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REBUTTAL TESTIMONY

OF

DANIEL J. LAWTON

Submitted on Behalf of the Office of the Public Counsel

MISSOURI GAS ENERGY

Case No. GR-2009-0355

September 28, 2009

OPC Exhibit No. 70
Case No(s). GR-2009-0355
Date 10-26-09 Rptr JF

REBUTTAL TESTIMONY OF

DANIEL J. LAWTON

CASE NO. GR-2009-0355

Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 701 Brazos, Suite 500, Austin, Texas 78701.

Q2. ARE YOU THE SAME DANIEL J. LAWTON WHO PREVIOUSLY FILED DIRECT TESTIMONY ON OR ABOUT AUGUST 21, 2009 IN THIS DOCKET?

A. Yes, I am.

Q3. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY?

A. The purpose of my testimony in the rebuttal phase of the proceedings is to address the direct testimony of Missouri Gas Energy ("MGE" or "Company") witness Frank J. Hanley's cost of capital recommendations in this proceeding, which were filed with this Commission in March 2009.

Q4. BEFORE ADDRESSING MR. HANLEY'S SPECIFIC COST OF CAPITAL MODELS, ANALYSES AND RECOMMENDATIONS IN THIS PROCEEDING, DO YOU HAVE ANY GENERAL COMMENTS REGARDING MR. HANLEY'S RECOMMENDATIONS IN THIS CASE?

A. Yes, I have a number of comments. First, Mr. Hanley's proposed equity return of 11.25% based on his comparable group analysis is out of date and overstated.[1] Further, Mr. Hanley's alternative equity return proposal of 15.25%, based on Southern Union

[1] Direct Testimony, Hanley at 2.

Company[2], is not only out-of-date, but so overstated for the operations of MGE that such a proposal is not reasonable for consideration.

I expect Mr. Hanley will update his testimony and reduce the primary recommendation of 11.25% by at least 60 basis points to a level of about 10.65%. Moreover, when Mr. Hanley's flawed analyses are corrected, his results will support the 10% equity return range I recommend in this proceeding.

Q5. WHAT EVIDENCE ARE YOU AWARE THAT LEADS TO THE CONCLUSION THAT MR. HANLEY WILL ACKNOWLEDGE HIS ANALYSES ARE OUT OF DATE AND UPDATE HIS RECOMMENDATION WITH A SUBSTANTIALLY LOWER NUMBER?

A. Mr. Hanley recently filed rebuttal testimony before the Public Utilities Commission of Nevada in a Southwest Gas Corporation case, Docket No. 09-04003, and stated "[d]ue to the significant changes in the capital markets over the approximately six months that have elapsed since my original common equity cost rate (ROE) recommendation was formulated, I deemed it necessary to provide an updated study that is more reflective of current and prospective capital market conditions. As a result of my updated study, I conclude that a proper common equity cost rate is 10.80%..."[3] Given that Mr. Hanley's Missouri testimony and analyses was filed in March 2009, before his April 3, 2009 Nevada testimony and given that he employed essentially the same comparable group of gas companies in each case – the "...significant changes in the capital markets..." should impact his Missouri analysis in the same fashion as his Nevada analysis. Thus, I expect Mr. Hanley will be filing an updated and more realistic cost of equity recommendation.

[2] *Id.* at 3.
[3] Rebuttal Testimony of Frank Hanley, In the Matter of Southwest Gas Corporation, Public Utilities Commission of Nevada, at 3.

Q6. DO YOU HAVE ANY COMMENTS REGARDING THE FACT THAT MR. HANLEY'S ORIGINAL COST OF CAPITAL RECOMMENDATION FAILED TO INCLUDE A REDUCTION FOR THE RISK SHIFTING ASSOCIATED WITH DECOUPLING OF REVENUES THROUGH THE STRAIGHT FIXED VARIABLE ("SFV") OF MGE?

