

BEFORE THE WYOMING PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE AMENDED)
GENERAL RATE APPLICATION OF)
PINEDALE NATURAL GAS, INC., FOR) Docket No. 30016-41-GR-06
AUTHORITY TO ESTABLISH A) Record No. 10400
REVISED OVERALL RATE OF)
RETURN OF 11.5% TO REFLECT)
CHANGES IN THE COSTS OF)
PROVIDING NATURAL GAS SERVICE)

PRE-FILED DIRECT TESTIMONY OF

Bryce J. Freeman

On Behalf of the Office of Consumer Advocate

Testimony Filed: January 8, 2008

Hearing Begins: January 15, 2008

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Bryce J. Freeman. My business address is 2515 Warren Avenue, Suite 304, Cheyenne, WY, 82002. I am the Administrator of the Wyoming Office of Consumer Advocate (OCA). The OCA is an independent consumer advocacy agency that was created by an act of the legislature in the 2003 general session.

Q. WHAT IS THE FUNCTION OF THE OCA?

A. Pursuant to W.S. § 37-2-401,

The office of consumer advocate shall represent the interests of Wyoming citizens and all classes of utility customers in matters involving public utilities. In the exercise of its powers the office of the consumer advocate shall consider all relevant factors, including, but not limited to, the provision of safe, efficient and reliable utility services at just and reasonable prices.

Q. ARE THE ANALYSES AND RECOMMENDATIONS OF THE OCA, IN THIS OR ANY OTHER CASE BEFORE THE COMMISSION, INFLUENCED OR DIRECTED BY THE COMMISSION?

A. No. Although the OCA is a division within the Commission according to W.S. § 37-2-401, it is a separate division with no reporting or supervisory links to the Commission and the OCA has the right under W.S. § 37-2-402(ii), to appeal decisions of the Commission that it does not find in the public interest. The only link between the OCA and the Public Service Commission is the source of common funding provided by the assessment on gross utility operating revenues; this assessment funds both the Commission and the OCA. Additionally, as Administrator of the OCA I report directly to the Governor of Wyoming.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND OCCUPATIONAL EXPERIENCE.

A. I received a Bachelor of Science degree in business administration from the University of Wyoming in 1982. The area of concentration in my undergraduate work was statistics. After graduating from the University of Wyoming, I was employed for three years by the Laramie County Treasurer as Deputy Treasurer, and then for six years by the Wyoming Department of Revenue as a Principal Appraiser dealing primarily with utility valuation and capital cost issues. I came to the Wyoming Public Service Commission in April of 1994, in the capacity of Senior Economist, serving in that position for approximately two years. In 1996 I accepted a position as Lead Rate Analyst in the rates and pricing section on the Commission Staff, and in May of 2003 I was appointed Administrator of the OCA.

Q. HAVE YOU TESTIFIED BEFORE THIS COMMISSION IN PREVIOUS PROCEEDINGS?

A. Yes. I have detailed the cases in which I have testified before this Commission, in Appendix A attached to my testimony.

Q. ON WHOSE BEHALF DO YOU APPEAR HERE TODAY?

A. I appear here today on behalf of the OCA. As I indicated previously, the OCA is an independent party in this proceeding, separate and apart from the Commission or its advisory staff.

Q. AS A MEMBER OF THE OCA, DO YOU ADVOCATE THE INTERESTS OF CERTAIN GROUPS OF CONSUMERS OVER OTHERS?

A. No. As a member of the OCA, it is my statutory obligation to advocate the best interest of all citizens in the state. Specifically, W.S. § 37-2-401 states that the OCA “shall represent the interests of Wyoming citizens and all classes of utility customers in matters involving public utilities.” This public interest standard requires the OCA to represent the broadest possible utility consumer constituency, even though some of those consumers may also be represented independently as parties in this case. The OCA is responsible for balancing the positions and recommendations of the Company, and of other parties, to arrive at a set of recommendations that serve the overall long term public interest.

Q. ARE YOU SPONSORING ANY EXHIBITS IN THIS PROCEEDING?

A. Yes, I am sponsoring one exhibit labeled as OCA Exhibit BJJ 1 which is attached to my testimony in this proceeding.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony in this proceeding, in association with testimony offered by Ms. Amy Zamora on behalf of the OCA, is to address the five specific issues that the Commission identified for review in its order granting rehearing in this docket. Specifically, those issues are as follows:

- a. A review of the evidence received by the Commission as contained in the record to ensure that the record is complete.
- b. A review of rate case expense and particularly the claimed legal/consultant expense as amortized for inclusion as an expense.

