxable income (i.e. current Federal taxable loss). Columbia Kentucky's Federal NOLC represents the Company's cumulative Federal taxable losses for tax years 2011, and 2014-2017. These losses are primarily attributed to accelerated tax and bonus depreciation under IRC Sections 168 and 168(k), as depicted in Attachment Rebuttal JAH-1, Page 1. According to the IRS, NOL carryforwards are required to be normalized and calculated using a "with and without" approach. This means that the IRS considers an NOL to be created first by accelerated tax depreciation (including bonus). Only in a situation where the NOL is larger than the accelerated tax depreciation is the NOL considered to have been created by other tax deductions.

Q. Did the Company follow the IRS guidance in calculating its NOLC in this proceeding?

A. Yes. The Company computed a "with and without" presentation of accelerated tax and bonus depreciation Federal taxable income for tax years 2011 to the forecasted test period 2022. Specifically, for years 2011 and 2014-2017 the Company recognized a Federal taxable loss (Attachment Rebuttal JAH-1, Page 1, Line 8). However, without accelerated tax and bonus depreciation the Company would have otherwise recognized Federal taxable income (Attachment Rebuttal JAH-1, Page 1, Line 9) for years 2011 and 2014-2017. Therefore, consistent with IRS PLRs, all of the Columbia Kentucky's Federal NOLC to have been created from accelerated tax depreciation (including bonus).

Q. Has the Internal Revenue Service (IRS) addressed the characterization of the Federal NOLC as it relates to normalization requirements of IRC Section 168(i)(9) and Treas. Reg Section 1.167(l)-1 for rate making purposes?

A. Yes. The IRS has issued private letter rulings (PLRs) that confirm that in order to avoid a normalization violation, NOLC ADIT assets must be included in rate base and that the correct method for determining the amount that must be included is a "with and without" approach. Please refer to Attachment Rebuttal JAH-2 and Attachment Rebuttal JAH-3 for the PLR the IRS issued to Columbia Gas of Maryland and a redacted PLR the IRS issued to an unrelated Kentucky regulated utility, respectively.

Q. Please summarize the determination of the PLRs.

A. The PLRs conclude that 1) a reduction of a Taxpayer's rate base by the balance of its ADIT accounts, unreduced by its NOLC-related deferred tax account, would be inconsistent with the normalization requirements of IRC Section 168(i)(9) and Treas. Reg Section 1.167(l)-1, 2) reduction of the Taxpayer's rate base less than the amount attributed to accelerated depreciation computed on the "last dollars deducted" basis would be inconsistent with the normalization requirements of IRC Section 168(i)(9) and Treas. Reg Section 1.167(l)-1, and 3) reduction in the Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the normalization requirements of IRC Section 168(i)(9) and Treas. Reg Section 1.167(l)-1.

Q. Has Columbia Kentucky received a PLR from the IRS on this issue?

A. No. However, the PLR issued to Columbia Gas of Maryland represents the same fact pattern for Columbia Kentucky, and therefore would result in the same outcome. Also, as I noted above, another Kentucky regulated utility requested and received the same response as Columbia Gas of Maryland's PLR.

Q. How did the TCJA impact the Company's Federal NOLC?

A. TCJA required a re-measurement of the ADIT balances as of December 31, 2017 at the new Federal income tax rate. Columbia Kentucky recognized deficient ADIT of $1,026,003 related to the Federal NOLC attributed to the TCJA reduction of the Federal income tax rate to 21%. Additionally, the Company recognized excess ADIT of ($30,098,662) related to the cumulative book/tax difference for plant in service, including accelerated tax and bonus deprecation the Company had recognized in years prior to December 31, 2017. Based on the aforementioned PLRs issued by the IRS, a reduction of a Taxpayer's rate base by the balance of its ADIT accounts, unreduced by its NOLC-related deferred tax account, would result be inconsistent with the normalization requirements of IRC Ssection 168(i)(9) and Treas. Reg Section 1.167(l)-1. In accordance with the Commission's Order in Case No. 2018-00041, the Company's amortizes the Federal NOL deficient ADIT balance over 39 years based on the book depreciation composite rate and amortizes cumulative book/tax plant in service excess ADIT under the average rate assumption method ("ARAM") in order to comply with the normalization consistency rules and avoid a "flow-through" impact on the costs of service computation for the amortization of the deficient ADIT.

Q. Does OAG Witness Dittemore's Schedule Schedule DND-2.13 overstate the amount of the Federal NOLC deficient ADIT balance?

A. Yes. The amount included in OAG Witness Dittemore's Schedule DND-2.13 represents the Federal NOLC deficient ADIT of $1,209,351 grossed up for taxes that was recorded, net of excess ADIT, to a regulatory liability in Account 254 (See AG 1-101, Attachment A, Line 140). The associated tax gross-up of ($301,733) computed by tax effecting the deficient ADIT balance by the statutory tax rate of 24.95% (Federal rate, net of state benefit of 19.95% and State rate of 5%) is recorded to Account 190 (See AG 1-101, Attachment A, Lines 86 and 87). It appears that OAG Witness Dittemore unintentionally excluded the tax gross-up and overstated the amount of the Federal NOLC deficient ADIT balance.