A. Yes, I have a number of comments. First, Mr. Hanley's direct testimony at page 3, lines 8-15 address this point where Mr. Hanley states:

> I determined, based on the data shown on Schedule FJH-3, that approximately 84.5% on average of the proxy group's revenues are partially or fully decoupled. Consequently, a common equity cost rate derived from my proxy group of nine LDC's [ ] is reflective of a similar level of risk reduction for MGE as a result of its SFV rate design. Thus, there is a quid pro quo vis-à-vis the proxy of nine LDCs and no adjustment to common equity cost rate derived from the proxy group is needed as a result of MGE's SFV rate design.

The first problem with Mr. Hanley's conclusion is that there is no quid pro quo – he is just plain inconsistent. In his Nevada Southwest Gas testimony, filed in the same time frame, using essentially the same comparable group and concluding (incorrectly, I might add) that 93.8% on average that the proxy groups revenues were decoupled – he concluded the Southwest Gas equity return should be reduced for decoupling. Now, in this case with SFV a more favorable decoupling mechanism to the utility – he concludes no equity reduction for decoupling. This is just not credible or consistent with his own contemporaneous testimony on the same issue in Nevada.

Q7. DO YOU HAVE ANY COMMENTS REGARDING MR. HANLEY'S CLAIM THAT 84.5% ON AVERAGE OF THE PROXY GROUP'S REVENUES ARE PARTIALLY OR FULLY DECOUPLED?

A. Yes, I have a number of comments. First, I would note his analysis is inadequate and Mr. Hanley's conclusions are wrong. His 84.5% related to decoupling for the proxy group comes from the analysis contained in FJH-3. Mr. Hanley assumes that a SFV (decoupling) rate design is the economic equivalent of a weather normalization clause – that is incorrect. Moreover, he includes temporary gas reliability infrastructure program adjustments such as the GRIP adjustment in Texas as a decoupling adjustment – which it is not. Mr. Hanley ignores in total the minimum or fixed customer charges in his analysis. His entire analysis is a flawed exercise that has no useful purpose in evaluating the relative measure of decoupling embodied in the market comparables.

Q8. PLEASE EXPLAIN WHY WEATHER NORMALIZATION ADJUSTMENTS ARE NOT COMPARABLE OR EQUIVALENT TO SFV OR EVEN MARGIN TRACKER CLAUSES?

A. A weather normalization clause is limited to only weather sensitive sales and is implemented only when weather deviates from normal for those weather sensitive volumes.[4] On the other hand, SFV rate design or margin tracker mechanisms capture all sales, all revenues, and assure 100% of the recovery of the entire margin. While weather adjustment mechanisms have typically much smaller impacts. Thus, Mr. Hanley has overstated the amount of revenues that are truly subject to decoupling. Essentially, by treating all forms of decoupling as having an equal impact on revenue/margin recovery, Mr. Hanley overstates the level of decoupled revenue in the group and understates the risk shifting to customers in the case of MGE.

Q9. PLEASE PROVIDE AN EXAMPLE DEMONSTRATING THAT WEATHER NORMALIZATION ADJUSTMENTS ARE NOT EQUIVALENT TO TOTAL MARGIN DECOUPLING.

A. Included in my Schedule (DJL-1R) is an example of calculating weather sensitive volumes subject to decoupling. As can be seen in this analysis, about 59.8% of sales are subject to weather normalization while base load sales, non-weather sensitive volumes, represent about 40% of sales. Moreover, the weather sensitive sales are not totally

[4] Normal weather is typically measured in heating degree days based on a 10 year or 30 year historical average.

subject to adjustment. A weather normalization mechanism adjusts only the increment of change above or below normal weather conditions. Thus, in any year, if weather is so extreme that actual degree days are 50% of normal (an extreme event) then only about half the weather sensitive sales would be subject to adjustment. Therefore, even the most extreme examples 68,660,896 (137,321,792*50%) of sales, or about 30% of total sales are subject to adjustment.

