



ALISHA TILL
Direct (503) 290-3628
alisha@mrg-law.com

May 13, 2020

VIA ELECTRONIC FILING

Attention: Filing Center
Public Utility Commission of Oregon
P.O. Box 1088
Salem, Oregon 97308-1088

Re: UG 388 – NW Natural Request for a Rate Revision.

Attention Filing Center:

Attached for filing in the above-referenced docket is the Stipulating Parties' Joint Testimony in Support of the Partial Stipulation regarding Cost of Capital Issues.

Sincerely,

/s/ Alisha Till

Alisha Till
Paralegal

Attachment

BEFORE THE
PUBLIC UTILITY COMMISSION OF OREGON

DOCKET NO. UG 388

Joint Testimony in Support of Stipulation Regarding Cost of Capital Issues

Stipulating Parties: NW Natural Gas Company d/b/a NW Natural, Public Utility Commission of Oregon Staff, and the Oregon Citizens' Utility Board

NW NATURAL-STAFF-CUB EXHIBIT 100

**Joint Testimony of Brody Wilson, Dr. Bente Villadsen, Matt Muldoon,
Moya Enright, and Bob Jenks**

May 13, 2020

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1 (ROE) and Cost of Long-Term Debt (LT Debt). The Alliance of Western Energy
2 Consumers (AWEC) also signed the Stipulation but is filing separate supporting testimony.
3 Mr. Muldoon and Ms. Enright are also filing separate testimony in support of the
4 Stipulation, in addition to joining this Joint Testimony.

5 II. BACKGROUND

6 **Q. Please summarize the background and context of Docket No. UG 388.**

7 A. On December 30, 2019, NW Natural initiated this proceeding, Docket No. UG 388, by filing
8 a request for a general rate increase (Initial Filing). In its Initial Filing, NW Natural
9 requested a revision to customer rates that would increase the Company's annual Oregon
10 jurisdictional revenues from base rates by \$71.4 million, or an approximate 11.5 percent
11 increase over current customer rates. In the Testimony of Brody Wilson, the Company
12 requested that CoC be set based on a Capital Structure of 50 percent equity and 50
13 percent debt; ROE of 10.0 percent; and LT Debt of 4.596. The overall Rate of Return
14 requested by the Company was 7.317.

15 Administrative Law Judge Allan J. Arlow convened a prehearing conference on
16 January 30, 2020. In accordance with the prehearing conference order, the effective date
17 for rates will be November 1, 2020.

18 **Q. Have the Parties conducted discovery in this case?**

19 A. Yes. Since the Initial Filing, NW Natural has responded to over 450 data requests from
20 Staff, CUB, and AWEC. NW Natural has responded to 50 data requests related to CoC
21 issues.

22 **Q. Please describe the process to date in this docket.**

23 A. Staff held the first workshop in this docket on March 3, 2020. Prior to that workshop, Staff
24 notified the Parties that Staff wished to convert the first part of the workshop to a settlement

1 conference, specifically to address CoC issues. As a result of settlement discussions held
2 on that date, the Parties reached the settlement of the CoC issues reflected in the
3 Stipulation.

4 **Q. Please provide an overview of the issues addressed in the Stipulation.**

5 A. In the Stipulation, the Parties agreed to recommend that the Commission maintain for NW
6 Natural the Capital Structure and authorized ROE that are currently in effect, resulting in
7 a balanced Capital Structure of fifty percent equity and fifty percent debt, and an ROE of
8 9.4 percent. The Parties further agreed to decrease the Company's Cost of LT Debt from
9 4.596 percent to 4.529 percent. Agreement to these CoC components yield an overall
10 rate of return (ROR) of 6.965 percent, as shown on the chart below:

