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Before the
Public Service Commission of South Carolina

Application of Dominion Energy South Carolina, Incorporated for Adjustment of Rates and Charges (See Commission Order No. 2020-313)	**Docket No. 2020-125-E**

Surrebuttal Testimony of Scott Hempling

On Behalf of the
South Carolina Department of Consumer Affairs

December 17, 2020

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Surrebuttal Testimony of Scott Hempling

Q. Are you the same Scott Hempling who filed Direct Testimony in this proceeding?

A. Yes.

Q. Whose rebuttal testimony do you address?

A. First I address Ms. Elbert's rebuttal. She ignores a fact that has been clear for a century: In a monopoly setting, a company's financial interests conflict with its customers' interests. DESC has a monopoly over the retail sale and delivery of electricity to South Carolina's customers. By basing incentive compensation on its financial interests, DESC unavoidably causes conflicts with the customers' interests.

Turning to Mr. Fetter's rebuttal, I correct his misunderstanding of my testimony. While DESC wants the Commission to focus only on the proposed increase of $178 million, the Commission should focus on the proposed revenue requirement of $2.3 billion. To correct Mr. Fetter's rebuttal I re-explain what he missed: that with care, the Commission can address the $2.3 billion without upsetting legitimate shareholder expectations associated with costs already approved by the Commission and incurred by the company.

I. In a monopoly setting, incentive compensation based on the company's financial interests conflicts with the customers' interests

Q. Describe your overall concern with Ms. Elbert's Rebuttal Testimony on incentive compensation.

A. Underlying Ms. Elbert's testimony is a non-factual premise: that utility earnings and customer interests are always aligned. If that were true, if utility earnings and customer interests were always aligned, we would not need this proceeding—or any regulatory

proceeding. The conflict between utility earnings and customer interests—evidenced here by hundreds of pages of testimonial opposition, and repeated in nearly every Commission proceeding—is the very reason for utility regulation.

Because of this fundamental error, each of Ms. Elbert's points fails, as discussed next.

Q. Comment on Ms. Elbert's claim about the reasonableness of the companies' earnings.

A. Ms. Elbert asserts that underlying DESC's earnings-based compensation is a reasonable level of earnings.[1] Reasonable to whom? In most rate proceedings, including this one, company-customer conflicts over what is "reasonable" involve dozens, and sometimes hundreds, of millions of dollars. Earnings-based compensation rewards executives who persuade regulators to side with the company rather than with the customers. Earnings-based compensation breeds conflict. This point is not debatable.

Q. Comment on Ms. Elbert's connection of incentive compensation to the companies' budget processes.

A. Ms. Elbert says that DESC has a "culture of economic efficiency and cost control," achieving its goals through a "budget process."[2] If so, there is no need for incentives based on earnings. If the utility bases its budgets on economic efficiency, the company can achieve that economic efficiency by basing incentive compensation on its executives' meeting those budgets. Making earnings a distinct basis for compensation creates shareholder-customer conflict while providing no incremental customer benefit.

Q. Comment on Ms. Elbert's discussion of cost-cutting.

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[1] Elbert Direct at 4:11-5:4.

[2] *Id.* at 3:9-11.

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1 **A.** Ms. Elbert argues that earnings-based compensation drives employees to reduce costs so
2 as to create more distance from the budgeted revenues.[3] But as I explained with budgets:
3 If cost reduction is the goal (and assuming it is a legitimate goal), then the company can
4 base compensation on cost reduction. Again, basing compensation on earnings produces
5 no incremental benefit; it introduces conflict.

6 Ms. Elbert makes the common error of applying competitive market conduct to the
7 monopoly regulation context. In competitive markets, a company's revenues depend on
8 making sales at prices that are attractive to customers. In monopoly regulation, the utility's
9 revenues depend not on objective market forces but on subjective strategies of
10 persuasion—strategies developed by executives whose compensation is influenced by
11 earnings. So basing compensation on the distance between revenues and costs rewards
12 executives who persuade commissioners to approve high revenues. That reward system
13 conflicts with customers' interest in lower revenues. To be clear: I am not suggesting that
14 the customers' position is always the correct position. I am saying that rewarding
15 executives based on earnings rewards them for winning on revenues—regardless of
16 whether that win is good for consumers.