While weather normalization truly impacts a small percentage of sales and revenues – SFV rate design eliminates any need for weather or any type of adjustment clause. Under SFV 100% of margin revenues is assured for every customer on the system. The bottom line is that Mr. Hanley's analysis of the impact of other Company adjustment mechanisms is an incorrect analysis and fails to take into account the true impact of SFV rate design and decoupling.

Q10. EARLIER YOU STATED THAT MR. HANLEY HAS INCLUDED TEMPORARY GAS INFRASTRUCTURE ADJUSTMENTS AS DECOUPLING MECHANISMS, DO YOU HAVE A COMMENT?

A. Yes, temporary or interim gas infrastructure adjustments – such as the GRIP adjustment in Texas are not decoupling adjustments. In other words, Mr. Hanley is wrong again. The Texas GRIP adjustment employed in Mr. Hanley's analysis is codified in the Texas Utilities Code at Section 104.301 and I have included such in my Schedule (DJL-2R). This statutory provision is an interim rate adjustment that utility companies may employ to capture capital investment between rate proceedings. The full amount of recovery is subject to review and disallowance in subsequent cases. Moreover, the rate increase under this clause may be included in a company's customer charge or first volumetric block at the utility's discretion. This has nothing to do with decoupling – instead it addresses earning erosion and regulatory lag between rate proceedings. Mr. Hanley's inclusion of such a revenue adjustment as part of decoupled revenues – is wrong.

Q11. EARLIER YOU STATED MR. HANLEY IGNORED CUSTOMER CHARGES IN HIS DECOUPLING ANALYSIS, PLEASE COMMENT.

A. As I discussed in my direct testimony, the customer charge component of a customer bill, *i.e. the minimum charge, represents decoupled revenues.* For example, in this MGE case all margins for the residential class are collected through the customer charge – or complete decoupling. Yet, Mr. Hanley's analysis at FJH-3 totally ignores minimum bill or customer charges. Given that all utilities have a minimum charge, 100% of all comparable utilities have some form of decoupling. But, the question for a proper analysis is the percentage of margins that are recovered from methods other than volumes – not the percentage of revenues that may be subject to some adjustment mechanism.

Mr. Hanley's decoupling analysis is inconsistent with prior analyses and his decoupling analysis in FJH-3 is a flawed academic exercise with no application to the important issues in this case.

Q12. HOW DID MR. HANLEY ARRIVE AT HIS RECOMMENDED EQUITY RETURN OF 11.25%?

A. His equity return analysis is summarized in his Schedule FJH-1, page 2 of 17, which is summarized in the following table:

TABLE 1[5]
SUMMARY OF WITNESS HANLEY
ROE RECOMMENDATION

	Description	Result
1	Discounted Cash Flow (DCF)	9.82%
2	Risk Premium Model (RP)	12.36%
3	Capital Asset Pricing Model (CAPM)	11.33%
4	Comparable Earnings Model (CEM)	----------
5	MidPoint of Model Results	11.09%
6	Business Risk Adjustment	0.15%
7	Indicated Result ROE	11.24%

[5] Direct Testimony of Frank Hanley, Schedule FJH-1, p. 2 of 17.

Thus, Mr. Hanley estimates three equity return models, eliminated the CEM results and estimated the midpoint between the remaining end point results of 9.82% (DCF) and 12.36% RP or 11.09%. To this estimate he added 0.15% or 15 basis points for business risk resulting in an ROE estimate of 11.24% (11.09% + 0.15%) which he rounded to 11.25% for his testimony.

Q13. DO YOU HAVE ANY COMMENTS ON MR. HANLEY'S DCF ANALYSIS?

A. Generally, I agree with Mr. Hanley's DCF results as his DCF analysis of 9.82% certainly supports my 10% equity return recommendation in this case. I do expect that Mr. Hanley's DCF, when updated, will continue to support a 10% equity return.

I would note that Mr. Hanley's growth rate analysis is quite limited, relying only on Reuters and Value Line Investment Survey analysts estimates. In my opinion, a wider view of growth rates limits errors and bias.

Q14. DO YOU HAVE ANY COMMENTS ON MR. HANLEY'S RISK PREMIUM ANALYSIS?