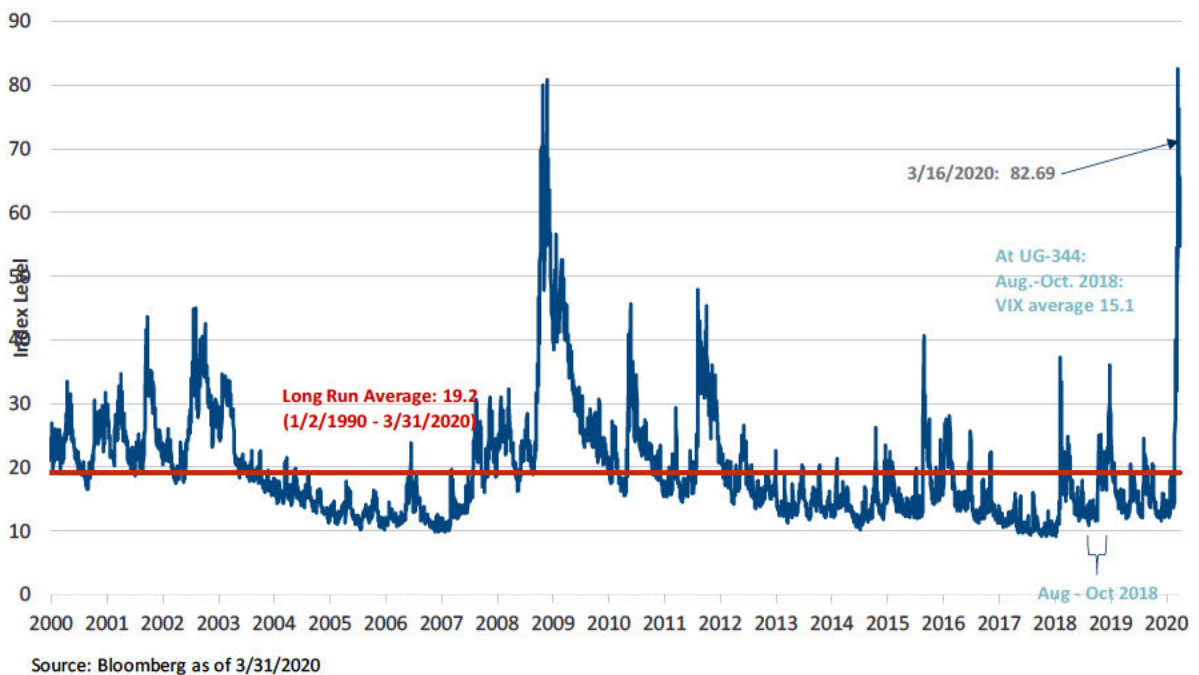
Agreed-upon Cost of Capital			
	Percent of Total Capital	Cost	Component
Long-Term Debt	50.0%	4.529%	2.265%
Common Equity	50.0%	9.40%	4.700%
Total	100.0%		6.965%

11 In this testimony, the Parties will explain why they believe that the terms of this
12 Stipulation will result in fair and reasonable rates, and the Parties will explain why they
13 continue to support these terms during the current economic uncertainty caused by the
14 COVID-19 pandemic. As is common with stipulations, each party has their independent
15 perspective for why entering into a stipulation is reasonable, and for that reason, each of
16 the Testifying Parties has also included an independent statement of support for this
17 Stipulation.

1 almost 1/3 of its market value. It has since gained about 18 percent back and as of May
2 11th stood at 2930.32. These are by all means extreme movements. Utility stocks have
3 also declined, and NW Natural's stock price dropped 24 percent between January 2 and
4 April 1, 2020.