- c. A review of interest calculated on shareholder loans to reflect the reduced level of the shareholder loans as submitted by the Company.
- d. A review of the “reset” interest rate on an existing legacy loan as submitted in a promissory note.
- e. A review of the basis for setting depreciations expense as found by the Commission in its Order.
- f. Rate design/rate spread issues.

In her testimony Ms. Zamora will address items b, c, e and f in the above list and my testimony will address item d, about which I testified at length in the original proceeding. The OCA will also be pleased to provide any assistance that the Commission may require in the satisfaction of item a in the above list although I will not address that particular item in my testimony in this proceeding.

Q. YOU AGREED WITH THE COMPANY ABOUT THE NEED FOR THIS REHEARING. DOES IT FOLLOW THAT YOU ALSO AGREE WITH COMPANY’S POSITION ON THIS ISSUE?

A. Not at all. It is my understanding from a layman’s perspective that the Company is entitled to rehearing if additional information comes to light, or if the facts and circumstances in evidence change, raising the possibility that the Commission’s determination might have been different if the additional information had been in evidence when the case was originally heard. In this case, the Company demonstrated that subsequent to the Commission’s order in this proceeding the interest rate on the above cited loan was reset to a higher level causing the Company to incur additional interest expenses that were not reflected in the Commission’s original finding. Pinedale sought rehearing on this issue and others as specified above. The OCA agrees that this is additional information and is ripe for rehearing, but we do not agree, as I will describe in my testimony, that the additional interest expense should be included in the final rates approved by the Commission.

Q. WAS THE SUBJECT OF THE INTEREST ON THIS LOAN RAISED IN THE ORIGINAL HEARING?

A. Yes. In fact extensive testimony was provided on this issue in the original hearing from both myself, on behalf of the OCA, as well as several witnesses for the Company. In its final order in the original proceeding, the Commission determined that since the interest rate had not been reset at the time the order was issued it was therefore not a known and measurable change and thus provided no basis upon which to increase the Company's interest expense.

Q. WHAT WAS YOUR POSITION REGARDING THE INTEREST EXPENSE IN QUESTION DURING THE ORIGINAL PROCEEDING?

A. My position on this issue is that the Company has failed to adequately support the need for this increased interest expense because it has failed to demonstrate, by the weight of substantial evidence, that the terms of the loan yield the lowest cost financing alternative reasonably available to the Company. Specifically, in its application, as well as during the rate case hearing, PNG witnesses testified that PNG has been aggressively seeking alternative financing for over ten years without success. PNG's owners testified that the Company is limited to very few financial institutions that will offer loans to PNG and that those offers come with restrictive conditions including the personal guarantee of the loans through a pledge of the owners' personal assets. PNG witnesses further testified that these lending restrictions essentially limit the company to relatively short term variable rate financing.

Yet, PNG witness Moses testified during the rate case hearing that longer term fixed rate financing would be available to the Company, albeit at a higher rate than that incorporated in the current loans at the time they were established. Mr. Moses testified that the bank loans currently on the books of the utility are short term loans that are indexed to the prime lending rate and the interest rate is reset periodically causing PNG's interest expense to fluctuate.

Q. HAS YOUR POSITION ON THIS ISSUE CHANGED?

A. No. I believe that the 6.8% cost of debt determined by the Commission and enumerated in its final order in this case is just and reasonable and in the public

interest. This is the cost of debt that the Company proposed when it filed the case, although it included debt service for two loans that had not been approved prior to the filing of the rate case application.

Pinedale amended its original application twice during the pendency of the original application, presumably to incorporate more cost into the rates to be charged to customers. However, it was left to the OCA to determine appropriate adjustments to revenue so that matching of revenues and expenses could be maintained. The OCA made and the Commission accepted the required adjustments. Now the Company wishes to further amend its filing to include interest expenses that it has allegedly incurred far beyond the end of the test year and which were not included in its financial and accounting statements in the original application.

The OCA based its analysis and recommendations in this case on the information that was available during the original proceeding, including its recommended weighted average cost of capital. All of those recommendations were designed to be integrated into rates that reasonably match revenues and expenses that will reflect the Company's costs during the period for which those rates are expected to be in effect. We are now more than a year beyond the end of the projected test year with actual known book test year numbers being compiled far before the end of the projected test year. The further beyond the end of the test year that changes are made to specific test year elements the less certain that all of the other elements, when combined, will actually match and be reflective of the rate effective period. The OCA is convinced that we are well beyond that point in this case and strongly recommends that the Commission resist the Company's request to continue revising the test year information. If the Company believes that the rates approved in the original proceeding, based on information that it filed and amended twice, are no longer reflective of its ongoing costs of operations, then it is free to file a new rate case at any time it deems appropriate.