A. Yes. Again, while I expect this analysis will be updated to correct his outdated analysis, a few general comments are necessary at this time. At page 49, lines 10-13, Mr. Hanley discusses the calculation of his market equity risk premium. The complete calculation is shown on his Schedule FJH-15, page 6 of 9. Mr. Hanley has concluded that the forecasted market returns that stockholders can expect to earn in each of the next three to five years is an incredible 28.85%.[6] From this enormous equity return, Mr. Hanley subtracts an estimate of Aaa corporate bond yields of 5.08%.[7] He concludes that the market risk premium (the premium an equity investor demands to purchase equity rather than debt), is an astounding 23.77%.[8] Rather than eliminate this obvious unreliable result,

[6] See FJH-15, p. 6, line 4.
[7] *Id.* at line 5.
[8] *Id.* at line 6.

Mr. Hanley assigns an arbitrary weighting of 20% and includes 20% of the outlier in his analysis.[9]

[9] *Id.* at Footnote 5.

Q15. IN YOUR OPINION, WHAT IS THE IMPACT OF INCLUDING AN UNRELIABLE 23.77% RISK PREMIUM AND ASSIGNING IT AN ARBITRARY 20% WEIGHTING?

A. An unreasonable result that has been weighted by a 20% factor – is still an unreasonable result. All the arbitrary weighting will not make an unreasonable result – reasonable.

Q16. ARE YOU AWARE OF ANY REGULATORY AUTHORITY IN THE UNITED STATES THAT HAS RELIED ON AN EQUITY RISK PREMIUM AT THE LEVELS PROPOSED BY MR. HANLEY?

A. No.

Q17. ARE YOU AWARE OF ANY INVESTOR SERVICES, ANALYST ESTIMATES, OR ANY CREDIBLE FORECASTING ENTITY THAT IS SUGGESTING THAT INVESTORS WILL EARN EQUITY RETURNS OF 28.85% OVER THE NEXT THREE TO FIVE YEARS?

A. No. Moreover, even the non-reputable firms such as the one run by Bernie Madoff didn't pay 28.85% returns in the best of times. Mr. Hanley's analysis is just unreasonable.

Q18. IS THE USE OF A 28.85% EQUITY RETURN FOR CALCULATING THE RISK PREMIUM INCONSISTENT WITH MR. HANLEY'S OTHER ANALYSES?

A. Yes. At page 73 of his direct testimony Hanley states the following regarding his comparable earnings model results:

> The median projected ROEs are 22.00% based on the comparable group…is on the high side and so far outside the range of common equity cost rates indicated for the proxy group of nine LDCs…that it is not meaningful and therefore is not included in my determination of the 11.25% common equity cost rate applicable to MGE.

Thus, Mr. Hanley concludes a 22.0% ROE result is beyond reasonable and must be excluded in his CEM analysis, but in his risk premium he relies on a 28.85% ROE to make his calculation. While he attempts to water down the impact of a 28.85% ROE through arbitrary weighting and other averaging techniques – his starting point of 28.85% is inconsistent with his conclusions related to the CEM 22.0% ROE results.

Q19. IS MR. HANLEY'S MULTI-PART RISK PREMIUM ANALYSIS A REASONABLE MEASURE FOR ESTIMATING COST OF EQUITY?

A. No. Mr. Hanley's analysis of risk premium should not be relied on in this or any case for estimating a reasonable cost of equity. Mr. Hanley's analysis is theoretically and fundamentally flawed which led him to overstate the cost of equity.

The basic problems with Mr. Hanley's analysis are threefold. First, Mr. Hanley relies on outdated data, specifically his reliance on the Ibbotson SBBI-2008 Valuation Yearbook shown at his Exhibit __(FJH-15) Sheet 6 of 9, Lines 1-3. Had Mr. Hanley employed the most recent data, his risk premium would have been about 5.6% rather than his claimed 6.20%.