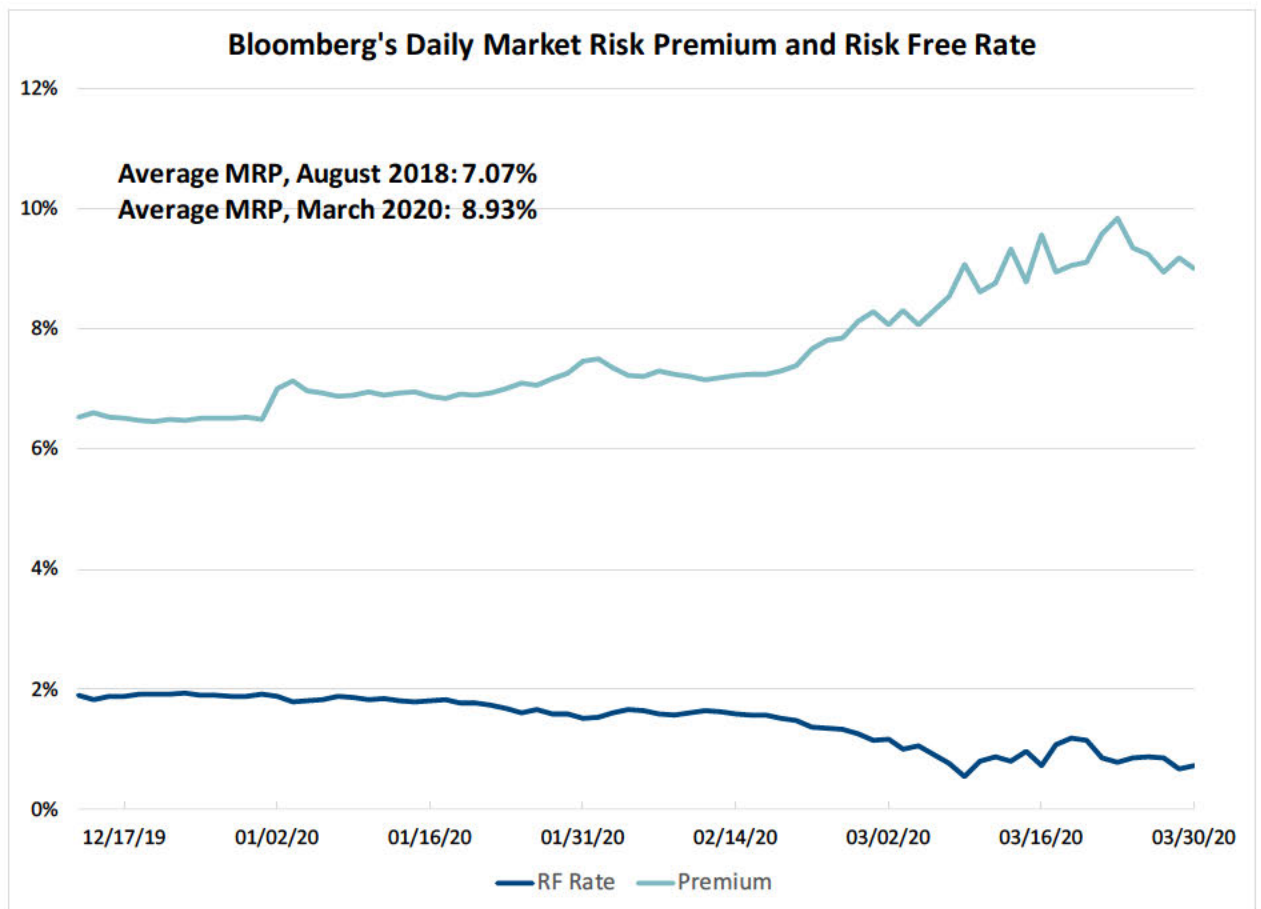
5 Second, market volatility is extreme. For example, the VIX index, which measures
6 the implied market volatility using stock options reached an all-time high on March 16, 2020.
7 While it has since declined to 46.8 as of April 3, it remains more than double its long-run
8 average and above any level seen since 2012. This is shown in the chart below, which
9 exhibits the VIX index from 2000 through April 1, 2020. The high level of the VIX shows a
10 very high level of investor uncertainty, which leads to high premiums above the risk-free
11 rate.

12 **Figure 1 – Chicago Board Options Exchange's (CBOE) Volatility Index (VIX)**



1 The increased volatility may lead to an increase in the market risk premium (MRP)
2 going forward. Recent forward-looking MRP calculations are consistent with that
3 observation and Bloomberg's forward-looking MRP has increased by about 200 basis
4 points over the last 30-45 days. The chart below shows the one year forward MRP as
5 calculated by Bloomberg as well as the comparable risk-free rate (Bloomberg bases its
6 calculation on the 10-year rate, so the risk-free rate is correspondingly the 10-year yield).

