IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PETITION OF PUBLIC SERVICE COMPANY OF NEW MEXICO FOR A REVISION TO ITS RATES, RULES AND CHARGES PURSUANT TO ADVICE NOTICE NOS. 755 AND 756,

PUBLIC SERVICE COMPANY OF NEW MEXICO,

Appellant,

vs.

NEW MEXICO PUBLIC REGULATION COMMISSION,

Appellee.

APPEAL FROM THE NEW MEXICO PUBLIC REGULATION COMMISSION

BRIEF OF AMICUS CURIAE THE NEW MEXICO UTILITY SHAREHOLDERS ALLIANCE

JONES, SNEAD, WERTHEIM & WENTWORTH, P. A.
JERRY WERTHEIM
JERRY TODD WERTHEIM
CAROL A. CLIFFORD
1800 Old Pecos Trail
P. O. Box 2228
Santa Fe, New Mexico 87504-2228
Telephone: (505) 982-0011
Fax: (505) 989-6288

Attorneys for Amicus Curiae
New Mexico Utility Shareholders Alliance

INTERESTS OF AMICUS CURIAE

The New Mexico Utility Shareholders Association ("NMUSA") is an association of shareholders of companies serving electric and gas utility industries in New Mexico. As shareholders in these New Mexico companies, NMUSA's members are deeply concerned that the rate of return authorized by the New Mexico Public Regulation Commission ("PRC" or Commission") for Public Service Company of New Mexico ("PNM") will hurt the company's chances of attracting capital from investors who can obtain higher rates in other jurisdictions. This will in turn suppress PNM's stock value for existing shareholders, many of whom NMUSA represents as a grassroots advocacy group.

On behalf of the New Mexico Utility Shareholders Alliance, Executive Director Carla J. Sonntag filed comments at the hearing before the Commission on December 13, 2006. Ms. Sonntag stressed that the proposed rate of return would "ensure safety, reliability and a viable company that [would] continue to provide for [New Mexico's] natural gas needs." RP ___. Investors have a legitimate interest in the financial integrity of regulated companies, and with specific reference to authorized rates of return, to assure that there is enough revenue not only for operating expenses but also for the capital costs of the business, its debt service and dividends on stock. *Fed'l Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S. Ct. 281, 288 (1944). The Commission's order on rate of return resulted in a failure to consider investor interests. It placed PNM far outside its peer group of regulated gas utilities. NMUSA asks this Court to set aside the Commission Order and remand this matter for further hearings on an

appropriate rate of return. NMUSA, as a representative of PNM shareholders, will highlight in its brief how the Commission failed to consider the financial integrity of PNM.

ARGUMENT

I. INTRODUCTION: THE NEW MEXICO PUBLIC REGULATION COMMISSION HAS FAILED TO MEET THE LEGAL STANDARDS FOR ADOPTION OF A FAIR AND REASONABLE RETURN ON EQUITY.

In its Final Order in Case 06-00210-UT, a rate case addressing the gas services operation of PNM, the Commission approved a return on equity of 9.53% for company. This rate was not supported by substantial evidence and, in arriving at this rate, the Commission acted in an arbitrary and capricious manner. Amicus Curiae, the New Mexico Utility Shareholders Alliance ("NMUSA"), submits this Brief in Chief in support of Public Service Company of New Mexico's appeal from the Final Order, specifically, PNM's contention that the Commission's approval of a rate of return on equity of 9.53% is not supported by substantial evidence in the record.

To fulfill its statutory charge under the Public Utilities Act in setting rates, the Commission has a duty to consider the interest of investors like the members of the NMUSA:

> It is the declared policy of the state the public interest, the interest of consumers **and the interest of investors** require the regulation and supervision of such public utilities to the end that reasonable and proper services shall be available at fair, just and reasonable rates, and to the end that capital and investment may be encouraged and attracted so as to provide for the construction, development and extension, without unnecessary duplication and economic waste, of proper plants and facilities for the rendition of service to the general public and to industry. Section 62-3-1(B) (1967) (emphasis supplied).

See also State v. Mountain States Tel. & Tel. Co., 54 N.M. 315, 325, 224 P.2d 155, 162 (1950). (the regulation of rates to be charged the public by public service corporations is a legislative function which has been delegated by legislature to the Commission); *and In re Petition of PNM Gas Serv.*, 2000-NMSC-012, para. 8, 129 N.M. 1, 9, 1 P.3d 383, 391 ("A reasonable rate of return is one that provides a fair opportunity for the utility to receive just compensation for its investments, . . . and that fulfills the statutory goal in Section 62-3-1(B) of enabling the utility 'to attract new capital to maintain, improve, and expand its services in response to consumer demand.'"), *citing* C.F. Phillips, *The Regulation of Public Utilities* at 170 (Pub. Util. Rep. 1993).

In reaching its decision below, the Commission omitted consideration of evidence that reflected investor's interests and expectations: The resulting return on equity did not properly balance investor interests. PNM's expert below, Dr. Samuel C. Hadaway, stressed the importance of investor interests in the Commission's determination of a rate of return for PNM: "Equity investors expect a return on their capital commensurate with the risks they have and consistent with returns that might be available from other similar investments. Hadaway Testimony at 7, lines 7 to 8. "For the utility to raise capital to finance replacement and new plant and equipment, it must have adequate return dollars to assure lenders that they will be paid." Hadaway at 9, lines 1 to 3. "In sum, utilities must be provided an opportunity to earn a return so that interest on debt can be paid and access to equity capital markets can be maintained. This, in turn, allows the utility to provide safe and reliable service to its customers." Hadaway at 9, lines 8 through 11.

In setting rates of return to achieve these statutory goals, this Court has charged the Commission with considering, among other factors, "current economic conditions,

the present cost of capital, [and] the rate of return of other enterprises having corresponding risk[.]" *Southern Union Gas Co. v. N.M. Pub. Serv. Comm'n*, 84 N.M. 330, 333, 503 P.2d 310, 313 (1972). There must be evidence to support the rate of return achieved through this process. *Id.*

The United States Supreme Court addressed these considerations in *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W.V.*, 262 U.S. 679, 692-93, 43 S. Ct. 675, 679 (1923) ("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; . . ."). *Accord Fed'l Power Comm'n v. Hope Nat'l Gas Co.*, 320 U.S. 591, 603, 64 S. Ct. 281, 288 (1944) ("By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."). This Court has cited *Bluefield* with approval in *In re Rates and Charges of Mountain States Tel. & Tel. Co.*, 99 N.M. 1, 8, 653 P.2d 501, 508 (1982).