Q. Does elimination of the ADIT for the Federal NOLC and deficient ADIT resulting from the TCJA re-measurement of the Federal NOLC from rate base result in a normalization violation?

A. Yes, a reduction of the Company's rate base by the balance of its ADIT accounts, unreduced by its NOLC-related deferred tax account, would is inconsistent with the normalization requirements of IRC Section 168(i)(9) and Treas. Reg Section 1.167(l)-1. The Company has computed the reduction to rate base by full amount of its ADIT account balance offset by the NOLC-related account balance on the "last dollar deducted" basis depicted on Attachment Rebuttal JAH-1, Page 2. IRC Section 168(f)(2) provides that the depreciation deduction determined under IRC Section 168 shall not apply to any public utility property if the Company does not use a normalization method of accounting. Consequently, a violation of the normalization requirements would result in the loss of the ability for Columbia Kentucky to accelerate tax depreciation over book depreciation.

Q. Please describe the consequence if Columbia Kentucky were to violate IRS normalization requirements.

A. Absolutely. At the outset, I want to state that Columbia Kentucky and NiSource take seriously the importance of complying with all state and Federal requirements, and knowing violating IRS requirements is not tenable. Moreover, a violation of the IRS normalization requirements would directly impact Columbia Kentucky customers. Specifically, a normalization violation would result in a substantial increase in customer rates since the Company could no longer recognize a reduction to rate base for the tax depreciation-related ADIT liabilities.

IV. TAX ACT ADJUSTMENT FACTOR ("TAAF") RIDER

Q. Please summarize OAG Witness Dittemore opposition to the Company's proposed TAAF Rider.

A. OAG Witness Dittemore indicates that "the magnitude of any future [income] tax [rate] change is unknown" and indicates that the Company is requesting "an immediate pass-through of any state/federal income tax rate change to its customers considering the magnitude such change may have on rates." While, OAG Witness Dittemore acknowledges the impact of such rate change will eventually be passed to Columbia Kentucky customers, he argues that the Commission should retain discretion in the timing and manner such changes are assigned to customers and the Company's proposed TAAF would limit the Commission's discretion as it is unclear as to what discretion the Commission would retain beyond a check for mathematical accuracy.

Furthermore, OAG Witness Dittemore argues that the Company assumes a change in tax code would be limited to a change in the state and federal tax rate, and would be conjecture to suggest what other tax code changes may accompany a statutory tax rate change modification requiring the Commission to consider the implications of other changes in the tax code beyond a change in the nominal federal tax rate.

Q. Do you agree with OAG Witness Dittemore basis for opposition of the TAAF Rider?

A. No, I do not. OAG Witness Dittemore does not challenge the fact that Columbia Kentucky tax changes are a flow through item. That is, the Company will either collect or refund tax dollars, based upon changes in the applicable tax rates. Despite this, he opposes the Company's proposed TAAF Rider because the magnitude of a future increase or decrease in Federal or state income tax rates is unknown. This statement appears to imply that a future increase or decrease in the Federal or state income tax rate would need to meet a certain threshold of magnitude in order to adjust customer rates. However, the Company's proposed TAAF is a temporary mechanism to capture the impact of a change in Federal or state income tax rates until its next rate case proceedings regardless of magnitude as expected under the Kentucky Revised Statute (KRS) 278.030 to ensure customer rates are just and reasonable.[1] The Company reiterates the uncertainty of when/if future Federal and state tax reform would be enacted and acknowledges that there are generally several provisions included in such tax reform. For instance, the TCJA included a decrease

[1] KRS 278.030 (1) Every utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person.

in the Federal income tax rate from 35% to 21% resulting in reduction in current federal tax expense and re-measurement of deferred taxes at 21% as of December 31, 2017 resulting in excess ADIT which recognition was deferred through establishing a regulatory liability; elimination of accelerated bonus depreciation for utilities; allowed utilities to retain full deductibility of corporate interest expense which under the law is limited for the broader corporate sector; and limitation to utilize the Federal net operating loss ("NOL") carryforward to 80% of taxable income with an unlimited carryforward period.[2] Of these provisions, only the decrease in the Federal tax rate had an impact on tax expense included in the cost of service computation. Bonus depreciation and NOL are temporary differences that results in a current/deferred tax expense offset. When and if future Federal and/or state tax reform is signed into law, the Company will summarize the provisions that impact Columbia Kentucky and prepare schedules to quantify the impact to tax expense included for recovery in its cost of service computation.