17 **Q. What about Ms. Elbert's reliance on company "leadership"?**

18 **A.** I explained that in a monopoly setting, compensating executives with stock, or basing
19 incentives on stock value, creates consumer risk. Why? Because in a monopoly setting,

[3] *Id* at 5:18-20 ("The financial goals associated with the AIP communicate the fact that the upward pressure on costs that these other goals might entail must be balanced and absorbed within the revenues budgeted to do so.").

stock value and customer benefit are not aligned.[4] Ms. Elbert ignores this point. Instead she describes stock value as reflecting the market's gauzy faith in a company's "leadership."[5] She should discuss the matter with Dr. Vander Weide, who explains that stock value reflects the market's cold calculation of the utility's likely future earnings.[6] And in a regulated monopoly setting, those earnings depend on maintaining and increasing rate base, cutting costs, persuading commissioners to approve the company's revenue proposal, and leveraging the utility's state-granted protection from competition into opportunities for more earnings. A utility's earnings also depend on persuading regulators to approve revenue levels that exceed prudent costs and reasonable returns—precisely what, according to some witnesses, DESC seeks to do in this proceeding.

Q. Does operational performance play a role in DESC's incentive compensation?

A. Yes, as it should. Ms. Elbert misquotes me as saying that "operational excellence is completely irrelevant to incentive compensation."[7] Uncomfortable with her company's facts, Ms. Elbert severed my words from their context. I said that "*at the threshold*

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[4] Hempling Direct at 29-30.

[5] Elbert Rebuttal at 7:21-8:3.

[6] *See*, *e.g.*, Dr. Vander Weide's Direct Testimony at 23:11-16 (explaining that the discounted cash flow method of estimating cost of equity "assumes that the current market price of a firm's stock is equal to the discounted value of all future cash flows equity investors expect to receive from their investment in the company"; and that the ex post risk premium method assumes that "an investor's expectations regarding the equity risk premium can be estimated from data on the DCF expected rate of return on equity compared to the interest rate on long term bonds").

[7] Elbert Rebuttal at 8:11-13 (misquoting my Direct Testimony at 34).

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operational excellence is completely irrelevant to incentive compensation."[8] The sentence immediately preceding what she quoted makes the context clear: Incentive compensation comes from funds made available by the Dominion Energy Board. Whether the Board makes any funds available, and the amount it makes available, depends solely on Dominion Energy's earnings. So *at the threshold*, operational excellence is completely irrelevant.

I was not part of the Commission's proceedings on V.C Summer Units 2 and 3. I have no special knowledge about whether or how SCE&G's actions and inactions led to the unfortunate outcome. But I recommend the Commission ask Ms. Elbert this question: Given that earnings rise with rate base, can Ms. Elbert be sure that SCE&G's earnings-based compensation for its executives played no role in their decision to seek pre-approval for and rate-basing of V.C. Summer 2 and 3? Can she be sure that the executives' earnings-based compensation played no role in their decisions to continue spending money beyond the project's failure point, and then fail to make essential data transparent to the Commission and the state's citizens? Can she be sure that there was no connection between the company's earnings expectations, the executives' earnings-based compensation, and the outcome of V.C. Summer 2 and 3? If the answer is no, if Ms. Elbert cannot be sure that earnings-based executive compensation played no role in a project failure whose billions in useless costs now fall on faultless shareholders and customers, then the Commission has its answer: eliminate compensation based on earnings.

Q. What about Ms. Elbert's concern that you offered no evidence of adverse effects (Elbert Rebuttal at 2:7-8)?

[8] Hempling Direct at 2:10-11 (emphasis added).

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A. That question is better addressed to Ms. Elbert: Does she really believe that the obvious conflict between shareholder earnings and customer interests has always favored the customer? As one influential court has held: "Agencies do not need to conduct experiments in order to rely on the prediction that an unsupported stone will fall."[9]

A century of utility regulation has taught us that shareholder interests do not automatically align with customer interests. It necessarily follows that basing compensation on shareholder interests risks creating conflicts with customer interests. And those conflicts are needless conflicts. A utility's sole purpose is to serve its customers. When it does so prudently, and when its commission sets rates lawfully, appropriate earnings follow.

DESC should compensate its executives and employees well—based on how well they serve the customers. Tying compensation to earnings introduces conflict with no incremental benefit.