7 **Figure 2 – Bloomberg Plot of MRP and Risk Free (R_f) Rate**

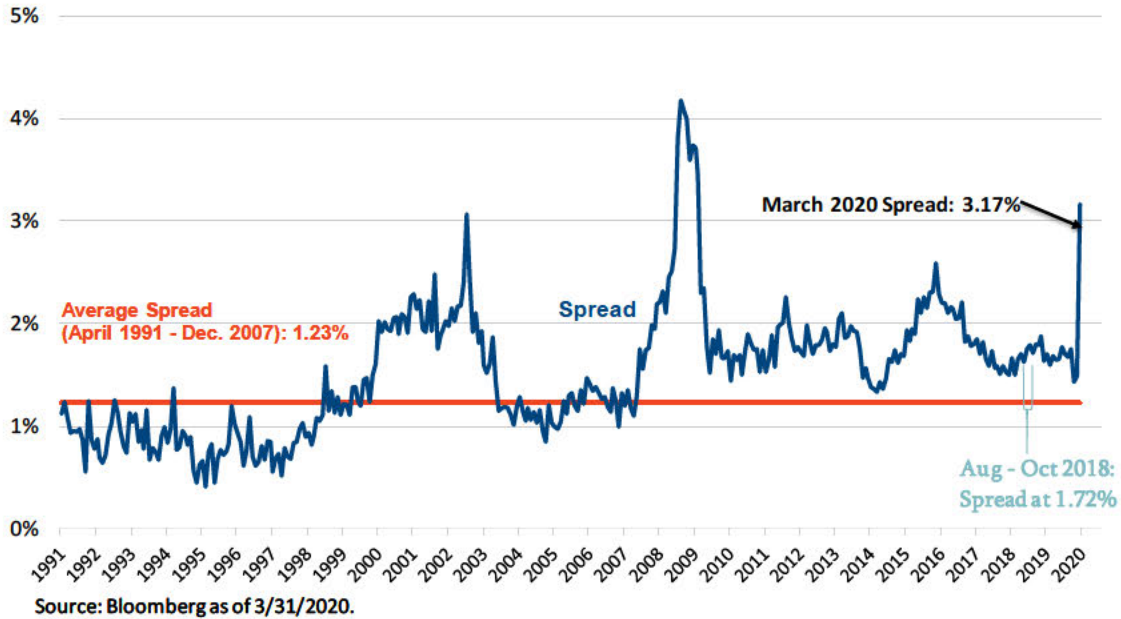


8 Third, government bond yields have declined sharply, so that the 30-year bond
9 yield dropped below 2 percent in February and as of April 1 was only 1.35 percent.¹

¹ Federal Reserve, FRED available at: <https://fred.stlouisfed.org/tags/series?t=interest+rate>.

1 However, the spread between the yield on 30-year utility bonds and like maturity
2 from about 1.3 percent to over 3.0 percent in March before receding. The increase in
3 spread is consistent with investors becoming more risk averse when times are highly
4 uncertain as shown in Figure 3 below.

Figure 3 – Spread of BBB Rated Utility Bonds over like maturity US Treasuries



5 Moreover, as we file this testimony there is uncertainty as to the future course of
6 the virus, as well as the market response. For example, an April 3, 2020 analysis by
7 McKinsey looks to a range of scenarios and finds that the most likely impact on the U.S.
8 gross domestic product (GDP) is negative 8 to 13 percent. The study also finds that the
9 most likely recovery to pre-COVID-19 GDP could occur between Q4, 2020 and Q2, 2024.²
10 The study also considers more severe impacts on the economy and a lengthier recovery.
11 Regardless, there is substantial uncertainty about the magnitude of the impact and the

² McKinsey & Company, "COVID-19: Briefing Materials," April 3, 2020, pp. 21-25 available at: <https://www.mckinsey.com/~media/mckinsey/business%20functions/risk/our%20insights/covid%2019%20implications%20for%20business/covid%2019%20march%2030/covid-19-facts-and-insights-april-3.ashx>.

1 timeline for recovery.

2 **Q. What is your general view of the reasonableness of the Stipulation in light of these**
3 **events?**

4 A. We believe that the Stipulation remains reasonable, and, as we discuss below in more
5 detail below, provides needed stability for both customers and the utility in these difficult
6 times.

7 ***CAPITAL STRUCTURE***

8 **Q. Please describe the capital structure agreed to by the Parties.**

9 A. The Parties agreed to a balanced capital structure for NW Natural of 50 percent equity
10 and 50 percent LT Debt.

11 **Q. What are the advantages of a 50/50 capital structure?**

12 A. A 50/50 capital structure maintains a strong equity component, which demonstrates a
13 utility's commitment to a strong and stable balance sheet, which in turn helps to maintain
14 the utility's credit ratings. Strong investment grade credit ratings provide the utility with
15 financing flexibility and liquidity, ensuring timely access to capital markets, which helps to
16 lower the cost of capital. At the same time, this balanced capital structure includes 50
17 percent debt, which helps to reduce the overall cost of capital.