Again, as proposed, the Company's TAAF is a would remain at zero until such time that future Federal and/or state tax reform is enacted.

[2] The Company notes that the CARES act signed into law on March 27, 2020 temporarily suspended the 80% limitation until the beginning of 2021.

At which time, the Company's will provide a summary of the provisions that impact Columbia Kentucky, and a schedule depicting the impact to tax expense to the Commission for review of the impact of future Federal and/or State tax reform and computation. The Company does not expect a delay in the timing that customers rates be adjusted to ensure they are just and reasonable upon the submission of the aforementioned information and schedules to the Commission for review.

Q. Do you view the proposed TAAF to be a novel idea?

A. No. The proposed TAAF, if approved, will function similarly to the manner in which the Commission managed the effect of TCJA in Case No. 2018-00041[3]. The TAAF, if approved, would alleviate administrative burden and avoid delays in implementing the impact on customer rates. The Company notes that the impacts from TCJA were not effective in customer rates until May 1, 2018.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

[3] The Company notes that Columbia filed the testimony in Case No. 2017-00481, Electronic Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Atmos Energy Corporation, Delta Natural Gas Company, Inc., Columbia Gas of Kentucky, Inc., Kentucky-American Water Company, and Water Service Corporation of Kentucky (filed Jan. 26, 2018). Case No. 2017-00481 was subsequently separated into this and other utility-specific investigations, and the record from Case No. 2017-00481 was incorporated into Case No. 2018-00041 proceeding by the Commission's January 30, 2018 initiating Order.

ATTACHMENTS
ARE EXCEL
SPREADSHEETS
AND UPLOADED
SEPARATELY

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Index Number: 167.22-01

Third Party Communication: None
Date of Communication: Not Applicable

Mr. Joseph W. Mulpas. Vice President and
Chief Accounting Officer
NiSource Inc.
801 East 86th Avenue
Merrillville, Indiana 46410

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PLR-116998-15
Date: AUG 19 2015

LEGEND:

Taxpayer	=	Columbia Gas of Maryland, Inc. EIN: 25-1093185
Parent	=	NiSource Inc. EIN: 35-2108964
State A	=	Maryland
State B	=	Delaware
Commission	=	Public Service Commission of Maryland
Year A	=	2008
Year B	=	2011
Date A	=	February 27, 2013
Date B	=	March 31, 2013
Case	=	Case No. 9316
Director	=	Industry Director, Natural Resources and Construction (SE:LB:NRC)

Dear Mr. Mulpas:

This letter responds to the request, dated May 14, 2015, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is primarily engaged in the regulated distribution of natural gas in State A. It is incorporated in State B and is wholly owned by Parent. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer incurred net operating losses (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "last dollars deducted" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission offsets rate base by Taxpayer's ADIT balance. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission was, if Commission allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then an offsetting reduction should be made to Taxpayer's income tax expense element of service.

A Utility Law Judge upheld Taxpayer's position with respect to the NOLC-related ADIT and ordered Taxpayer to seek a ruling from the Internal Revenue Service on this matter. This request is in response to that order.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated

depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the proposed order by the Utility Law Judge upholding Taxpayer's position that the NOLC-related deferred tax account must be included in the calculation of Taxpayer's ADIT is in accord with the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. In addition, such adjustment would be made specifically to mitigate the effect of the normalization rules in the calculation of Taxpayer's NOLC-related ADIT. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). This "offsetting reduction" would violate the normalization provisions.

Based on the representations submitted by Taxpayer, we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Internal Revenue Service

Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
Patrick S. Kirwan, ID No. 1000219435
Telephone Number:
(202) 317-6853
Refer Reply To:
CC:PSI:B06
PLR-103300-15
Date:
May 13, 2015

LEGEND:

Taxpayer	=
State A	=
State B	=
State C	=
Commission	=
Year A	=
Year B	=
Date A	=
Date B	=
Date C	=
Date D	=
Case	=
Director	=

Dear Mr. McDonald:

This letter responds to the request, dated January 9, 2015, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is the common parent of an affiliated group of corporations and is incorporated under the laws of State A and State B. Taxpayer is engaged primarily in the businesses of regulated natural gas distribution, regulated natural gas transmission, and regulated natural gas storage. Taxpayer's regulated natural gas distribution business delivers gas to customers in several states, including State C. Taxpayer is subject to, as relevant for this ruling, the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of its gas distribution service in State C. Taxpayer's rates are established on a "rate of return" basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer's application was based on a fully forecasted test period consisting of the twelve months ending on Date B. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. In a final order dated Date C, rates were approved by Commission for service rendered on or after Date D.

In each year from Year A to Year B, Taxpayer incurred a net operating loss carryforward (NOLC). In each of these years, Taxpayer claimed accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State C, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. The attorney general for State C argued against Taxpayer's proposed calculation of ADIT.