Q. IF THE COMMISSION IS INCLINED TO ACCEPT THE ADDITIONAL INFORMATION OFFERED BY THE COMPANY SHOULD ALSO ACCEPT THE COMPANY'S NEW PROPOSED COST OF DEBT?

A. No. In order to account for the Company's prudently incurred debt expense it will be necessary to adjust the actual amended debt expense as I will describe in the remainder of my testimony.

Q. DO YOU BELIEVE THAT THE COMMISSION'S DETERMINATION AT THE TIME THIS LOAN WAS APPROVED WOULD HAVE BEEN DIFFERENT HAD IT KNOWN ABOUT THE OPPORTUNITY FOR LONGER TERM FINANCING?

A. I think it is very likely that it would have. Given the opportunity to choose between a presumably lower cost, short term, variable rate source financing and longer term, perhaps higher rate source of financing, it is quite likely that the longer term financing, even though it might have carried a higher initial rate, would have been shown to be the lower cost source of financing over the long term. The point is that the Company deprived the Commission of the opportunity to make that decision because it did not present all reasonable financing alternatives, including a long term fixed rate alternative, to the Commission at the time the original loan was approved.

Q. CAN YOU GIVE THE COMMISSION AN EXAMPLE OF THE RELATIVE COST DIFFERENCE BETWEEN FIXED AND VARIABLE RATE FINANCING?

A. Yes. The simple table I have prepared in OCA Exhibit BJT 1 shows the difference in total interest cost between variable rate financing and fixed rate financing. While this example does not match the parameters of Pinedale's existing loan exactly, it is roughly similar. In this example I have assumed an original loan amount of \$500,000 to be amortized over a ten year period. In the variable rate column I assume that the annual interest rate is set at 6% for an initial three year period and reset to an 8.25% annual rate for years four through

ten. In the fixed rate column I assume that the entire principle amount of the loan will be amortized over the ten year period at an annual rate of 7%. As can be seen the fixed rate financing option results in interest cost savings of \$4,664.16 over the ten year life of the loan. Prudence dictates that the dollar difference between the variable rate financing that PNG proposes and the lower cost fixed rate financing, should not be allowed in customer rates.

Q. HOW DO YOU PROPOSE TO REMOVE THIS AMOUNT FROM RATES?

A. Since we don't know the exact dollar amount that should be disallowed, owing to the fact that it would be nearly impossible to determine what fixed annual interest rate would have been applicable at the time the original loan was approved, I suggest we go back to basic financial theory to determine the appropriate cost of debt to be included in PNG's rates.

For example, we know that there is a theoretical risk premium that investors demand for accepting the risk of equity investments over debt. We also know PNG's required return; it was established by the Commission in the original order in this case and is not subject to review in this rehearing proceeding. The allowed rate of return on equity is 10.75%. All that is necessary in order to determine an appropriate cost of debt for PNG, therefore, is to estimate a reasonable risk premium which can then be subtracted from PNG's allowed ROE to estimate a prudent debt rate.

Based on recent work that I have done in another case, I know that recent allowed returns on equity are averaging approximately 10.37% and utility bonds are yielding in the range of 6.45%. The difference between allowed returns on equity and the yield on debt is the risk premium that I spoke of earlier. Subtracting the 6.45% debt yield from the 10.37% equity return results in an average risk premium of 3.92%, which, when subtracted from PNG's allowed return indicates a cost of debt of 6.83%. These calculations are shown on OCA Exhibit BJJ 2.

Q. THIS IS A LOWER RATE THAN PNG WILL ACTUALLY BE INCURRING TO AMORTIZE THE LOAN. IS THAT REASONABLE?

A. Certainly. It is not uncommon for utilities to incur larger expenses for some items than are included in rates, for example if labor costs increase after rates are set then the rates will not recover all of the labor expense incurred by the utility. To be sure, some costs decrease as well, as the utility has the incentive manage its costs within the confines of existing rates to maximize its profit. If expenses increase to the point that the utility is not earning a fair return on its investment then it must request an increase in revenues.