PNM's witness testified that "[t]he cost of equity capital is the rate of return that equity investors expect to receive." Hadaway Testimony at 7, line 3. Consistent with Dr. Hadaway's testimony, a well-regarded expert in the field of regulatory finance, Dr. Roger A. Morin, explains that "the cost of capital to the utility is synonymous with the investor's return, and the cost of capital is the earnings that must be generated by the investment of that capital in order to pay its price, that is, in order to meet the investor's

required rate of return." R.A. Morin, *New Regulatory Finance* at 22 (Pub. Util. Rep. 2006). If the returns on investments of comparable risk are not the same, "the investor will switch out of those investments yielding low returns for the same degree of risk. This implies that a utility will be unable to attract capital unless it can offer returns to capital suppliers comparable to those achieve on alternate competing investments of similar risk." *Id.* From the perspective of amicus curiae NMUSA, the New Mexico Commission's actual and categorical exclusion of reasonable methods and results ignored important evidence of the demands of investors, which will make it difficult for PNM to attract capital. The Commission has failed its statutory and common law duty to balance investor and consumer interests, and has chosen a rate of return and range that are unreasonable, not supported by substantial evidence, and without rational basis.

II. THE COMMISSION'S CALCULATIONS RESULTING IN A RETURN ON EQUITY OF 9.53%, EMPLOYED NUMBERS IN THE RECORD THAT WERE NOT SUPPORTED BY ANY WITNESS.

The Commission has breached fundamental principles of fairness governing its actions: "Its great responsibility to the public requires the Commission to be thorough in its decision making. It must weigh all the evidence in the case and not arbitrarily disregard particularly important and qualified testimony." *Amer. Auto. Ass'n v. State Corp. Comm'n*, 95 N.M. 227, 229, 620 P.2d 881, 883 (1980). By rejecting expert testimony underpinning the methods used to achieve the results relied upon by the Commission, the Commission has left its rate and range unsupported by substantial evidence, without rational basis, and in the realm of unreasonableness.

An authorized rate of return is not supported by substantial evidence where, as is in this case, it is contradicted rather than supported by evidence in the record. *See In re*

Rates and Charges of Mountain States Tel. & Tel. Co., 99 N.M. at 7, 653 P.2d at 507. *See also Att'y Gen'l v. N.M. Pub. Util. Comm'n*, 2000-NMSC-008, para.6, 128 N.M. 747, 998 P.2d 1198 (2000) (The Court may reject that Commission's decision if "conflicting evidence renders incredible the evidence in support of the decision."), *citing Otero County Elec. Coop., Inc. v. N.M. Pub. Serv. Comm'n*, 108 N.M. 462, 465-66, 774 P.2d 1050, 1053-54 (1989). A result is arbitrary and capricious where it is "unreasonable or without a rational basis, when viewed in the light of the whole record." *Rio Grande Chapter of the Sierra Club v. N.M. Mining Comm'n*, 2003-NMSC-005, ¶ 17, 133 N.M. 97, 61 P.3d 806.

In approving a 9.53% return on equity, from a range of 9.17 to 9.9%, the Commission accepted a rate and a range that were rejected by the only two rate-of-return witnesses in the case. Those two witnesses were Dr. Samuel C. Hadaway on behalf of PNM and Mr. Thomas C. Patin on behalf of the Utility Division Staff of the Commission and supported by the Attorney General and the NNSA as a basis for the decision. The Commission rejected the testimony of Mr. Patin. RD at 51. The only testimony at issue, either in support of or in contradiction of the Commission's authorized rate, is that of PNM's witness, Dr. Hadaway. It was the testimony of Dr. Hadaway, and Dr. Hadaway alone, that the Commission cited as support for its calculations of rate of return. RD at 48. No other witness testified to the appropriateness of the rate-of-return of 9.53% adopted by the Commission.

In arriving at this rate and range, the Commission applied the traditional constant growth discounted cash flow ("DCF") model. Order at 9, para. 19 ("[T]he Commission agrees with the Hearing Examiner's recommendation that PNM's Traditional Constant

Growth DCF model, after eliminating Dr. Hadaway's proposed nominal GDP growth factor, should provide the basis for determining the ROE in this case."). The Commission relied upon the methods and calculations of PNM's witness, Dr. Hadaway, but rejected his testimony and opinions about those methods and calculations. The Commission was not merely weighing evidence in the record, it undertook to make calculations based on figures in the record that had been rejected by the witness who presented them. No other witness testified to the appropriateness of the rate-of-return of 9.53% adopted by the Commission.

Dr. Hadaway's testimony worked as a piece, but the Commission fragmented his opinions and inputs, picking and choosing to reach a result. On behalf of PNM, Dr. Hadaway recommended a return of 11 percent, employing alternative versions of the DCF model and checked the results against the results of applying the risk premium method and a review of forecasted interest rates. Testimony at 2.

Generally speaking, under the DCF model an estimated return on equity "is simply the sum of the expected dividend yield and the expected long-term dividend (or price) growth rate." Hadaway at 16, lines 6 to 7. Dr. Hadaway initially made calculations under three DCF methods: (1) traditional constant growth DCF model; (2) the constant growth model, long-term DCF model; and (3) the low near-term growth, two-stage growth. Hadaway Direct at 31, lines 16 to 20; 32, lines 1 to 6. Dr. Hadaway began with a selection of a 10-company group of local distribution companies ("LDCs") with investment grade senior secured bond ratings (at least BBB or Baa from either Standard & Poor's or Moody's). Hadaway Direct at 3, lines 6 to 8. The dividend yields used in each of the three models is taken from Value Line's dividend projections for the

coming year and stock prices. Hadaway Direct. at 32, lines 6 to 8. Neither Dr. Hadaway's 10-company group nor his projected dividend yields were called into question, indeed, they form a part of the analysis of both the Commission and the Hearing Examiner. Order at 9, para. 19; RD at 48.