Commission, in its final order, agreed with Taxpayer but concluded that the ambiguity in the relevant normalization regulations warranted an assessment of the issue by the IRS and this ruling request followed.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, to reduce Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer ensures that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc:

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF KEVIN L. JOHNSON ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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David S. Samford
L. Allyson Honaker
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Attorneys for Applicant
COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Kevin L. Johnson and my business address is 290 W. Nationwide Blvd., Columbus, Ohio, 43215.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. In my rebuttal testimony, I will be addressing arguments and conclusions presented in the direct testimony of Mr. David Dittemore, witness of The Office of the Attorney General, on cash working capital.

Q. What cash working capital ("CWC") adjustments is Mr. Dittemore requesting?

A. Mr. Dittemore is requesting the following CWC adjustments as noted on Pages 36-37 of his direct testimony:

1. Eliminate Depreciation Expense from the Lead Lag study calculation;
2. Eliminate the Company's entire $1.28 million balance sheet analysis calculation and;
3. Include a negative CWC value of $(9,280,364)

Q. Do you agree with any of Mr. Dittemore's requested cash working capital adjustments?

A. No, I do not agree and will discuss each adjustment separately.

<u>**Eliminate Depreciation Expense from the Lead Lag study calculation.**</u>

Q. Did Mr. Dittemore make an adjustment to remove Depreciation Expense from the cash working capital calculation and why?

A: Yes. Mr. Dittemore argues Depreciation and Amortization expense should be excluded from the Lead Lag study calculation since it is not a cash expense.

Q. Please describe the methodology CKY used to determine CWC for ratemaking purposes.

A: As noted in Columbia's Response to the Attorney General's First Request for Information, No. 89 and in my Direct Testimony (Page 6, Beginning Line 6), Columbia Kentucky used the methodology consistent with another NiSource affiliate, Columbia Gas of Virginia, to prepare its Lead Lag Study to determine CWC. Similar to as presented in this rate case, Columbia Gas of Virginia also presented Depreciation and Amortization with a full revenue lag and zero lead days in its last rate case (Case No. PUR-2018-00131). Using the Virginia method as a guide to compute CWC is similar to the approach taken by Louisville Gas and Electric in its prior cases (Case No. 2020-00350 and Case No. 2018-00295), both of which included a positive amount for Depreciation and Amortization calculated by using a full revenue lag and zero lead days.

Q. Do you agree with Mr. Dittemore that Depreciation and Amortization expense should be excluded from the Lead Lag study calculation? Why?

A: No, I do not agree. The Depreciation and Amortization expense inclusion in CWC reduces the calculation of the 13-month average rate base in the month the costs are recorded as recognition that the customers provided a return of the investments. The Company experiences a lag between the reduction of the rate base and the actual receipt of the customer payment. As presented, the CWC calculation provides for the carrying cost of the revenue lag. Excluding depreciation from the Lead Lag study calculation does not give the Company the opportunity to earn a full return on its investments.

Q. Has the Commission weighed in on this issue in the past cases?

A: Yes. Although this is the first case the Company has prepared a Lead Lag study, other companies have prepared Lead Lag studies before this Commission. The Commission has found non-cash items such as Depreciation and Amortization expense was appropriate to be included in the Lead Lag study calculation. In Kentucky-American's 2018 rate case (Case No. 2018-00358), the Commission stated:

> We agree with Kentucky-American that the Attorney General has consistently presented, and the Commission has consistently refused to adopt, the arguments raised here regarding the inclusion of non-cash items in the calculation of working capital…Therefore, consistent with precedent and base upon the evidence in the record, we find the Attorney General/LFUCG's proposal regarding cash working capital should be denied.[1]

The Commission also addressed the inclusion of depreciation expense in the CWC Kentucky-American Case No. 92-452 by stating:

> The depreciation expense represents their recovery of that investment from the customers over the respective plant lives. There is a considerable delay in the recovery of depreciation charges from the customers… depreciation, amortization, and deferred taxes are noncash items, but noncash items can produce a need for cash working capital. Depreciation expense does not require a cash payment, although cash was expended at the time the property was acquired, and the recorded depreciation is used to offset the investment in property even though it has yet to be received from the customer through rates. The same applies to amortization and deferred taxes.[2]

Q. Please summarize your conclusion on Mr. Dittemore's exclusion of Depreciation and Amortization expense from CWC.

[1] Case No. 2018-00358, *Application of Kentucky-American Water Company for an Adjustment of Rates*, (Ky. PSC June 27, 2019) at pp. 8-9.
[2] Case No. 92-452, *Notice of Adjustment of the Rates of Kentucky-American Water Company*, (Ky. PSC November 19, 1993) at pp. 18-19.

A: Based on the arguments presented above and consistent with proceedings in past cases before the Commission, Mr. Dittemore's proposal to exclude Depreciation and Amortization expense from the CWC calculation should be rejected.