Second, as discussed earlier, Mr. Hanley's reliance on estimated annual market returns of 28.85% per annum is just not realistic. Even his attempts to lower the impact of these enormous returns by averaging, employing a reduction for beta and arbitrarily weighting these returns and resulting risk premiums with an arbitrary 20% weight, does not make the use of 28.85% annual stock returns reasonable. Instead, the result after weighting is just as unreasonable as before weighting.

Third, Mr. Hanley mixes and matches risk premiums based on bond ratings Aaa, Aa, A and Baa in his analysis. Such mixing and matching of these various risk measures does not improve the accuracy or reliability of the results. Instead, the analysis is left with some undefined risk measure which is inapplicable to the case at hand.

In summary, Mr. Hanley's risk premium measures are substantially overstated and the overall analysis should not be a basis for establishing equity return in this case.

Q20. DO YOU HAVE ANY COMMENTS REGARDING MR. HANLEY'S CAPITAL ASSET PRICING MODEL?

A. Yes. Mr. Hanley's attempt to estimate an equity return for Southwest and the companies in the proxy group suffers from the same flaws as discussed earlier related to his attempt to estimate a risk premium estimate. Again, Mr. Hanley relies on market return estimates of 28.85% per year. This is just not credible and should be discarded. Mr. Hanley also continues to rely on outdated data from his Morningstar source. Lastly, Mr. Hanley calculates his risk premium based on the arithmetic "income" return of long-term government bonds – while excluding the capital appreciation on those same bonds.[10] In my opinion, the risk premium computation (equity cost less debt cost) should reflect the income and appreciation or total return for both the equity and less risky debt measure.

Q21. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[10] See Hanley Exhibit__(FJH-14), Sheet 3, Note 1

ESTIMATE OF WEATHER NORMALIZATION SALES
IMPACT ON WEATHER SENSITIVE SALES

MONTH	CUSTOMERS	SALES	USE PER CUSTOMER	BASE USAGE	WEATHER SENSITIVE USAGE	WEATHER SENSITIVE SALES
JAN	438,465	44,811,123	102.20	17.54	84.66	37,122,557
FEB	438,465	38,190,301	87.10	17.54	69.56	30,501,735
MAR	438,465	28,894,844	65.90	17.54	48.36	21,206,278
APR	438,465	17,100,135	39.00	17.54	21.46	9,411,569
MAY	438,465	12,023,145	27.42	17.54	9.89	4,334,579
JUN	438,465	10,168,678	23.19	17.54	5.66	2,480,112
JUL	438,465	8,164,291	18.62	17.54	1.08	0
AUG	438,465	7,178,172	16.37	17.54	-1.16	0
SEP	438,465	7,723,236	17.61	17.54	0.08	0
OCT	438,465	8,582,546	19.57	17.54	2.04	893,980
NOV	438,465	12,854,772	29.32	17.54	11.78	5,166,206
DEC	438,465	33,893,345	77.30	17.54	59.76	26,204,779
TOTAL	5,261,580	229,584,588				**137,321,792**
BASE USAGE TOTAL			**17.54**			**59.81%**

INTERIM ADJUSTMENT FOR CHANGES IN INVESTMENT IS NOT DECOUPLING

Westlaw

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Effective: September 1, 2005

Vernon's Texas Statutes and Codes Annotated Currentness
Utilities Code (Refs & Annos)
Title 3. Gas Regulation
Subtitle A. Gas Utility Regulatory Act
Chapter 104. Rates and Services (Refs & Annos)
Subchapter G. Interim Cost Recovery and Rate Adjustment
§ 104.301. Interim Adjustment for Changes in Investment