Dr. Hadaway's traditional constant growth DCF model employs four equally-weighted estimates from data provided by major investment services, Value Line and Zacks. Direct at 31, lines 16-20 and 32, lines 1 to 8. Dr. Hadaway's second model, the constant growth, long-term DCF model uses Value Line's projected growth in nominal GDP for the DCF growth rate. Hadaway Direct at 32, lines 2 to 3. His third model, the two-stage model, uses Value Line's three-to-five year dividend growth projections and long-term projected growth in GDP. Hadaway Direct at 32, lines 3 to 6.

Dr. Hadaway's updated three-model DCF analysis produced a range of 10.4 percent to 11.0 percent. Hadaway Rebuttal at 20, lines 15 to 16 & PNM Ex. SCH-3, Rebuttal. He excluded the result of the traditional constant growth DCF model of 9.6 to 9.7 percent because those results failed to meet his risk premium checks of reasonableness addressed in this brief under Paragraph III. Hadaway Rebuttal at 20, lines 18 to 21. Each of Dr. Hadaway's DCF methods applied a gross domestic product ("GDP") growth factor of 6.6% as a component of his calculation. *See, e.g.,* PNM Ex. SCH-3 Rebuttal. Dr. Hadaway provided extensive testimony in regard to the value of GDP growth estimates in lieu of other growth data. *See, e.g.* Hadaway Direct at 31, lines 16 to 20 to 35, lines 1 to 4.

The Commission took Dr. Hadaway's results and altered them to achieve an authorized return of 9.53 percent. Final Order at 9, para. 21 to 11, para. 23. Neither the

floor nor the ceiling adopted by the Commission find support in the record, and, therefore, its final resulting median rate of 9.53 percent is unsupported by substantial evidence, unreasonable, and lacks a rational basis.

To establish its floor, 9.17%, the Commission averaged the B*R, Zacks and Value Line growth estimates (4.94%), and average dividend yield (4.23%) in Dr. Hadaway's exhibit, PNM Exhibit SCH-3 Rebuttal at 2. Order at 9, para. 19 & 10, para. 21. *See also* RD at 48 *and* PNM Ex. SCH-3 Rebuttal at 2. In employing these figures, the Commission ignores Dr. Hadaway's criticism of these results and rejection of the rates derived from these calculations, with nothing in the record to support its own position. Order at 9, para. 19. The effect of eliminating Dr. Hadaway's GDP growth factor from this calculation is to lower the estimate by 43 basis points. PNM Ex. SCH-3 Rebuttal at 2. No consideration is given to the results of Dr. Hadaway's other two models. PNM Ex. SCH-3 Rebuttal at 3-4. The only rationale provided by the Commission for this calculation is it had "often relied upon the Value Line and BR growth factors" in the past, and the Zacks factor was between the other two factors, thus, "a good indication that the Zacks factor also provides a valid measure of growth." Order at 10, para. 21.

To establish the top end of its range, 9.9%, the Commission added the Value Line growth factor of 5.67% to the dividend yield of 4.23% from Dr. Hadaway's Exhibit, PNM Exhibit SCH-3, p. 2. Order at 10-11, para. 22. The only explanation for including only the Value line growth factor, to establish the upper limit of its range is "the Commission's long-standing reliance upon Value Line as an accepted measure of growth[.]" Order at 11, para. 22. No other explanation is given for the exclusion of other growth estimates used by Dr. Hadaway in his version of the traditional constant growth

DCF model. Again, no consideration is given to the results of Dr. Hadaway's other 2 models. PNM Ex. SCH-3 at 3-4. For its authorized ROE, the Commission picked the rate that represented the average of its floor and ceiling, 9.535%. Order at 11, para. 23.

The Commission fails to explain why three growth estimates should be used to establish a floor of 9.17% and only one growth estimate, Value Line, should be considered in setting its ceiling rate of 9.9%. It is not enough to merely demonstrate calculations used to achieve a result, the Commission must explain how that result is supported by credible evidence in the record. The Commission may not rely wholly on its own expertise. *N.M. Att'y Gen'l v. N.M. Pub. Util. Comm'n*, 2000-NMSC-008, para. 13, 128 N.M. 747, 751, 998 P.2d at 1202 (*"Att'y Gen'l v. NMPUC")*. Cobbling a result from the fragments of Dr. Hadaway's work, cannot provide substantial evidence, and is arbitrary and capricious.

The Commission rationalized use of the DCF model based on past practice: "the Commission is part of the majority of states that place primary reliance on the DCF model, and no party, including PNM, has presented any credible alternative methodology." Order at 9, para. 19. The Commission's previous use of the traditional constant growth DCF model does not justify its selective use of calculations within the model results presented by Dr. Hadaway.

Recognizing that it had deviated from the logic of the Hearing Examiner's recommendations, the Commission provides the following justification: "Although the Commission and the Hearing Examiner used different routes to arrive at substantially the same ROE, it is 'the result reached, not the method employed which is controlling.'" Order at 22, para. 23, *citing Hobbs Gas Co. v. N.M. Pub. Serv. Comm'n*, 94 N.M. 731,

734, 616 P.2d 1116, 1119 (1980). The Commission also relies on an order of the New Mexico Public Service Commission, *In re Pub. Serv. Comm'n,* 73 P.U.R.4th 617 (1985) to support the notion that the "Commission can mix and match testimony and calculations and set a reasonable return that is not a figure that any single witness recommends." Order at 16, page 8.[1] The Commission then expands upon this concept:

> In other words, the test is not whether the Commission's determinations in a case were previously presented in a hearing and subject to cross-examination, but whether the facts relied upon to make that determination were presented in the hearing and subject to cross-examination." Order at 8, para. 16.