<u>Eliminate the Company's entire $1.28 million balance sheet analysis calculation.</u>

Q. What is the purpose of the Company including a Balance Sheet Analysis as a component of its Lead Lag study CWC calculation?

A: As noted in Columbia's Response to the Attorney General's Second Request for Information, No. 86 discovery request, the Lead Lag study is focused on the income statement analysis of CWC while the balance sheet analysis focuses on the CWC impact of items not otherwise included on the income statement. Not including the balance sheet analysis would leave an incomplete picture of the calculated CWC impact on Rate Base.

Q. What are Mr. Dittemore's thoughts on the balance sheet analysis?

A: Mr. Dittemore believes the entire $1.28 million balance sheet analysis should be excluded from the CWC calculation.

Q. What reasons does Mr. Dittemore give for excluding these balances from the CWC calculation?

A: Mr. Dittemore refers to the Attorney General's Second Request for Information, No. 86 and says;

"the $1.28 million balance includes both fair value of pension plan assets as well as the transactions related to non-qualifed retirement plans. The SERP plan is a non-qualified retirement plan. The fair value of pension plan assets fluctuates based upon market returns of the underlying assets. Ratepayers should not be required to provide a return on pension assets that are impacted by variations in the equity and bond markets. Secondly, the impacts of SERP plan assets should not be in Rate Base consistent with the Commission's precedent to disallow SERP costs as a recoverable expense. The two accounts incorporating these transactions drive the positive balance requested by the Company. Therefore, I have eliminated the $1.28 million requested balance from the lead-lag analysis."

Q. Do you agree with Mr. Dittemore's first argument that the balance sheet analysis should be excluded from the CWC calculation since "pension plan assets fluctuates based upon market returns of the underlying assets"?

A: No. As noted in Columbia's Response to the Attorney General's Second Request for Information, No. 86, the difference between cash payments to pension and OPEB trust funds and the pension and OPEB expense amounts recognized to date are recorded to the 182 account, as well as FERC accounts 128, 228, and 242. The net of all these previously mentioned balance sheet accounts quantifies the net cash the company has paid in advance of expense recognition to the trusts or the net cash the company owes the trust that has been expensed to date. As a result, it is therefore appropriate to include all four FERC accounts mentioned above in Rate Base.

Q. Do you agree with Mr. Dittemore's second argument that the balance sheet analysis should be excluded from the CWC calculation since "the

SERP plan is a non-qualified retirement plan" and "the impacts of SERP plan assets should not be in Rate Base consistent with the Commission's precedent to disallow SERP costs as a recoverable expense"?

A: No. As Mr. Dittemore noted, Columbia's Response to the Attorney General's First Request for Information, No. 89 lists the various components comprising the balances reflected in the Company's balance sheet analysis. The balance sheet analysis is included on Sheet 1 (Base Period) and Sheet 2 (Forecast Period) of my Direct Testimony Attachment KLJ-CWC-1.

On Line 4 of Sheet 2 (Forecast Period) of my Direct Testimony Attachment KLJ-CWC-1, the line item Mr. Dittemore is referencing is described as "182 – NC Reg Asset Pension/OPEB" with a 13 Month Average amount of $5,027,744. Lines 4 and 5 on tab "(WP) Sh 2 BSA (FTP)" of Columbia's Response to the Attorney General's First Request for Information, No. 89 further breaks down the balance of the "182 – NC Reg Asset Pension/OPEB" line into two lines; Line 4, Account "18235114 – NC Reg Asset FAS 158 OPEB" with a 13 Month Average amount of $1,448,807 and Line 5, Accounts "18235115 & 18235450 – NC Reg Asset FAS 158 Pension" with a 13 Month Average amount of $3,578,937.

The "18235115 & 18235450 – NC Reg Asset FAS 158 Pension" line with a 13 Month Average amount of $3,578,937 does represent both qualified and non-qualified pension plan regulatory assets. General Ledger ("GL") Account 18235115 contains the qualified regulatory asset and the GL Account 18235450 represents the non-qualified regulatory asset. The qualified and non-qualified breakdown was not included in Columbia's Response to the Attorney General's First Request for Information, No. 89 as it was not broken out in the Company's original supporting documents. However, after review while preparing this rebuttal testimony, it was determined that <u>only $8,084</u> of the total "18235115 & 18235450 – NC Reg Asset FAS 158 Pension" 13 Month Average account balance of $3,578,937 is non-qualified.

Q. Please summarize the balances making up the 182 – NC Reg Asset Pension/OPEB" with a 13 Month Average amount of $5,027,744 that was shown on Line 4 of Sheet 2 (Forecast Period) of Johnson Testimony Attachment KLJ-CWC-1.