18 **Q. Is a 50/50 capital structure consistent with the capital structures approved by the**
19 **Commission for NW Natural in past rate cases?**

20 A. Yes. The Commission adopted a 50/50 capital structure for NW Natural in 2018³, in UG
21 344, and a 50/50 capital structure for NW Natural in 2012, in UG 221.⁴

³ *In the Matter of Northwest Natural Gas Company, dba NW Natural, Request for a General Rate Revision*, Docket UG 344, Order No. 18-419 at 4 (Oct. 26, 2018).

⁴ *In the Matter of Northwest Natural Gas Company, dba NW Natural, Request for a General Rate Revision*, Docket UG 221, Order No. 12-437 at 3 (Nov. 16, 2012).

1 **Q. Is the adoption of a 50/50 capital structure consistent with the Commission's**
2 **general policy?**

3 A. Yes. As noted in the separate testimony of Mr. Muldoon and Ms. Enright in support of the
4 Stipulation, the Commission has generally accepted that a 50/50 capital structure
5 balances the lower cost of borrowing against the credit enhancement represented by
6 equity.

7 **Q. Please comment on the stipulated capital structure in light of current market**
8 **conditions.**

9 A. We believe that a balanced capital structure with 50 percent equity provides the Company
10 with sufficient equity to withstand adverse economic conditions such as we are facing
11 today. The strong equity component will help to lower NW Natural's cost of debt—which
12 is particularly critical given the increasing spread in yield between utility bonds and
13 government bonds. Additionally, a strong equity component of 50 percent will prove vital
14 if the current crisis results in the liquidity constraints, we saw during the 2008-2009
15 Financial Crisis; in that circumstance, long-term debt financing may not be available for all
16 utilities or if available, it may be at very high costs.

17 ***RETURN ON EQUITY***

18 **Q. Please describe the ROE agreed to by the Parties.**

19 A. The Parties agreed to an ROE for NW Natural of 9.4 percent.

20 **Q. Is this ROE consistent with that approved by the Commission for NW Natural in past**
21 **rate cases?**

22 A. Yes. The Commission adopted a 9.4 percent ROE for NW Natural in 2018 in UG 344⁵,

⁵ Order No. 18-419 at 4.

1 and a 9.5 percent ROE for NW Natural in 2012 in UG 221.⁶

2 **Q. How does an ROE of 9.4 percent comport with the modelling performed by NW**
3 **Natural's expert witness, Bente Villadsen, and Staff's experts, Mr. Muldoon and Ms.**
4 **Enright?**

5 A. In her Opening Testimony, Dr. Villadsen presented her analysis of NW Natural's ROE. Her
6 models produced a range of 9.4 to 10.5 percent. In their separate testimony, Mr. Muldoon
7 and Ms. Enright present their analysis of NW Natural's ROE, which produces a range of
8 8.80 to 9.35 percent. Accordingly, the 9.4 percent ROE agreed to in the Stipulation lands
9 just above the top of Staff's range and at the bottom of Dr. Villadsen's range, and therefore
10 represents a compromise of the models' results.

11 **Q. What was the Parties' initial reasoning in adopting a 9.4 ROE for NW Natural?**

12 A. The Parties acknowledged that 9.4 percent was within a reasonable range of ROEs for NW
13 Natural and further believed that maintaining NW Natural's ROE at the level at which it was
14 recently set in its last rate case would benefit both the Company and its customers by
15 providing stability and certainty.

16 **Q. Neither Dr. Villadsen's nor Mr. Muldoon's analysis take into account the**
17 **circumstances of the current financial volatility balanced against downward**
18 **projections of U.S. productivity and gross domestic product (GDP). Should the**
19 **Commission wait for further information?**

20 A. No, we do not believe so. It would not be fruitful to re-run financial models when markets
21 are volatile. And while it is difficult to predict how long the current volatility will persist, we
22 do not expect markets to return to anything that looks like "normal" for the next several
23 months. So, even if we waited to re-run our models until mid-summer, when the hearing

⁶ Order No. 12-437 at 6.