This "mix and match" approach to models and model results, is inconsistent with past practices of New Mexico's regulatory commissions. To begin with, in the case relied upon by the Commission, *In re Pub. Serv. Comm'n,* 73 P.U.R.4th 617, 629-30 (1985), the New Mexico Public Service Commission addressed a challenge to the hearing examiner's use of two different growth estimates in his DCF calculations:

> While the use of two different growth rates is technically inconsistent with a true constant growth DCF model, it does not violate the theoretical underpinnings of the widely accepted general DCF model. Numerous cost of capital witnesses have successfully presented testimony before this commission using separate growth rates in their DCF analyses to estimate the expected dividend and long-term growth rates. Indeed, PNM's witness in this case, Dr. Moyer, relied on a nonconstant growth version of

[1] The Public Service Commission's holding in that case, does not support the approach taken by the Commission in the present case. In its 1985 order, Public Service Commission supports the use of multiple methods to achieve a reliable result. One of the issues raised in that case was whether the hearing examiner erred in using two dividend growth rates in the constant growth DCF model. In response to this challenge, "the commission [found] that the use of multiple growth rates in a DCF analysis is not 'schizophrenic,' is commonly relied upon, and is a legitimate application of the DCF model." at 17. Further, "[t]he proper application of the DCF model requires the use of the best estimate of investor expectations regarding the expected dividend and the long-term growth rate. The best estimate may be based upon a constant growth model, a nonconstant growth model, or a combination of the two."

> the DCF model in his analysis. The commission finds that the use of multiple growth rates in a DCF analysis is not "schizophrenic," is commonly relied upon, and is a legitimate application of the DCF model.

It was proper, therefore, to adjust the growth factors used in the DCF model and to use different versions of the model: Such pragmatic adjustments not categorical disqualify the estimate or the opinion of the expert tendering the resulting estimate. Similarly, in *In re PNM Gas Serv.*, 176 PUR 4th 89, 1997 WL 107295 *178 (N.M.P.U.C. 1997), the Public Regulation Commission cited the results of one witnesses multi-stage DCF model as confirmation that its decision adopting Staff's witness's recommendation based on the "dividend yield plus growth version of the DCF model" was correct. New Mexico's regulatory bodies have not regarded the traditional DCF model in a monolithic way. They have viewed the results of various methods in the context of the testimony and evidence before them.

Thus, while the Commission was not bound to accept Dr. Hadaway's testimony, it was obligated to enter an order that was supported by substantial evidence in the record. *Att'y Gen'l v. NMPUC,* 2000-NMSC-008, para.6, 128 N.M. at 749, 998 P.2d at 1200, *citing N.M. Att'y Gen'l v. N.M. Pub. Serv. Comm'n,* 101 N.M. 549, 554, 685 P.2d 957, 962 (1984). By deviating from Dr. Hadaway's results in a manner that he had rejected for principled reasons, the Commission's result deviated in an unsupported way from competent, credible evidence. *Pub. Serv. Co. of N.M. v. N.M. Pub. Serv. Comm'n,* 92 N.M. 721, 722, 594 P.2d 1177, 1179 (1979). Had some witness come forward with opinion or analysis in support of the Commission, this would be a different case.

To understand why the Commission's order does not find support in the record, one must examine the reasons Dr. Hadaway employed growth factors in his opinion. Dr.

Hadaway explicitly rejected the so-called traditional constant growth DCF results. Citing "[r]ecent events and current market conditions in the gas utility industry[,]" Dr. Hadaway testified that a reliable "constant" growth rate could not be achieved. Hadaway Testimony at 17, lines 18 to 22 & 18, lines 4 to 11. Dr. Hadaway supported this position with a comparison of 2001 and 2006 projected growth rates from Value Line Investment Surveys. PNM Ex. SCH-3. This comparison shows differences in projected growth rates of 2.7 and 1.6 percent. PNM Ex. SCH-3. These results, he concluded, express "dramatic changes in growth rates [that] are not consistent with the very long-term growth rate requirements of the constant growth DCF model." Hadaway Testimony at 34, lines 6 to 7.

In lodging its criticism of the use of the GDP growth factor, based on its assertion that "PNM has failed to show that investors expect the growth of Dr. Hadaway's comparable group of natural gas utilities to be the same as the overall economy," the Commission has simply ignored, rather than weighed, Dr. Hadaway's extensive testimony about the utility of GDP growth in estimating dividend growth. *See, e.g.,* Hadaway Direct at 32, lines 13 to 25. As Dr. Hadaway explains, the use of long-term economic growth rates, such as GDP, mediate the inconsistencies in the shorter-terms projections. Hadaway Direct, at 34, 1 to 9.

It is well-recognized that longer term growth projections mitigate the weaknesses of the DCF model, in recognition of the fact that "all company growth rates, especially utility services growth rates, converge to a level consistent with the growth rate of the aggregate economy." R.A. Morin, *New Regulatory Finance,* at 308. The use of nominal

GDP growth factors as part of a DCF analysis finds support in Dr. Morin's influential treatise as a way to mitigate the weaknesses of the DCF method:

> The problem is that from the standpoint of the DCF model that extends into perpetuity, analysts' horizons are too short, typically five years. It is often unrealistic for such growth to continue into perpetuity. . . . A reasonable alternative to the constant growth DCF model is to use a multi-state DCF model that more appropriately captures the path of future dividend growth . . . . The growth rate in U.S. real GDP has been reasonably stable over time. Therefore, its historical performance is a reasonable estimate of expected long-term future performance. R.A. Morin, *New Regulatory Finance*, at 308 to 311.

The Commission's critique of the GDP factor is unreasonable in light of Dr. Hadaway's factually uncontradicted testimony as to the value of GDP growth estimate. The Hearing Examiner, and by extension, the Commission, rely heavily on critiques of the use of the GDP growth factor found in decisions of other commissions, chiefly Illinois and Arkansas. RD at 39-42; Order at 9, para. 20.

The Hearing Examiner had stated that the use of nominal GDP growth had not been accepted by other jurisdictions, citing to an Illinois Commerce Commission decision rejecting the use of historic GDP growth. RD at 37 to 40. The Hearing Examiner concluded that "PNM has failed to meet its burden of proof that historic nominal GDP growth is a useful measure of expected growth for a regulated utility." RD at 40.