A: The balances making up the 182 – NC Reg Asset Pension/OPEB 13 Month Average amount of $5,027,744 are as follows:

Qualified Pension Regulatory Asset - $3,570,853
Non-Qualified Pension Regulatory Asset - $8,084
OPEB Regulatory Asset - $1,448,807

Q. Do you agree with Mr. Dittemore that the balance sheet analysis should be excluded from the CWC calculation?

A: No.

Q. Why do you believe the balance sheet analysis should remain in the CWC calculation?

A: As mentioned above, including the balance sheet analysis gives the full picture of the calculated CWC impacts on Rate Base. Mr. Dittemore is focusing on one piece of the balance sheet analysis (pensions) and is requesting the entire balance be removed. Furthermore, as mentioned above, only $8,084 of the balance sheet analysis is related to the non-qualified pension regulatory asset. This very small amount should not be a primary reason for removing the entire balance sheet analysis. However, as noted in Witness Cartella's Rebuttal Testimony, SERP costs are being removed from this case. The Company does not object to the removal of $8,084 from the balance sheet analysis.

<u>Include a negative cash working capital value of $(9,280,364).</u>

Q. Is Mr. Dittemore proposing the Company include a CWC adjustment in this case and what is the amount he is proposing?

A: Yes. Mr. Dittemore is proposing the Company include a CWC reduction to Rate Base of negative $(9,280,364).

Q. Do you agree with Mr. Dittemore that this reduction to Rate Base should be made?

A: No.

Q. What was the test year working capital requirement resulting from the application of the lead lag method of calculating CWC?

A: The calculated as filed test year CWC component using the Lead Lag method is ($6,942,997).

Q. Is the Company using the results of the Lead Lag study to determine the CWC component of the allowance for working capital?

A: No. The Company is not making an adjustment for CWC.

Q. Why is the Company's CWC calculation negative when using the Lead Lag method of calculating CWC?

A: As noted in Columbia's Response to Staff's Third Request for Information, No. 35, Columbia Kentucky's receivables are low as a result of the cumulative impact of credit balances building in certain customers' accounts who are enrolled in the Budget Plan offered by Columbia Kentucky. The Columbia Kentucky Budget Plan allows customers to pay the same amount each month as calculated based on the usage, weather, and projected costs of that customer. The Columbia Kentucky Budget Plan resets annually in April. As a result of the Budget Plan resetting in

April, these Budget Plan customers may build a credit in their accounts as they go through the summer months into the heating season.

Q. What is the impact on the Company's CWC calculation if the impacts of the Budget Plan resetting in April are removed?

A: As noted in Columbia's Response to Staff's Third Request for Information, No. 35, the Company's CWC calculation would be $(365,312) if the impacts of the Budget Plan resetting in April were removed.

Q. Is there more than one way to calculate a CWC requirement?

A: Yes. The Commission has previously accepted the Company's calculation of CWC using the formula approach of taking 1/8 of operations and maintenance expenses.

Q. What were the calculated results using the 1/8 of operations and maintenance expenses formula approach to determining CWC?

A: Using the formula approach of 1/8 of forecasted period operations and maintenance expenses, the calculated CWC requirement was $6,983,685.

Q. Please summarize the results of the calculated potential CWC requirements?

A: The potential calculated CWC requirements are shown below:

- 1/8 O&M Expense (formula approach) Calculation - $6,983,685
- Company's Requested CWC - $0
- Lead Lag method Calculation - $(6,942,997)
- AG's Requested CWC – $(9,280,364)

Q. Why is the Company not requesting a CWC adjustment?

A: There are multiple reasons the Company is not requesting a CWC requirement in this case.

1. The negative CWC calculation using the Lead Lag method is driven by the Budget Plan resetting in April each year. The Budget Plan is offered to our customers and allows them to pay the same amount each month as calculated based on the usage, weather, and projected costs of that customer. Columbia has the highest enrollment in budget billing among all of the NiSource local distribution companies across its six state footprint. Imputing a negative CWC in this instance would punish Columbia for the timing of budget plan resets when customers' behavior demonstrates they like the Budget Plan program as it is today.
2. In past cases, the Company has used the 1/8 of Operations & Maintenance expense formula approach to calculate its CWC requirement. Had the Company used this method in this case, the Company would have calculated a $6,983,685 requirement. As noted above, the difference between calculating the CWC requirement using the 1/8 Operation & Maintenance expense formula approach and the Lead Lag method is significant. The

Company is not requesting the full amount that would have been requested in prior cases using the 1/8 Operation & Maintenance expense formula approach but instead is reducing the amount that would have been requested by not requesting a CWC adjustment.

3. The Company believes the Commission has not required a negative CWC adjustment in other rate cases, including Case No. 2019-00271 and Case No. 2020-00174. In both cases, the Commission reduced the CWC adjustment to zero as a result of the sale of accounts receivable even though the results could have resulted in a negative amount.