1 is set, and the evidentiary record closes, we are unlikely to obtain helpful results. Moreover,
2 it is important to remember that ROE models always capture a moment in time, and that
3 there will always be hope for better information in the future. For these reasons, while we
4 think it is important to recognize that we are in a time of substantial volatility, we
5 nevertheless recommend that the Commission determine ROE for NW Natural based on
6 the modelling conducted by Staff and NW Natural, which was conducted under more
7 normal conditions.

8 **Q. Please explain why, given current market conditions, the stipulated ROE of 9.4**
9 **percent is reasonable.**

10 A. As we have noted, NW Natural's costs of equity may differ from that modelled. However,
11 there are several reasons why we believe that the stipulated ROE of 9.4 percent remains
12 reasonable and in the public interest.

13 **First**, a 9.4 percent ROE provides both customers and the Company the certainty
14 of a consistent and stable ROE at a time of significant uncertainty. As such, customers
15 avoid an increase in ROE at a time when they may be facing financial hardship. At the
16 same time, the settlement assures NW Natural of a return that will ensure sufficient
17 revenues to allow it to continue to invest in necessary infrastructure and fund operations
18 as required to provide safe and reliable utility service.

19 **Additionally**, the settled ROE is consistent with those adopted for NW Natural
20 since 2012, and therefore suggests a reasonable return when rates will go into effect.

21 The Parties agree that this balanced approach to ROE is consistent with *Hope* and
22 *Bluefield*.⁷

⁷ *Bluefield Water Works & Improvement Co. v. Public Service Com'n of West Virginia*, 262 U.S. 679 (1923) ("Bluefield"), and *Federal Power Com'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("Hope").

1 ***COST OF LONG-TERM DEBT***

2 **Q. Please describe the Cost of LT Debt agreed to by the Parties.**

3 A. The Parties have agreed to a Cost of LT Debt of 4.529 percent.

4 **Q. What was the Parties' initial reasoning in agreeing to this Cost of LT Debt?**

5 A. The Parties considered the cost of NW Natural's outstanding debt, as well as anticipated
6 issuances, to come up with a reasonable compromise LT Debt that is approximately 75
7 basis points lower than that requested by the Company.

8 **Q. You have noted above that since the date that the Parties settled the CoC issues,**
9 **the Federal Government has lowered interest rates and the yield on government**
10 **bonds has decreased. Do you believe the settled Cost of LT Debt is reasonable in**
11 **light of current conditions?**

12 A. Yes. It is important to keep in mind that the settled Cost of LT Debt is based primarily on
13 the Company's embedded debt—and not forecasts for future issuances. Any decrease in
14 debt costs beyond those contemplated at the time of the settlement was entered will have
15 a relatively small impact on NW Natural's overall Cost of LT Debt. Moreover, we do not
16 believe that the current low rates for risk-free debt are reflective of the rates NW Natural
17 will pay when it borrows in the future. While the Federal Government has lowered interest
18 rates and the yield on government bonds has declined, the spread between the yield on
19 utility bonds and government bonds has increased. The Testifying Parties do not agree
20 on the import and predictive ability of indicative like-rated debt series' coupon rates and
21 market forwards at this time but do agree that the stipulated Cost of Long-Term Debt is a
22 fair compromise given large uncertainties.

1 **OVERALL RATE OF RETURN**

2 **Q. What is the overall rate of return, based on the settled Capital Structure, ROE and**
3 **Cost of LT Debt?**

4 A. The overall rate of return based on the settled components is 6.965 percent.

5 **Q. Do you agree that this overall rate of return is appropriate and will result in fair and**
6 **reasonable rates?**

7 A. Yes. The settled rate of return represents a decrease from NW Natural's current
8 authorized rate of return of 7.317 percent—which is a benefit to NW Natural's customers
9 but is nevertheless sufficient to assure confidence in the financial soundness of the utility.

10 **NW NATURAL**

11 **Q. Dr. Villadsen and Mr. Wilson, please explain why NW Natural supports the**
12 **Stipulation.**

13 A. These are challenging times for the Company, our customers, and the global economy.
14 Not only are we facing substantial volatility in financial markets, there is uncertainty as to
15 how long the volatility may persist. As discussed above, given our current situation, we
16 believe that the most prudent course is to provide stability for our Company and its
17 customers by holding the current Capital Structure and ROE steady, and making a modest
18 adjustment to Cost of LT-Debt.