II. Though protected from competition, DESC cannot escape its duty to operate as if subject to competition—the duty to operate at lowest feasible cost

Q. Do you wish to supplement Mr. Fetter's brief history of your and his professional interactions?

A. Yes. I am pleased to interact again with Mr. Fetter, whose amiability and professionalism I have long appreciated. His summary of our joint work[10] omitted a high point. In a 2010

[9] *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1027 (D.C. Cir. 1987) (finding that regulators need not conduct factual hearings to learn that monopolists will act in their self-interest).

[10] Fetter Rebuttal at 23:16-23.

proceeding on the Kemper lignite-fired generation project, he was a witness for Mississippi Power Company; I was outside counsel for the Mississippi Public Service Commission, responsible for questioning the witnesses. Playing those two roles, Mr. Fetter and I had an on-the-record discussion about assigning responsibility for large capital expenditures, in a context where the risks and consequences of financial and technological failure were high. Several observers said afterwards that our joint, unscripted performance met the highest standards.

To meet those standards again here, I respectfully correct two misimpressions Mr. Fetter has inadvertently created about my Direct Testimony.

Q. Comment on the utility's obligation to operate at lowest feasible cost.

A. My Direct Testimony explained that standard regulatory practice requires utilities to operate with all reasonable economies, incur the lowest feasible cost, and use all available cost savings opportunities.[11] Mr. Fetter criticizes the "least-cost" standard as requiring "perfection."[12] He is incorrect, as a matter of dictionary definition, law and policy. I fully agree that "perfection" is never the right regulatory standard, because perfection is too costly. I say so, explicitly, in my textbook.[13] That perfection is too costly automatically distinguishes "perfection" from "least-cost"; perfection is aspirational and unattainable; least-cost is doable.

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[11] Hempling Direct 10:5-6.

[12] Fetter Rebuttal 25:9-10.

[13] Scott Hempling, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* 241 (Amer. Bar Assoc. 2013) (explaining that prudence does not require perfection, because "perfection is not worth paying for").

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Mr. Fetter also errs in viewing the "least-cost" standard as precluding alternative solutions. I fully agree with him that "there can be more than one prudent alternative."[14] But to be prudent, each of those alternatives must achieve cost-effectiveness—they must be the lowest-cost way to satisfy the need. In a competitive market, like the one that Mr. Fetter and I operate in as advisors and witnesses, the company that doesn't provide the most cost-effective service loses customers to companies that do. A utility with a government-granted monopoly does not get to escape this standard just because its customers are captive. I feel relatively sure that Mr. Fetter agrees with me on these principles; he has merely misinterpreted my language as inconsistent with them.

Q. Comment on the Commission's duty to assess not only the proposed $178 million increase but also the full $2.3 billion revenue requirement.

A. More disturbing is Mr. Fetter's other misunderstanding of my testimony.[15] I pointed out that by framing its Application as merely a request for a $178 million increase, DESC diverted attention from what it really is seeking: approval of a $2.3 billion revenue requirement. I urged the Commission to assess the whole iceberg, not just the tip, because customers pay for the whole. But I also made clear, explicitly so, that the Commission could not unring bells: It could not question the prudence of costs already approved and already incurred. The statutory prohibition against retroactivity, the Constitution's protection of legitimate shareholder expectations, and wise policy all preclude such unsettling of past decisions. I could not have been clearer.

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[14] Fetter Rebuttal at 25:10-11.

[15] *Id*. at 25:12-23 (referring, without basis and without specific references to my testimony, to investor concerns about "disallowances of . . . previously-reviewed expenditures").

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Then I made, again clearly, a distinct point: that while DESC's $2.3 billion revenue requirement includes rate base costs that already have been approved and incurred, it also includes operating costs that have not yet been incurred. When the sum of (a) those prospective operating costs and (b) their associated not-yet-recovered rate base investments exceed (c) the sum of prospective operating costs and prospective capital expenditures of alternatives, all measured over a reasonable time horizon (such as where existing coal plants might be economically replaced by lower-emitting alternatives), prudence requires the utility to take the lower-cost path, accompanied by recovery of the associated already-incurred-but-not-yet-recovered asset costs. That result is required by the utility's obligation to operate at lowest feasible cost.[16]

Nowhere in my testimony, or in any of my 36 years of writings, have I suggested that regulators may dishonor legitimate shareholder expectations created by lawful commission decisions. I hope that Mr. Fetter, consistent with our decades of mutual amicability and professionalism, will correct his misimpression himself.

Q. Does this complete your surrebuttal testimony?

A. Yes.

[16] Hempling Direct at 25:6-26:11.

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