Q. Please summarize your recommendations.

A: Based on the detail provided above, the Commission should reject Mr. Dittemore's suggestion to exclude Depreciation and Amortization expense and the $1.28 million balance sheet analysis from the Lead Lag study calculation. The Company also recommends a $0 CWC requirement as a reasonable recommendation as the results from the two studies vary greatly.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF	)	Case No. 2021-00183
COLUMBIA GAS OF KENTUCKY,	)	
INC. FOR AN ADJUSTMENT OF	)	
RATES; APPROVAL OF	)	
DEPRECIATION STUDY; APPROVAL	)	
OF TARIFF REVISIONS; ISSUANCE	)	
OF A CERTIFICATE OF PUBLIC	)	
CONVENIENCE AND NECESSITY;	)	
AND OTHER RELIEF	)	

PREPARED REBUTTAL TESTIMONY OF KIMBERLY CARTELLA ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Kimberly K. Cartella. My business address is 3101 N. Ridge Rd., Lorain, OH 44055.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. I will respond to the testimony of Attorney General Witness David Dittemore's testimony regarding expenses related to short-term incentive compensation (referred to as Corporate Incentive Plan "CIP"), long term incentive ("LTI") compensation, Supplemental Executive Retirement Plan ("SERP"), and regarding exclusion of certain 401k costs.

Q. Please describe NiSource's and Columbia's compensation and benefits philosophy.

A. NiSource's compensation and benefits philosophy is to compensate employees and provide benefits that are competitive in comparison to the utility industry, as well as general industry (all industry) employers, in order to attract, retain and motivate employees who are qualified to perform the functions needed by the Company. This philosophy enables the Company to meet its obligations to provide safe, reliable and affordable service to its customers. This philosophy is consistent across all NiSource companies.

Q. Did Mr. Dittemore propose an adjustment to CIP compensation?

A. Yes. Mr. Dittemore proposed an adjustment to remove the portion of CIP compensation related to financial goals from the cost of service, which he states is 70% for 2020 and 2021. He further claims that the financial goals benefit shareholders and not rate payers.

Q. Do you agree with Mr. Dittemore's proposed adjustment?

A. No. The purpose of CIP is to motivate employees by setting achievable goals that include providing safe, reliable, efficient, and cost-effective service to our customers and to recognize successful achievement of those goals.

Q. Should 100% CIP recovery be allowed?

A. Yes. The Company goals related to safety, customer, quality of service, and containment of costs are all customer-oriented goals by which every Company employee is expected to abide. Employees are accountable for these goals, and employees take action to reinforce these goals in order to achieve incentive recognition. The financial goal is intended to motivate employees to provide cost-effective service to our customers. By removing recovery of the portion related to financial goals, it sends a message that being efficient and cost-effective to meet the Company's budget is not important. The Company believes that it is critically important that our employees focus on and are recognized for all aspects of providing safe, reliable and cost-effective service.

Q. Why does the company have a CIP program?

A. As part of the Company's compensation and benefits programs, the CIP is an important program to allow the Company to not only recognize employees for achieving safety, customer, and financial goals but also to competitively compensate our employees in alignment with similar roles at other utility companies. This allows us to attract and retain quality talent that will deliver safe, reliable, and cost-effective service to customers. If the Company is to provide high-quality service to its customers, it is imperative that it be able to attract and retain quality talent, and to do so, all aspects of the total compensation and benefits package, including STI, must be competitive with other industry employers. If not, the Company places itself at high risk of losing talent to competitors. This would create a loss of valuable skills and would have a significant financial impact in the form of turnover costs, which would ultimately be borne by the Company's customers. It also would have an impact on safety and customer service goals, as less experienced leaders could be brought into the organization.

Q. Please briefly describe Witness Dittemore's proposed LTI adjustment.

A. Mr. Dittemore recommended an adjustment to remove a portion of the LTI expense for the Company's direct costs and those costs allocated from NCSC. He stated that 82% of LTI expense relates to achieving financial goals and recommends that this portion of the LTI be removed from the cost of service. He further claims that the financial goals benefit shareholders and not rate payers.

Q. Do you agree with the LTI adjustment recommended by Mr. Dittemore?

A. No. The Company proposes that 100% of these costs be allowed. The entire portion of LTI provides benefits to Columbia's customers as stated below. The 2020 and 2021 LTI programs include goals in the following categories: customer, safety, culture, environmental, workforce diversity, and financial.

Q. Please explain how LTI provides benefits to Columbia's customers.

A. LTI is designed to attract and retain executive talent for a long period of time. LTI compensation is a common element of compensation at key management levels of organizations throughout the United States, including major utilities and, as such, the costs should be allowed. LTI compensation allows NiSource to attract and retain individuals at executive levels which would be extremely difficult to accomplish without this element of compensation. Retaining key leaders and attracting new talented individuals is critical in order for Columbia to maintain high quality of service, efficiency and safety. Therefore, offering LTI is an appropriate cost of providing reliable service to the Company's customers. If the Company did not provide LTI, it would be at high risk of losing talent to competitors. The potential departure of Company leadership would create a loss of valuable skills and institutional knowledge. This would have significant financial impact in the form of turnover costs, including recruiting costs, relocation costs, and training costs. In addition, leadership sets the tone and direction for the Company.

