

Before the North Dakota Public Service Commission  
State of North Dakota

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

Case No. PU-17-398  
OAH File No. 20170622  
Exhibit \_\_\_\_

**RETURN ON EQUITY**

Supplemental Direct Testimony Of  
**ROBERT B. HEVERT**

March 23, 2018

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## **I. INTRODUCTION**

1 Q. PLEASE STATE YOUR NAME, AFFILIATION, AND BUSINESS ADDRESS.

2 A. My name is Robert B. Hevert. I am a Partner of ScottMadden, Inc. (“ScottMadden”).  
3 My business address is 1900 West Park Drive, Suite 250, Westborough, MA 01581.

4 Q. PLEASE STATE THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY.

5 A. The purpose of my Supplemental Testimony is provide information relating to recent  
6 market developments in relation to the Tax Cuts and Jobs Act of 2017 (“TCJA”),  
7 Specifically, I discuss the market price performance of electric utilities relative to other  
8 market sectors, electric utility company dividend yields, the implications of the TCJA for  
9 utility credit ratings, and the importance of considering the effect of the TCJA on the  
10 Cost of Equity of Otter Tail Power Company (“OTP” or the “Company”) if the  
11 Commission implements expense reductions relating to the TCJA in this case.

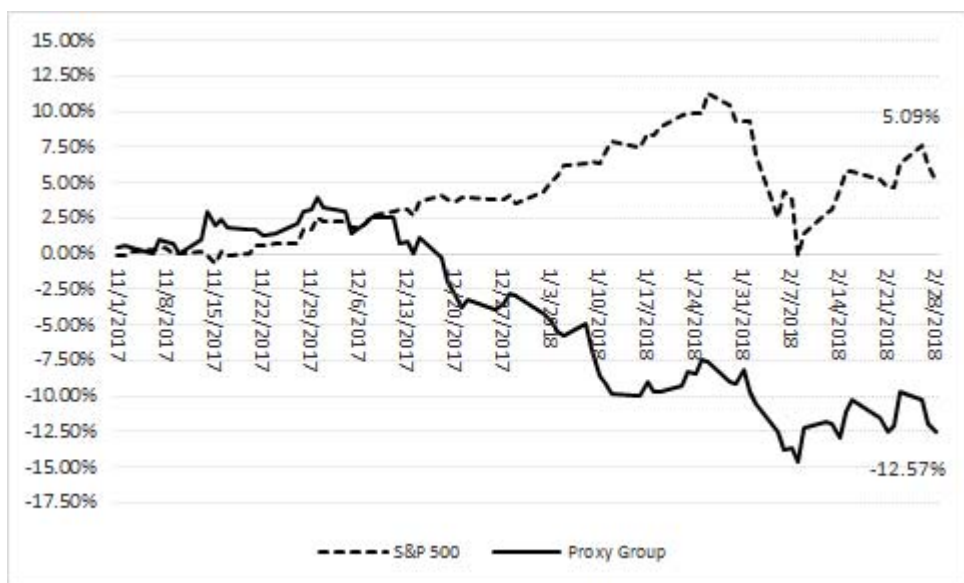
## **II. MARKET DEVELOPMENTS RELATED TO THE TCJA**

12 Q. PLEASE SUMMARIZE UTILITY MARKET PRICE PERFORMANCE IN RELATION  
13 TO THE TCJA.

14 A. Since shortly before the TCJA was signed (December 22, 2017), electric utilities (as  
15 reflected by my Proxy Group) have significantly underperformed the overall market. As  
16 Chart 1 (below) demonstrates, from November 1, 2017 through February 28, 2018 the  
17 S&P 500 gained about 5.09 percent in value. In stark contrast, my Proxy Group lost  
18 about 12.57 percent, underperforming the overall market by 17.66 percentage points.

1

**Chart 1: Relative Performance Since November 2017<sup>1</sup>**



2

3 Q. WHAT DOES THIS DATA INDICATE?

4 A. A reasonable inference to be drawn from that data is that investors have been re-

5 evaluating electric utilities relative to other market sectors. To the extent investors now

6 view utilities as less attractive relative to alternative investments, the stock prices will

7 fall, and the dividend yields will increase. As explained below, because rating agencies

8 have begun to discuss the negative consequences of the TCJA for utilities' cash flow, a

9 reasonable conclusion is that equity investors also have begun to recognize those

10 consequences, and to allocate their capital to other market sectors.