The Hearing Examiner accepts wholesale critiques of the method developed in the records of these other commissions. Apparently, this extensive use of the findings of other commissions is appropriate for this purpose, but entirely inappropriate when authorized rates of return that far exceed this Commission's result. *Compare* Order at 7, para. 15 *with* 9, para. 20. Both rulings, though inconsistent, are founded in the belief that the Commission can ignore the evidence before it and simply pick and choose what to

pay attention to: findings by other commissions, or mathematical models or raw data in the record before it.

In its exceptions, PNM cited the Commission to the *In re Application of Kansas City Power & Light Co.*, Case No. ER-2006-0314, 2006 WL 4041675 *11 (Dec. 21, 2006) (*"KCPL")*. PNM Exceptions, at 7, n. 2. In *KCPL,* the Missouri Public Service Commission authorized a return on equity of 11%, based on Dr. Hadaway's recommendation. *Id.* The Missouri Commission first established a range of reasonableness, 9.37% to 11.37%, using data from a survey of regulatory decisions from around the country. 2006 WL 4041675 *7. In the Missiouri case, as in the case below, Dr. Hadaway used the same three DCF models. 2006 WL 4041675 * 8. He applied the long-term forecasted growth in GDP which yielded a range of 11.2% to 11.3%, and the multi-state DCF model which yielded a range of 10.6% to 10.8%. *Id.* He excluded the results of his traditional DCF model, 9.3 to 9.4% as being too low. *Id.* The Commission adopted Dr. Hadaway's recommendation which was within the "zone of reasonableness" it had established, finding Dr. Hadaway's comparative group, and his analysis, the most credible. 2006 WL 4041675 *11.

In the case below, the Commission ignored the *KCPL* decision in regard to its analysis of the use of the GDP growth factor and risk premium method, relying instead on the decisions cited by the Hearing Examiner. Order at 9, para. 20.[2] Neither the

[2] The Commission also cites critiques of Staff and the Attorney General that patently misinterpret the decision. Order at 5, para. 10 & 6, para. 12. Staff reduces the *KCPL* holding to a reliance on Dr. Hadaway's superior credentials, a fact noted by the Missouri Commission, but not the sole reason, nor the most cogent reason, for the decision. *KCPL*, 2006 WL 4041675 *11. The Attorney General attempts to distinguish *KCPL* on the ground that the company has requested pre-approval of long-term rates, thereby rendering the circumstances unique. Order at 6, para. 12. The Missouri Commission

Commission nor the Hearing Examiner cite to any part of the record in lodging their critique of this factor. *See, e.g.*, RD at 51 ("The Commission has never accepted using nominal historic GDP growth as a basis for determining the growth rate in a DCF model. Accordingly, we will not rely on Dr. Hadaway's use of nominal historic GDP growth.") These general statements imply that the Commission and Hearing Examiner are falling back on the Commission's expertise to ferret out the right result, untroubled by the lack of a record to support their conclusions.

The purported fairness of the result reached cannot and will not substitute for credible evidence supporting that result. The record supporting a decision must demonstrate not only that the result was fair, but that the Commission properly fulfilled its duty to balance investor and consumer interests. The Commission's general statements to the effect that it has considered investor interests are no substitute for specific factual evidence. *Pub. Serv. Co. of N.M.*, 92 N.M. at 722, 594 P.2d at 1179.

The Commission's ROE result, the product of plucking numbers from witness exhibits outside the context of testimony and other evidence, does not meet the standard for rate-setting most clearly set forth in *Att'y Gen'l v. NMPUC.* In that case, the Court was asked to consider whether a decision of the PRC approving modifications to a rate design stipulated by the parties was supported by substantial evidence. 2000-NMSC-008, para. 5, 128 N.M. at 749, 998 P.2d at 1200. The Commission's approved plan established a two-tiered rate plan that was not suggested in the proposed stipulation. 2000-NMSC-008, para. 1, 128 N.M. at 748, 998 P.2d at 1199. The Court found the

---

authorized a 25 basis point "adder" on top of the 11% ROE to accommodate the company's needs during its near-term construction phase, analyzing this issue separately and quantifying the additional investment risk separately. 2006 WL 4041675 *11.

Commission's explanation of its modification to the stipulation was not supported by the record:

> The specific testimony relied upon by the PRC in support of their allegation is contrary to, rather than in support of, the PRC modification to the stipulation. . . . We believe the PRC has used a witness' discussion of the stipulation as the basis of an 'issue' or as 'evidence' in the record. This attempt is improper and must fail." *Att'y Gen'l v. NMPUC,* 2000-NMSC-008, para. 9, 128 N.M. at 750, 998 P.2d at 1201.

In overturning the PUC's order, the Supreme Court explained that the setting of rates based on raw data that is inconsistent with expert testimony and "taken out of testimonial context[,]" was not justified and the result is not supported by substantial evidence. *Att'y Gen'l v. NMPUC,* 2000-NMSC-008, para. 11, 128 N.M. at 750-51, 998 P.2d at 1201-1202.

The holding of *Att'y Gen'l v. NMPUC,* follows upon earlier decisions that reject the Commission's plucking of facts from the record, achieving a set result, and then justifying that result with general declarations that the Commission has applied the particulars of the law to actual facts. In *Pub. Serv. Co. of N.M.. v. N.M. Pub. Serv. Comm'n,* 92 N.M. at 722, 594 P.2d at 1179, the Court held the following: "General statements are no substitute for specific factual evidence. The Commission does not point to any such evidence to justify a 4 percent rate." In that case, the expert witnesses for both the Commission and for PNM testified that a rate of return between 13 percent and 14.8 percent was justified; the Commission argued that it was entitled to "ignore the expert testimony presented to it, and to set a rate inconsistent with that testimony." *Id.* The Court held that the Commission's powers in rate-setting "did not justify the setting of rates, inconsistent with the expert testimony, which were not otherwise supported by substantial evidence." *Id.* (The district court did not err in rejecting the 4 percent rate of

return and annulling the Commission's decision.). *See also In re Petition of P.N.M. Gas Serv.*, 129 N.M. 1, 14, 1 P.3d 383, 396 (2000) ("Based on our review of the record, we believe the Commission simply lacked enough evidence of data more recent than that utilized by Staff to reformulate the proposals of Staff and PNMGS concerning the weighted cost of capital.").