Q. Do you agree with Mr. Dittemore's statement that 82% of LTI expense relates to achieving financial goals? If not and if an adjustment were to be made to LTI expenses, what is the correct percentage related to financial goals?

A. If an adjustment is made to the Company's LTI expense in this proceeding, the adjustment should be no more than 76 percent. The portion of the LTI compensation historic base period expense incurred in 2020 related to financial goals was 65 percent and the portion of the LTI compensation historic base period expenses incurred in 2021 related to financial goals was 82 percent. Thus, a weighted average of 76 percent of

LTI compensation expenses is the accurate percentage tied to financial goals. Any adjustment made should not exceed 76%.

Q. Please briefly describe Witness Dittemore's proposed SERP adjustment.

A. Mr. Dittemore suggests that these costs should not be recoverable.

Q. Do you agree with Mr. Dittemore's proposed SERP adjustment?

A. No. The Company disagrees. SERP is part of the compensation and benefits program that is provided to employees. The Company's compensation and benefits program, taken as a whole and including SERP, provides the means to competitively compensate employees in order to attract and retain quality employees responsible for the safe and reliable service to Columbia.

Q. Please briefly describe Witness Dittemore's recommendation to remove certain 401k costs.

A. Mr. Dittemore stated that the Commission finds that it is excessive and unreasonable to contribute to both a defined-benefit pension plan and a 401k plan for salaried employees.

Q. Do you agree with Mr. Dittemore's proposed 401k adjustment?

A. No. The Company disagrees. These benefits are part of a competitive compensation and benefits program offered to our employees. As part of a significant cost-savings initiative, the pension program was discontinued on January 1, 2010 for exempt employees and on January 1, 2013 for nonexempt, non-union employees. At that time, the remaining employees in the pension plan programs were also converted to a less costly account balance program, and new hires were not offered a pension plan. This cost savings initiative lowered pension plan costs for the company. The employees who were in the pension program at that time continue to accrue the account balance pension benefits. All new hires since that time do not receive any pension benefits. The Company has both a pension program and 401k match for a declining number of employees.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.

Columbia Exhibit No.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the matter of:	)	
	)	
ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. FOR AN ADJUSTMENT OF RATES; APPROVAL OF DEPRECIATION STUDY; APPROVAL OF TARIFF REVISIONS; ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY; AND OTHER RELIEF	)	Case No. 2021-00183

PREPARED REBUTTAL TESTIMONY OF
DAVID A. ROY
ON BEHALF OF COLUMBIA GAS OF KENTUCKY, INC.

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COLUMBIA GAS OF KENTUCKY, INC.

October 22, 2021

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is David A. Roy and my business address is 2001 Mercer Road, Lexington, Kentucky, 40511.

Q. Did you provide Direct Testimony in this proceeding?

A. Yes I did.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The Attorney General's ("AG") witness David Dittemore made some recommendations with regards to Columbia's SMRP program in his written testimony. I intend to comment on a couple of those recommendations.

Q. What recommendations does the AG witness Dittemore make with regards to Columbia's SMRP and its' request to expand the SMRP to include first generation plastic pipe?

A. Witness Dittemore does not object to the inclusion of first generation plastic pipe within the SMRP, but does recommend that the Commission require Columbia to establish the need for replacement by providing some level of objective data. Additionally, witness Dittemore recommends that the Commission establish an appropriate annual cap on SMRP-qualifying expenditures that's recoverable through the SMRP mechanism.

Q. Do you agree with witness Dittemore's recommendation to require Columbia to provide some level of objective data to establish a need for the replacement of first generation plastic pipe?

A. I do not. This vintage pipe is known to develop stress cracking and fail in various circumstances. Additionally, when selecting projects to include within the SMRP, Columbia will use its risk prioritization software to aid in selecting projects. Typically, the only time SMRP projects are not selected based on risk is in cases where a municipality, the State, or some other entity intends to complete some level of road construction where Columbia's facilities are in conflict and Columbia is required to move its facilities. In those cases, we will generally replace our facilities if they are bare steel, cast iron or in the future first generation plastic pipe so we don't have to tear the road up at a later date.

Q. Does Columbia believe it's necessary for the Commission to establish an annual Cap on SMRP expenditures?

A. No. Each year, Columbia makes a filing to the Commission that indicates the level of spend and the proposed projects Columbia intends to undertake the following year for its' SMRP mechanism. This filing is reviewed and either approved, adjusted, or denied by the Commission.

The Commission already has the ability to review and approve the anticipated level of spend.

Q. Does this conclude your Rebuttal Testimony?

A: Yes.