11 Q. DID THE PROXY GROUP DIVIDEND YIELD INCREASE CONTEMPORANEOUS WITH THE TCJA?

13 A. Yes, since the beginning of December 2017 the dividend yield for my Proxy Group

14 increased by about 62 basis points, while the 30-year Treasury yield increased by about

15 37 basis points (*see* Chart 2, below). Again, that data suggests the fall in price among

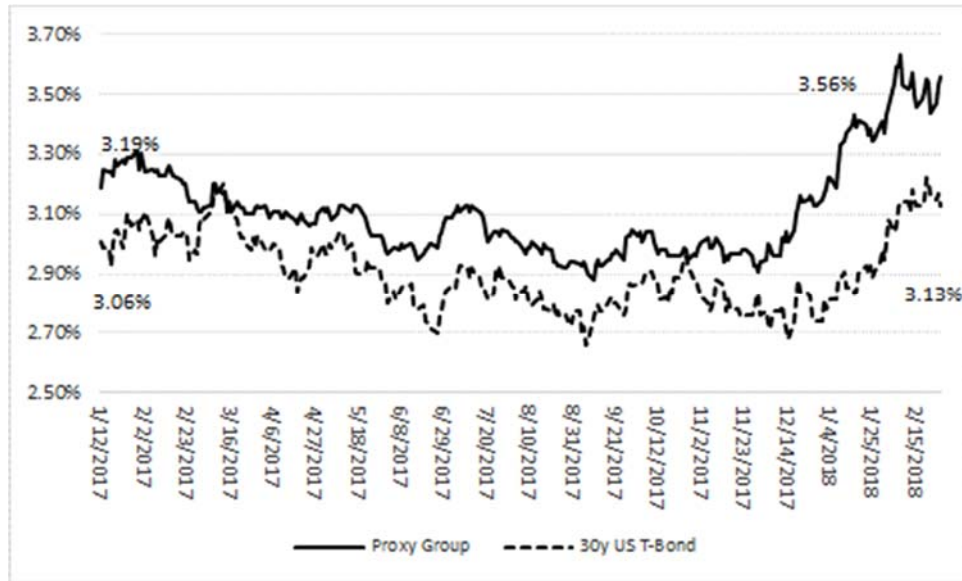
16 utility stocks may be a matter of relative value stemming from concerns regarding the

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<sup>1</sup> Source: S&P Global Market Intelligence. Proxy group calculated as an index.

1 TCJA's effect on utilities' cash flow. As discussed below, the rating agencies all recently  
2 have evaluated the utility sector in the context of the TCJA.

3  
4 **Chart 2: Proxy Group Dividend Yield**  
5 **vs. 30-Year Treasury Yield<sup>2</sup>**



6  
7 Further, as shown in Chart 2, although the spread between the proxy group dividend yield  
8 and the 30-year Treasury yield increased, the 30-year Treasury yield also increased  
9 significantly since the analytical period in my Direct Testimony (i.e., September 29,  
10 2017), and, in particular, since December 2017.<sup>3</sup> As discussed in my Direct Testimony,  
11 the increase in interest rates, and expectation of further increases, may lead to lower  
12 utility valuations, higher dividend yields, and higher growth rates, which would suggest  
13 higher Discounted Cash Flow (“DCF”) results, and a higher ROE.<sup>4</sup>

14 Q. ARE THERE REASONS TO EXPECT THE TCJA MAY AFFECT THE MODELS  
15 USED TO ESTIMATE THE COST OF EQUITY?

<sup>2</sup> Source: S&P Global Market Intelligence. My proxy group calculated as an index.

<sup>3</sup> The 30-day average of the 30-year Treasury yield increased from 2.77 percent in my Direct Testimony to 3.06 percent as of February 28, 2018. The 30-year Treasury yield was approximately the same as of September 29, 2017 and in December 2017, but, as shown in Chart 2, increased significantly after December 2017.

<sup>4</sup> Direct Testimony of Robert B. Hevert, at 59.

1 A. Yes, there are. As discussed in my Direct Testimony, the Constant Growth DCF model is  
2 based on several assumptions that together assume current market conditions essentially  
3 will remain in place, unchanged, in perpetuity. Because we have seen a significant  
4 change in utility valuations, we should recognize the mean DCF results likely are not  
5 reliable indicators of the Company's Cost of Equity. That is, the results of the DCF  
6 model should be viewed with caution when they change significantly over short periods  
7 of time, because the model assumes that current market conditions will exist on an  
8 ongoing basis.

9 Q. WHAT CONCERNS HAVE RATING AGENCIES RAISED AS THEY CONSIDER  
10 THE IMPLICATIONS OF THE TCJA FOR UTILITIES' CASH FLOW?

11 A. The rating agencies have observed that a reduction in utilities' revenue associated with  
12 lower income taxes and the potential return of excess accumulated deferred income taxes  
13 also may reduce utilities' cash flow.<sup>5</sup> As FitchRatings pointed out "[a]bsent mitigating  
14 strategies on the regulatory front, this is expected to lead to weaker credit metrics and  
15 negative rating actions for issuers with limited headroom to absorb the leverage creep."<sup>6</sup>  
16 In a similar vein, Standard & Poor's observed that the TCJA is "...negative for credit  
17 quality because the combination of a lower tax rate and the loss of stimulus provisions  
18 related to bonus depreciation or full expensing of capital spending will create headwinds  
19 in operating cash-flow generation capabilities as customer rates are lowered in response  
20 to the new tax code."<sup>7</sup> Moody's Investors Services ("Moody's) stated the following:

21 Tax reform is credit negative for US regulated utilities because the lower  
22 21% statutory tax rate reduces cash collected from customers, while the  
23 loss of bonus depreciation reduces tax deferrals, all else being equal.  
24 Moody's calculates that the recent changes in tax laws will dilute a utility's

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<sup>5</sup> See S&P Global Market Intelligence, *Rating agencies warn tax reform could drag US utility sector credit quality*, January 25, 2018.