19 **Q. Can you provide any general observations as to how the current volatility may be**
20 **immediately impacting NW Natural's costs of equity?**

21 A. Certainly. In the short to mid-term, the current volatility impacts investors' attitudes toward
22 risk. As investors become more risk averse, they require a higher premium to invest in
23 securities that are not risk-free. Thus, the market risk premium increases, which would be
24 expected to lead to an increase in NW Natural's cost of equity. This increase in NW

1 Natural's cost of equity would indicate a higher ROE than would have been indicated prior
2 to the financial crisis.

3 Separately, the immediate effect of a declining stock price is that the dividend paid
4 per dollar invested increases, so that the dividend yield increases, which results in an
5 increase in ROE estimates. At the same time a forward-looking equity risk premium
6 increase will result in an increase in ROE because the risk premium investors require
7 increases. This understanding is consistent with the results of a study by Barclays, which
8 has identified sharp increases in utility costs of equity metrics since February 19, 2020.
9 Barclay's study, which was issued on March 28, 2020, concludes that the short-to-medium
10 term cost of equity has increased by more than 600 basis points, while the paper estimates
11 the 2-year cost of equity is up by about 450 basis points. Thus, the cost of equity is
12 expected to remain elevated for an extended period of time.

13 As a result, it its very likely that NW Natural's costs of equity are significantly higher
14 today than they were when Dr. Villadsen ran her models, and that Dr. Villadsen's ROE
15 estimates would be significantly higher if she were to re-run her models today.

16 That said, over a longer period, it can be expected that growth rates will adjust to
17 the new reality and thus lead to lower costs of equity or ROE estimates. It is also plausible
18 that some may hold dividends steady or even reduce dividends, which would further put
19 downward pressure on ROE estimates. In short, in the near-term ROE estimates would
20 increase, and over time, plausibly return to a level more comparable to that of the past.

21 Figures 1 and 3 above allow for a comparison of the market volatility relative to
22 conditions at the time of NW Naturals 2018 rate case, when the Parties agreed to an ROE
23 of 9.4 percent.⁸ As explained above, the current volatility has increased substantially as

⁸ Order No. 18-419 at 4.

1 has the forward-looking market risk premium and the spread between utility and
2 government bond yields. All of these are indications that the return investors require over
3 and above the risk-free rate has increased dramatically since the last rate case, so that if
4 an ROE of 9.4 percent was appropriate in 2018, then 9.4 percent or above is appropriate
5 for April 2020.

6 **Q. Can you provide any general observations as to how the condition of the current**
7 **debt markets may be impacting NW Natural's cost of debt?**

8 A. As noted above, while the cost of risk-free debt is extremely low, spreads have increased.
9 The table below shows the bond issuances for regulated utilities between February 12
10 and April 1, 2020 and demonstrates that the spread has increased from below 100 basis
11 points in mid-February 2020 to above 250 basis points in March 2020. Importantly, all of
12 the issuances in the table below except SCE are investment grade and above BBB (i.e.,
13 they are not BBB- and bordering the non-investment grade). Thus, there is empirical
14 evidence that while the government bond yield has declined, the spread between utility
15 and government bond yields has increased. The lone BBB- issuance came at a spread
16 of 462. This increase in the spread suggests that the Stipulation's Cost of LT Debt is
17 reasonable, even in view of the historically low cost of risk-free debt.