The return on equity and range arrived at by the Commission in an unexplained, unsupported manner must be overturned. *See Att'y Gen'l v. NMPUC,* 2000-NMSC-008, para. 13, 128 N.M. at 751, 998 P.2d at 1202 ("Numerous other jurisdictions also require at least an explanation on the part of the Commission as to why it went against the whole weight of the testimony, in order to facilitate judicial review. [citations omitted] Such an explanation is not to be found in this case and on the record, we are inclined to vacate the order because we cannot otherwise determine how the Commission could have reached its conclusion ignoring the competent, credible, and uncontradicted testimony.").

Other states courts that have considered the scope of a regulatory body's authority in setting rates of return have reached similar results. In *Railroad Comm'n of Texas v. Lone Star Gas Co.*, 618 S.W.2d 121 (Tx. 1981), the Texas Supreme Court held that "the examiner's use of the discounted cash flow formula is not supported by substantial evidence." In that case, the expert's testimony was "profoundly critical of the usefulness of the formula[,]" and could not be viewed as "evidence supportive of the Commission's adoption of the discounted cash flow formula."

Similarly, in *Hibbing Taconite Co. v. Minn. Pub. Serv. Comm'n,* 302 N.W.2d 5, 11 (Minn. 1981) the Minnesota Supreme Court held that the Minnesota Public Service Commission had not stated facts with sufficient specificity to "provide an adequate basis

for judicial review." The commission below had concluded that the two experts' recommendations "were highly judgmental and merely established a range of reasonableness from which the PSC chose the figure of 4.3 percent." The PSC had merely stated that it adopted the growth figure of 4.3 percent and failed to state the facts and figures the PSC used in calculating the growth factor. "Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling."

Once the Commission it rejected Dr. Hadaway's testimony, it removed its result from testimonial context. Not only was there no record evidence to support the Commission's range and rate, the record actually contradicts the findings of the Commission. The Court should overturn the Commission's return on equity and the range from which it was derived.

NMUSA has a particular interest in the substance of what the Commission ignored: investor interests. The Legislature required the Commission to consider such interests. Though candid about its use of a "mix and match" method, the Commission's consideration of investor interests amounts to adjudicative lip service. This Court has rejected such declarations as an inadequate substitute for substantial evidence, and should do so again here.

III. THE COMMISSION IGNORED IMPORTANT CHECKS OF REASONABLENESS BASED ON THE RISK PREMIUM METHOD THAT WOULD HAVE SHOWN THE COMMISSION'S ROE AND RANGE TO BE UNREASONABLE.

In reaching its rate of return result, the Commission rejected evidence in the record that strongly suggests that the rate and range it chose were outside a zone of reasonableness. The Commission simply ignores inconvenient facts in the record: the

authorized rates of return from more than 50 other jurisdictions and current bond yields. These elements of proof, though not decisive, add weight to PNM's witness's result and weigh heavily against the Commission's result. Most troubling, however, is not the conflict in the factual record, but the complete lack of reason and rationale for the Commission's rejection of so-called checks of reasonableness.

In order to satisfy itself that its rate of 9.53%, within the range 9.17% to 9.9%, was fair, the Commission had to have a reason to disregard the results produced by Dr. Hadaway in applying the risk premium method as a check of reasonableness for his 11% return on equity using DCF models. By eliminating the results of this method, the Commission artificially and unfairly limited its consideration of investor interests, removed the rates from testimonial context and achieved a result that is not supported by substantial evidence. The Commission's disregard of this evidence is also arbitrary and capricious when considered in light of it re-calculations of DCF results to achieve a rate.

Dr. Hadaway's risk premium method is based on the well-accepted precept that equity securities are riskier than debt and, therefore, that equity investors require a higher rate of return. Hadaway Direct at 20, lines 15 to 16. Application of this method answers the question: "What rate of return should equity investors reasonably expect relative to returns that are currently available from long-term bonds?" Hadaway Direct at 22, lines 4-6. The risk premium method is conceptually sound and widely used by analysts, investors and expert witnesses to estimate the cost of equity. R.A. Morin, *New Regulatory Finance,* at 108 & 130.

In performing his risk premium study, Dr. Hadaway compared authorized ROEs for gas utilities for the period 1980 through 2005 to contemporaneous long-term utility

interest rates: "The differences between the average authorized ROEs and the average interest rate for each year is the indicated equity risk premium." Hadaway Direct at 36, lines 2 to 6. He then added the indicated average risk premium to the forecasted triple-B utility bond interest rate (6.75%) to estimate ROE. Hadaway Direct at 36, lines 6 to 7. Dr. Hadaway used published risk premium data from three different sources in make his calculations. Hadaway Direct at 37, lines 10 to 14. At hearing, Dr. Hadaway updated his results using then-current data which resulted in a range of 10.5 to 11 percent. Tr. 12/18/06, at 132 lines 1 to 9. The results of his risk premium analysis validated his recommendation and confirmed the results of the DCF methods employed by the witness. Hadaway Direct at 22, lines 21-22; 23, lines 1 to 5.

It is important to note, that the Commission did not specifically reject the risk premium method used by Dr. Hadaway. Instead, the Commission and its Hearing Examiner attacked the component parts of the method: projected bond yields and authorized ROEs for other gas utilities. These criticisms are unfounded, and resulted in the Commission giving inadequate consideration to investor interest, the very focus of the risk premium analysis.

A. The Results of Dr. Hadaway's Risk Premium Method Produced an ROE and Range That Were Significantly Higher Than the Commission's.