Q. ISN'T THE COMMISSION REQUIRED TO ALLOW THE COMPANY TO RECOVER ITS KNOWN AND MEASURABLE COSTS?

A. The Commission is only required to afford the Company a reasonable opportunity to recover its prudently incurred expenses and earn a fair return on its investment in utility facilities. Had the Company been prudent in its capital financing practices, in my judgment, it would have achieved a lower capital financing cost. Capital financing costs over the level that I've estimated in this case are imprudent and should not be recovered in customer rates.

Q. SO, IS THE COMPANY JUST OUT OF LUCK IN RECOVERING THE INCREASED INTEREST EXPENSE ASSOCIATED WITH THIS LOAN?

A. No. The Company has a number of options available to it to mitigate this disallowance. First, the Company should certainly understand that it must do all it can to minimize its cost of capital financing because imprudent amounts will not be recovered from customers. If the Company is paying annual interest based on an 8.25% rate but is only recovering 6.83% in rates it should immediately seek to refinance the loan with lower cost capital and should apply to the Commission for approval of any such refinancing.

Secondly, the Company certainly has the ability, as I said earlier, to manage its costs to mitigate the impact of this increase in interest expense. If interest

expenses can't be reduced to the level approved by the Commission the Company certainly has the opportunity to reduce expenses in other areas, through efficiencies and sound management of the utility, to offset the shortfall.

Finally, as with all other expenses incurred by the utility, if those expenses increase to the point that earnings are insufficient to produce an acceptable return, then the Company is free to request that the Commission review the expenses and authorize a rate increase if necessary. The point here is that the actual expenses of a utility are almost never included in the revenue requirement used to set rates without adjustment. Rather, the actual expenses are used as a starting point and on a relative basis are subjected to tests of reasonability and prudence. Interest on long term debt is no different from any other operating expense in this regard.

Q. SHOULD A REFINANCING OF THIS LOAN BE APPROVED AUTOMATICALLY?

A. No, particularly in light of the fact that the Commission didn't have all of the information necessary to make an informed decision at the time it issued its original order approving this loan. The referenced statutes set out a minimum threshold that securities filings must meet in order to approved. But, W.S. § 37-6-101 also requires the issuance to in the public interest. My contention is that had the Company provided all of the information necessary to support its original application, including a long term fixed rate financing alternative, the Commission may well have found the Company's selected short term variable rate financing to be inconsistent with the public interest, even if all of the other statutory requirements were satisfied. The Commission should not allow PNG to deprive it of its lawful right and obligation to make such a public interest determination.

Q. DO YOU HAVE ANY THOUGHTS WITH REGARD TO THE COMPLETENESS OF THE RECORD IN THIS PROCEEDING?

A Yes. As stated in our response to PNG's initial petition for rehearing, we are generally concerned that certain aspects of the Commission's decision, may lack

full support in the record. This statement was made specifically with regard to the rate design proposed by Mr. Biedermann during deliberations and subsequently adopted by the Commission. The OCA supports the curative action taken by the Commission during this rehearing.

Q. HAVING EXPRESSED CONCERN WITH REGARD TO THE COMPLETENESS OF THE RECORD AND SUPPORT OF CURATIVE ACTION, DOES THE OCA TAKE ISSUE WITH ANY ASPECT OF THE ORDER WHICH MAY HAVE LACKED FULL SUPPORT IN THE RECORD DURING THE INITIAL PHASES OF THIS PROCEEDING?

A. No.

Q. DOES THAT CONCLUDE YOUR TESTIMONY IN THIS REHEARING PROCEEDING?

A. Yes, it does.

Year	Ten Year Financing Cost ¹	
	Variable Rate Financing ²	Fixed Rate Financing ³
1	\$28,976.19	\$33,865.91
2	\$26,655.37	\$31,277.61
3	\$24,190.41	\$28,502.97
4	\$29,789.79	\$25,527.36
5	\$26,203.97	\$22,336.64
6	\$22,310.11	\$18,915.27
7	\$18,082.96	\$15,246.56
8	\$13,493.57	\$11,312.64
9	\$8,510.91	\$7,094.34
10	\$3,101.28	\$2,571.10
Total	\$201,314.56	\$196,650.40
Interest		

¹ \$500,000 original loan amount.
² Assumes a 6% annual interest rate for the first 3 years and 8.25% APR
³ Assumes a 7% APR for the entire amortization of the loan.

Pindale Allowed ROE	10.75%
Average Allowed Utility ROE	10.37%
Average Utility Bond Yield	6.45%
Average Equity Risk Premium	3.92%
Pinedale Cost of Debt	6.83%