Table 1: Bond Issuances for Regulated Utilities

Utility	Spread to benchmark		Moody's rating	S&P Global rating	Fitch rating	Type	Maturity year	News date
	Treasury (bps)							
1 DTE Energy Co.	195.0		Aa3	A	A+	2.625% general and refunding mortgage bonds	2081	4/1/2020
2 Edison International	462.5		Baa3	BBB-	BBB-	4.95% senior notes	2025	4/1/2020
3 Exelon Corp.	337.5		Baa2	BBB	BBB+	4.05% senior notes	2080	4/1/2020
4 Exelon Corp.	337.5		Baa2	BBB	BBB+	4.70% senior notes	2050	4/1/2020
5 AEP Transmission Co. LLC	235.0		A2	A-	A	3.652% senior notes	2050	4/1/2020
6 Dominion Energy Inc.	280.0		Baa2	BBB	BBB+	3.375% senior notes series C	2080	4/1/2020
7 Ameren Corp.	285.0		Baa1	BBB		3.50% senior notes	2081	4/1/2020
8 Southern California Edison Co.	275.0		A3	A-	BBB+	3.70% first and refunding mortgage bonds series 2018E	2025	3/31/2020
9 Oklahoma Gas and Electric Co.	260.0		A3	A-	A	3.25% senior notes	2080	3/31/2020
10 Xcel	270.0		Baa1	BBB+	BBB+	3.40% senior notes	2080	3/30/2020
11 Florida Power & Light Co.	237.5		Aa2	A+	AA-	2.85% first mortgage bonds	2025	3/27/2020
12 Entergy Louisiana LLC	275.0		A2	A		4.20% collateral trust mortgage bonds	2048	3/27/2020
13 Consumers Energy Co.	200.0		Aa3	A	A+	3.50% first mortgage bonds	2051	3/26/2020
14 NSTAR Electric Co.	325.0		A1	A	A+	3.95% debentures	2080	3/24/2020
15 Dominion Energy Inc.	265.0		Baa2	BBB	BBB+	3.30% senior notes series A	2025	3/19/2020
16 Dominion Energy Inc.	275.0		Baa2	BBB	BBB+	3.60% senior notes series B	2027	3/19/2020
17 Entergy Arkansas LLC	175.0		A2	A		4.00% first mortgage bonds	2028	3/18/2020
18 AEP Ohio	170.0		A2	A-		2.60% senior notes	2080	3/17/2020
19 Florida Power & Light Co.	3-mo London interbank offered rate - 0.30%		A1	A		floating-rate notes	2070	3/16/2020
20 Duke Energy Indiana LLC	165.0		Aa3	A		2.75% first mortgage bonds series ZZZ	2050	3/11/2020
21 Entergy Texas Inc.	137.5		Baa1	A		3.55% first mortgage bonds	2049	3/10/2020
22 Entergy Louisiana LLC	130.0		A2	A		2.90% collateral trust mortgage bonds	2051	3/6/2020
23 Southern California Edison Co.	170.0		A3	A-	BBB+	3.65% first and refunding mortgage bonds series 2020A	2050	3/6/2020
24 Southern California Edison Co.	125.0		A3	A-	BBB+	2.25% first and refunding mortgage bonds series 2020B	2080	3/6/2020
25 Commonwealth Edison Co.	68.0		A1	A	A	2.20% first mortgage bonds series 128	2080	2/26/2020
26 Commonwealth Edison Co.	100.0		A1	A	A	3.00% first mortgage bonds series 129	2050	2/26/2020
27 DTE Energy Co.	68.0		Aa3	A	A+	2.25% general and refunding mortgage bonds series A	2080	2/12/2020
28 DTE Energy Co.	90.0		Aa3	A	A+	2.95% general and refunding mortgage bonds series B	2050	2/12/2020

Notes:
Red highlight indicates spread to benchmark Treasury is above 250 bps.
The term of the benchmark Treasury corresponds to that of the bond.

1 **OPUC Staff**

2 **Q. Mr. Muldoon and Ms. Enright, please explain why Staff supports the Stipulation.**

3 A. We are filing separate testimony specifically explaining why Staff supports the Stipulation.

4 **CUB**

5 **Q. Mr. Jenks, Please explain why CUB supports the Stipulation.**

6 A. CUB believes the Stipulation is a reasonable compromise of the issues related to ROE
7 and Capital Structure that serves to both protect customers in Oregon and offers a fair
8 return for the Company in light of changing economic circumstances. Residential
9 customers in Oregon are facing record levels of unemployment from the economic fallout
10 related to COVID-19 and many businesses are struggling to survive. Under these
11 circumstances, CUB believes it would be highly inappropriate to increase returns/profits
12 to shareholders. To CUB, ensuring that the Company's ROE will not increase during this
13 tumultuous time is an important element of our support for the Stipulation. Further, the

1 9.4 ROE in the Stipulation is well within the range of reasonableness as indicated in the
2 analysis of Staff and the Company. A 9.4 ROE and a 50/50 Capital Structure aligns with
3 the Company's peer utilities. While the future remains uncertain, CUB supported the
4 Stipulation because it represents a fair compromise between the Company and its
5 customers based upon the information we have available to us at this time.

6 **Q. Does this conclude your testimony?**

7 A. Yes.