The Commission's order never directly addresses the risk premium method or the results it produced that were part of the record. In adopting the Hearing Examiner's recommended decision without comment, the Court may assume that the Commission approved of the Hearing Examiner's proposed findings and conclusions on this issue. The Hearing Examiner asserted two criticisms of Dr. Hadaway's use of bond yields in his

risk premium calculations. The first criticism was that Dr. Hadaway used projected bond yields rather than actual yields. RD at 47. This was the subject of a lengthy examination of Dr. Hadaway by the Hearing Examiner at the hearing in the case. Dr. Hadaway testified that the actual yield was at the time of the hearing, 6.1%, or 65 basis points lower than Dr. Hadaway's earlier projections. RD at 45. Knowing this, the Hearing Examiner could have adjusted the result by adding the 4.29% equity risk premium to the Triple-B bond yield of 6.1 % to obtain a rate of 10.39%. *Compare* RD at 29 *with* RD at 45 *and* PNM Ex. SCH-4 Rebuttal. Or, under other risk premium calculations discussed, the adjustment would have resulted in a range between 10.24 to 11.23 percent. *Compare* RD at 29 *with* RD at 45 *and* Hadaway Dir. at 39, lines 7 to 12. This result could have been used as a check of reasonableness against the Hearing Examiner's DCF results and would have revealed them to be unreasonably low. RD at 54. The Hearing Examiner's range (9.17% to 9.535%) and the Commission's (9.17% to 9.9%) stand significantly low when compared with these results. The testimony on actual and projected bond yields confirmed the reasonableness of PNM's request, demonstrating that the 11% rate adequately addresses investor interests. In rejecting these measures, or at best ignoring them, the Commission has plucked the ROEs from testimonial context leaving its decision unsupported in the record, and undervaluing investor interests in its analysis. *Att'y Gen'l v. NMPUC*, 2000-NMSC-008, para. 11, 128 N.M. at 750-51, 998 P.2d at 1201-1202.

The second criticism of Dr. Hadaway's risk premium analysis is that Dr. Hadaway used those results "to exclude the results of his traditional constant growth DCF model from his recommended 'reasonable' return on equity range." RD at 47-48. This

objection simply confirms that the Hearing Examiner chose, categorically, to ignore checks of reasonableness in the record. The risk premium method and the results it derives are either appropriate and should be considered with the other evidence, or the method and results are so flawed as to be unreliable and should be disregarded. Dr. Hadaway was correct in comparing his DCF results to this data. The Hearing Examiner acted arbitrarily and capriciously in totally disregarding the results achieved by the risk premium method. Neither the Hearing Examiner nor the Commission advanced a coherent objection to the method itself. The Hearing Examiner's criticisms about bond yield rates were addressed by Dr. Hadaway and produced a resulting range of 10.24 to 11.23% that the Commission and Hearing Examiner should have considered. In the end, the sum total of the criticisms of the risk premium components suggested only that the results of the method, even with those criticisms, confirmed the reasonableness of PNM's request. They did not warrant ignoring the check of reasonableness altogether. The Commission's rate, which is inconsistent with Dr. Hadaway's testimony and the evidence related to the components of the risk premium method, is not supported by substantial evidence. *Att'y Gen'l v. NMPUC*, 2000-NMSC-008, para. 11, 128 N.M. at 750-51, 998 P.2d at 1201-1202.

The Commission and Hearing Examiner's disregard of the risk premium method and unwillingness to consider or adjust its components to accommodate new data that arose late in the proceeding, stands in stark contrast to the Hearing Examiner and Commission's manipulation of Dr. Hadaway's DCF results. This disregard of meaningful corroborative evidence is also in contrast to past practice of New Mexico regulatory bodies. The New Mexico Public Service Company permitted a risk premium

to be added to the results of the DCF model. *In re Pub. Serv. Co.*,111 PUR4th 313, 1990 WL 488711 *397-98 (N.M.P.S.C. 1990). The PSC commented that the end result, based on Staff's witness's testimony, was corroborated by the testimony of PNM's witness who had used the DCF, CAPM and risk premium methods. 111 PUR4th 313, 1990 WL 488711 *395 & 398.

If it is conceptually appropriate for the Commission to re-calculate the DCF results to produce a rate and range not supported by the witnesses, would it not be appropriate to use the adjusted bond yield results produced by examination of Dr. Hadaway that suggest a return within the range of 10.24 to 11.23%? In this regard, the Commission and Hearing Examiner's consideration of the evidence is both inconsistent and result-oriented. The result is that the Commission has eliminated from its consideration an important indicator of earnings of "other enterprises having corresponding risk[.]" *Southern Union Gas Co. v. N.M. Pub. Serv. Comm'n*, 84 N.M. 330, 333, 503 P.2d 310, 313 (1972). Without this data, there is little, if any evidence to fulfill this important component of the Commission's charge in setting a rate of return. To justify its decision, the Commission had to ignore significant evidence in the record. This result is not supported by substantial evidence.

B. Commission States That it is not Required to Consider Rates From Other Jurisdictions, Then Considers Two, Low Rates Without Explanation (Arizona and Minnesota); This Selective Use of Record Evidence was Arbitrary and Capricious.

Authorized returns on equity for other gas utilities formed an integral part of Dr. Hadaway's risk premium analysis. These returns demonstrate the response of regulatory commissions to a myriad of market and industry conditions that are described in detail by Dr. Hadaway. Hadaway Direct at 23, lines 7 to 22 through 31, lines 1 to 3. These

important factors include the performance of utility stocks in recent years, the industry's investment potential, changes in the industry, market uncertainties arising from such factors as labor costs, lower customer usage, and volatile gas prices. *Id.*

In its Order, the Commission addresses PNM's assertion that the Hearing Examiner ignored results from other jurisdictions; however, the Commission's reasoning is intrinsically flawed. Lacking a rational basis, the Commission's rejection of this evidence is arbitrary and capricious. The Commission first cites with approval the Hearing Examiner's reliance on the KCPL decision, specifically the statement that the Commission "should not 'unthinkingly mirror the national average[,]'" to support the proposition that the Commission is not bound by such returns. Order at 7, para. 15. This statement of the Missouri Commission was taken out of context: that Commission actually used ROEs authorized by commissions around the country to create its zone of reasonableness before arriving at an ROE based on Dr. Hadaway's testimony. *KCPL,* 2006 WL 4041675 *7. In *conflict with* the Missouri Commission, the New Mexico Commission held "[t]hus while not ignoring the ROEs granted by the other states, the Commission's decision should not be determined by the returns granted elsewhere, but must be determined relying on the Commission's expert judgment and guided by the record evidence in this case." Order at 7, para. 15.

There are two significant problems with this holding: First, the holding is based on a recommended decision from the Hearing Examiner that rejected the substantial evidence of returns approved by other jurisdictions and selected the results from two jurisdictions that were outliers. Second, the Commission ignores important, uncontradicted evidence in the record that demonstrates that its chosen ROE is too low.