(a) A gas utility that has filed a rate case under Subchapter C [FN1] within the preceding two years may file with the regulatory authority a tariff or rate schedule that provides for an interim adjustment in the utility's monthly customer charge or initial block rate to recover the cost of changes in the investment in service for gas utility services. The adjustment shall be allocated among the gas utility's classes of customers in the same manner as the cost of service was allocated among classes of customers in the utility's latest effective rates for the area in which the tariff or rate schedule is implemented. The gas utility shall file the tariff or rate schedule, or the annual adjustment under Subsection (c), with the regulatory authority at least 60 days before the proposed implementation date of the tariff, rate schedule, or annual adjustment. The gas utility shall provide notice of the tariff, rate schedule, or annual adjustment to affected customers by bill insert or direct mail not later than the 45th day after the date the utility files the tariff, rate schedule, or annual adjustment with the regulatory authority. During the 60-day period, the regulatory authority may act to suspend the implementation of the tariff, rate schedule, or annual adjustment for up to 45 days. After the issuance of a final order or decision by a regulatory authority in a rate case that is filed after the implementation of a tariff or rate schedule under this section, any change in investment that has been included in an interim adjustment in accordance with the tariff or rate schedule under this section shall no longer be subject to subsequent review for reasonableness or prudence. Until the issuance of a final order or decision by a regulatory authority in a rate case that is filed after the implementation of a tariff or rate schedule under this section, all amounts collected under the tariff or rate schedule before the filing of the rate case are subject to refund.

(b) The amount the gas utility shall adjust the utility's rates upward or downward under the tariff or rate schedule each calendar year is based on the difference between the value of the invested capital for the preceding calendar year and the value of the invested capital for the calendar year preceding that calendar year. The value of the invested capital is equal to the original cost of the investment at the time the investment was first dedicated to public use minus the accumulated depreciation related to that investment.

(c) The interim adjustment shall be recalculated on an annual basis in accordance with the requirements of Subsection (b). The gas utility may file a request with the regulatory authority to suspend the operation of the tariff

or rate schedule for any year. The request must be in writing and state the reasons why the suspension is justified. The regulatory authority may grant the suspension on a showing by the utility of reasonable justification.

(d) A gas utility may only adjust the utility's rates under the tariff or rate schedule for the return on investment, depreciation expense, ad valorem taxes, revenue related taxes, and incremental federal income taxes related to the difference in the value of the invested capital as determined under Subsection (b). The return on investment, depreciation, and incremental federal income tax factors used in the computation must be the same as the factors reflected in the final order issued by or settlement agreement approved by the regulatory authority establishing the gas utility's latest effective rates for the area in which the tariff or rate schedule is implemented.

(e) A gas utility that implements a tariff or rate schedule under this section shall file with the regulatory authority an annual report describing the investment projects completed and placed in service during the preceding calendar year and the investments retired or abandoned during the preceding calendar year. The annual report shall also state the cost, need, and customers benefited by the change in investment.

(f) In addition to the report required under Subsection (e), the gas utility shall file with the regulatory authority an annual earnings monitoring report demonstrating the utility's earnings during the preceding calendar year.

(g) If the gas utility is earning a return on invested capital, as demonstrated by the report filed under Subsection (f), of more than 75 basis points above the return established in the latest effective rates approved by a regulatory authority for the area in which the tariff or rate schedule is implemented under this section, the gas utility shall file a statement with that report stating the reasons why the rates are not unreasonable or in violation of law.

(h) If a gas utility that implements a tariff or rate schedule under this section does not file a rate case under Subchapter C [FN1] before the fifth anniversary of the date on which the tariff or rate schedule takes effect, the gas utility shall file a rate case under that subchapter not later than the 180th day after that anniversary in relation to any rates subject to the tariff or rate schedule.

(i) This section does not limit the power of a regulatory authority under Section 104.151.

(j) A gas utility implementing a tariff or rate schedule under this section shall reimburse the railroad commission the utility's proportionate share of the railroad commission's costs related to the administration of the interim rate adjustment mechanism provided by this section.

CREDIT(S)

Added by Acts 2003, 78th Leg., ch. 938, § 1, eff. Sept. 1, 2003. Amended by Acts 2005, 79th Leg., ch. 948, § 1,

eff. Sept. 1, 2005.

[FN1] V.T.C.A., Utilities Code § 104.101.

Current through Chapters effective immediately through Ch. 87 of the 2009 Regular Session of the 81st Legislature.

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