<sup>6</sup> FitchRatings Special Report, *Tax Reform Impact on the U.S. Utilities, Power & Gas Sector*, January 24, 2018.

<sup>7</sup> S&P Global Ratings, *U.S. Tax Reform: For Utilities' Credit Quality, Challenges Abound*, January 24, 2018.

1 ratio of cash flow before changes in working capital to debt by  
2 approximately 150 - 250 basis points on average, depending to some  
3 degree on the size of the company's capital expenditure programs. From a  
4 leverage perspective, Moody's estimates that debt to total capitalization  
5 ratios will increase, based on the lower value of deferred tax liabilities.<sup>8</sup>  
6 (Emphasis added.)

7 All three rating agencies, therefore, have observed the negative effects of the TCJA on  
8 utilities' cash flow, and the potential consequences for their credit profiles. Moody's  
9 noted the significance of a utility's capital expenditure program, and the Company has a  
10 very extensive capital expenditure program, as I explained in my Direct Testimony.

11 Q. HAVE THE RATING AGENCIES ALSO DISCUSSED POSSIBLE REGULATORY  
12 REACTIONS TO THE CASH FLOW IMPLICATIONS OF THE TCJA?

13 A. Yes. Moody's, for example, identified approaches to help preserve credit profiles,  
14 including "...accelerated cost recovery of certain regulatory assets or future investment;  
15 changes to the equity layer or allowed ROEs in rates, and other actions." Moody's also  
16 suggested that "[c]hanges to corporate financial policies could include changes to  
17 capitalization, the financing of future investments, dividend growth, or others."<sup>9</sup>  
18 FitchRatings observed the following:

19 A majority of states have opened dockets or requested all utilities in the  
20 state to submit an analysis on the implications of the tax reform. While  
21 regulators will be keen to provide some sort of rate relief for customers,  
22 such actions could take many forms and vary in time frame. Some  
23 jurisdictions may be open to a negotiated outcome that focuses more on  
24 benefits of rate stability and creditworthy utilities rather than immediate  
25 rate reductions. In the former, many tools could be employed, including  
26 the following:

- 27 • Deferral of lower tax expense to use as an offset to expected future rate  
28 increases either from the recovery of regulatory deferrals or rate base  
29 growth

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<sup>8</sup> Moody's Investors' Service, *Rating Action: Moody's changes outlooks on 25 US regulated utilities primarily impacted by tax reform*, January 19, 2018.

<sup>9</sup> *Ibid.*

- 1 • Return of excess unprotected ADIT over a longer-term horizon
- 2 • Increase in authorized equity ratio and/or return on equity
- 3 • Accelerated depreciation on some assets
- 4 • Lower capex<sup>10</sup>

5 As both Moody's and FitchRatings discussed, regulatory responses may vary by  
6 company and jurisdiction, but may include a variety of potential approaches.

### III. CONCLUSION

7 Q. WHAT CONCLUSIONS DO YOU DRAW FROM THE DATA AND INFORMATION  
8 DISCUSSED ABOVE?

9 A. There is little question that the TCJA has increased cash flow-related risks for utilities,  
10 including the Company. Those risks are manifested in the sector's significant  
11 underperformance relative to the broad market, and in the comments of financial  
12 participants such as the rating agencies. If the Commission is to incorporate the change  
13 in federal tax rates implemented by the TCJA in the Company's revenue requirements, it  
14 also should consider the effect of TCJA on the Company's Cost of Equity.

15 Q. ARE YOU RECOMMENDING A HIGHER ROE IN THIS PROCEEDING DUE TO  
16 THE TCJA?

17 A. No, I am not. Rather, I recommend that the Commission consider the capital market  
18 implications of the TCJA as part of its review. Based on the data and information  
19 discussed above, it is my view that the cumulative effects of the TCJA on the Company,  
20 including the effect of the Company's extensive capital expenditure program, clearly  
21 support an ROE at the high end of the range set forth in my Direct Testimony, and a  
22 finding that the Company's requested ROE of 10.30 percent in this case is just and  
23 reasonable.

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<sup>10</sup> FitchRatings Special Report, *Tax Reform Impact on the U.S. Utilities, Power & Gas Sector*, January 24, 2018.

- 1 Q. DOES THIS CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?
- 2 A. Yes, it does.