The Recommended Decision follows the same logic as the Commission did. It first cites two holdings to support the principle that "[t]he average return allowed in other states in other cases is not controlling. At most, the decisions on this issue in other states provide a very small part of a much larger economic picture." RD at 35. The Hearing Examiner then cites three decisions to support his resulting return: an Arizona Corporation Commission decision approving a return on equity of 9.50%; a Minnesota Public Utility Commission decision approving a return on equity of 9.71%; and a New Mexico PRC decision involving the New Mexico-American Water Company approving a return of 9.715%. RD at 35, n.7. These rates are well below the compiled results for the period 2004 to 2006 relied upon by Dr. Hadaway. Hadaway Rebuttal at 3, lines 11-17. Neither the Hearing Examiner nor the Commission has stated why these three results are meaningful. They make no attempt to compare these regulated entities to PNM. Moreover, if the consideration of the return data compiled by Dr. Hadaway is of no importance, these selective results should not have any significance to the Commission ROE decision. The most problematic aspect of the Commission's rejection of Dr. Hadaway's data is that it eliminates one important measure of returns of entities having comparable risk. There is no attempt to distinguish Dr. Hadaway's reasoning and results, only an attempt to find two out-of-state decisions that have *results* that are about the same as the Commission's.

One crucial fact distinguishes these out-of-state decisions. These commissions had record evidence to support their decisions. The Arizona Corporation Commission and Minnesota Public Utility Commission decisions relied upon by the Hearing Examiner do not support the method employed by the Hearing Examiner and Commission to

achieve their results. In the Arizona case, the Commission adopted the recommendation of the Staff's witness that not only had been derived from application of the DCF model, but had been corroborated by calculations under three other models. 247 P.U.R. 4th 243, 2006 WL 756092 *45. In the Minnesota case, the commission adopted the recommendation of the Department's witness, without re-calculation or manipulation. 254 PUR 4th 23, 2006 WL 4013562 *49. The Arizona and Minnesota Commissions had substantial evidence to support their decisions, where the New Mexico Commission simply does not.

The Commission's analysis suffers for its selective consideration of ROEs from other jurisdictions. Dr. Hadaway's testimony related to these rates is part of the great weight of evidence in the record that undermines the Commission ROE of 9.53%. The Commission's decision to exclude the substantial portion of this evidence in favor of two unexplained results, was arbitrary and capricious, "unreasonable or without a rational basis" in the record. *Rio Grande Chapter of the Sierra Club v. N.M. Mining Comm'n,* 2003-NMSC-005, ¶ 17, 133 N.M. at ___, 61 P.3d at 813; *McDaniel v. N.M. Bd. of Med. Exam'rs*, 86 N.M. 447, 449, 525 P.2d. 374, 376 (1974). Had the Commission wanted to use the Arizona and Minnesota decisions, it would have to accept as a general premise that out-of-state ROEs should form part of the determination of the rates, something it specifically rejected. It might then have attempted to compare New Mexico *substantively* to Arizona and Minnesota, and given PNM an opportunity to rebut its comparison.

This Court has previously looked to authorized rates of return from other jurisdictions as a check of reasonableness when considering rates authorized by a New Mexico Commission. In *In re Rates and Charter of Mountain States Tel. & Tel. Co.,* 99

N.M. at 9, 653 P.2d at 509, Mountain States challenged the rate of return authorized by the New Mexico Corporation Commission. Noting that rate regulation requires "a balancing of competing interests," – including of course investor interests -- the Court remarks that "[t]he approved rate of return does not appear out of line as compared with other rates of return permitted in other states of which we are aware." 99 N.M. at 9, 653 P.2d at 509. The Court then cites to a Georgia Public Service Commission rate issued in the same year. *Id.*

The Commission's statement of its general policy that its decision "should not be determined by the return granted elsewhere," (Order at 7, para. 15), while a truism, was arbitrarily and capriciously applied given evidence in the record. The Commission selectively used other rates of return to confirm its result, ignoring ample other evidence that would have called the rate of 9.53% into question and the actual evidence that supported those decisions in the out-of-state commissions. The Commission, in effect, substituted its general conclusion that it was not bound to consider other states' rates for a fair evaluation of the results in other states as a check of reasonableness of PNM's recommended ROE. In this way, the Commission's determination was arbitrary and capricious. *See also PNM Gas Services v. NMPUC,* 2000-NMSC-012, para. 77, 129 N.M. at 26-27, 1 P.3d at 408-409 (denial of rate case expenses in their entirety was arbitrary and capricious where there was irrefutable evidence that the utility had prudently incurred substantial, if un-quantified, expenses), *citing Butler Township Water Co. v. Pennsylvania Pub. Util. Comm'n,* 81 Pa. Cmwlth. 40, 473 A.2d 219, 221 (1984) ("The declaration of a policy based on general conclusions may not be substituted for an evaluation of the evidence in each case.").

Dr. Morin, a recognized expert in regulatory finance, has counseled regulators against the "dangerous and inappropriate" practice of relying on one methodology to determine the cost of equity. R.A. Morin, *New Regulatory Finance*, at 28. The result of the Commission's decision below, reflects what Dr. Morin foresaw, that by using one methodology, the regulator tied its own hands, ignored relevant evidence and "back[ed] itself into a corner." R.A. Morin, at 28. The Commission's decision to ignore checks of reasonableness, including interest rates and authorized ROEs, gave the erroneous impression that the Commission's result was fair, when in reality, it was unreasonably low.

CONCLUSION

The return on equity approved by the Commission was unlawful and unreasonable, unsupported by substantial evidence, and adopted in an arbitrary and capricious manner. The Supreme Court should annul and vacate the order and remand the case to the Commission with directions to enter a new order that comports with the law and this Court's opinion.

Respectfully submitted,

JONES, SNEAD, WERTHEIM
& WENTWORTH, P. A.

By_____

JERRY WERTHEIM
JERRY TODD WERTHEIM
CAROL A. CLIFFORD
1800 Old Pecos Trail
P. O. Box 2228
Santa Fe, New Mexico 87504-2228
(505) 982-0011

Attorneys for Amicus Curiae