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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION
UTILITY SERVICES – FINANCIAL ANALYSIS

REBUTTAL TESTIMONY

OF

ZEPHANIA MAREVANGEPO

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LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP.
d/b/a LIBERTY UTILITIES

CASE NO. GR-2014-0152

Jefferson City, Missouri
July 2014

*** Denotes Proprietary Information ***

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1 REBUTTAL TESTIMONY

2 OF

3 ZEPHANIA MAREVANGEPO

4 LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP.
5 d/b/a LIBERTY UTILITIES

6 CASE NO. GR-2014-0152

7 Q. Please state your name.

8 A. My name is Zephania Marevangepo.

9 Q. Are you the same Zephania Marevangepo who prepared the Rate of Return
10 Section of the Staff's Revenue Requirement Cost of Service Report ("Staff Report") that was
11 filed in this Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty
12 Midstates" or "Company") rate case?

13 A. Yes.

14 Q. What is the purpose of your rebuttal testimony?

15 A. The purpose of my rebuttal testimony is to respond to certain rate of return of
16 positions sponsored by Liberty Midstates' cost of equity expert witness – Robert Hevert.

17 **EXECUTIVE SUMMARY**

18 Q. Would you please summarize the specific rate of return positions sponsored
19 by Robert Hevert that you wish to address?

20 A. Robert Hevert sponsored (1) a Liberty-Midstates-allocated ratemaking capital
21 structure, which comprised 58.34 percent equity and 41.66 percent long-term debt (2) a
22 return on the equity of 10.50 percent and (3) a 4.78 percent Liberty-Midstates-allocated
23 embedded cost of debt. As already expressed in Staff's revenue requirement report, Staff

1 established that Liberty Midstates' parent company (Liberty Utilities Company **"LUCo"**) is a
2 rated entity and Liberty Midstates is not; and the embedded debt cost that was allocated to
3 Liberty Midstates was based on LUCo's consolidated business and financial risk profile and
4 not Liberty Midstates. Consequently, Staff recommended the use of LUCo's consolidated
5 capital structure and embedded cost of debt to set Missouri customer rates.

6 Robert Hevert's recommended 10.50 percent return on common equity was based on
7 his estimated cost of equity range of 10.00 percent to 10.50 percent. Staff will discuss later in
8 this testimony the unreasonableness of the inputs and/ or assumptions made by Robert Hevert
9 in order to determine this cost of equity range.

10 Q. Would you please summarize the specific aspects of Staff's recommendation
11 that relate to Robert Hevert's positions cited above?

12 A. Staff recommended the use of LUCo's capital structure as the
13 rate-making capital structure. This capital structure comprised * * percent equity and
14 * * percent long-term debt as of the test year date –September 30, 2013. Due to the
15 discovery issues expressed in Staff's Report, the embedded cost of debt sponsored by Staff
16 was based on LUCo's stated interest rates associated with the outstanding long-term debt
17 balance.[1] Staff was not able to give consideration to debt issuance expenses due to the
18 Company not providing this information.

19 Q. Please state and explain any specific issues that Staff updated after filing its
20 direct position.

21 A. In light of the additional information received through a response to Staff's
22 Data Request No. 0177.2, Staff updated its consolidated embedded cost of debt

[1] Staff report revenue requirement cost of service: page 21, lines 20 through 28.

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1 recommendation from * * percent to * * percent. Staff's higher cost of debt
2 estimate is due to the fact that the Company provided information regarding debt issuance
3 costs that allowed Staff to take this into consideration in its calculations.
4 Q. Did the embedded cost of debt adjustment impact any other facets of Staff's
5 recommendation?
6 A. Yes. The embedded cost of debt adjustment raised Staff's overall rate of
7 return range from 6.30-6.80 percent to 6.39-6.85 percent.

8 **ROBERT HEVERT'S TESTIMONY**

9 Q. Would you please highlight the major areas of Robert Hevert's
10 recommendation that Staff will address?
11 A. Capital structure, embedded cost of debt, and cost of equity. Staff will address
12 these accordingly.

13 **CAPITAL STRUCTURE**

14 Q. Would you please explain the differences between Robert Hevert's and Staff's
15 capital structure recommendations?
16 A. Staff recommended LUCo's consolidated capital structure consisting of
17 * * percent common equity and * * percent long-term debt. Robert Hevert
18 recommended Liberty Midstates' allocated capital structure consisting of 58.34 percent
19 equity and 41.66 percent long-term debt. Staff recommends the Commission reject the use of
20 Liberty Midstates' allocated capital structure for purposes of determining customer rates in
21 this case.
22 Q. Would you please explain why Staff believes the allocated rate-making capital
23 structure sponsored by Robert Hevert should be rejected?

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1 A. Liberty Midstates, as an entity, (1) does not have a credit rating, (2) does not
2 issue equity, (3) does not issue long-term debt, (4) does not raise its own short-term debt and
3 (5) its capital structure has no bearing on the cost of capital required by investors.

4 All the activities listed above occur at the LUCo level. Consequently, Staff
5 recommends that the Commission use LUCo's capital structure for purposes of determining
6 Missouri customer rates.

7 Q. Would you please provide Staff's basic understanding of LUCo's
8 allocation process?

9 A. Based on the information presented by Algonquin Power & Utilities
10 Corporation's (APUC) Chief Executive Officer – Ian Robertson during meetings in the
11 acquisition case (GM-2012-0037) and also confirmed by the Company's response to Staff's
12 Data Request No. 0177.2 in this rate case, LUCo issues long-term debt to debt investors and
13 equity to its parent company (APUC); and then allocates portions of this capital to the
14 operations that need capital at the time. Thus, Liberty Midstates' capital structure is defined
15 as an allocated capital structure.

16 Q. Does Staff know if LUCo has a targeted capital structure for Liberty Midstates
17 or any of its subsidiaries?

18 A. No. However, in response to Staff's Data Request No. 0185.1, the Company
19 suggested that the levels of capital for each of LUCo's operations are not stable since they
20 are simply a function of the amount of capital needed at a point in time and the timing of
21 capital needed. However, even if LUCo did indicate it had a targeted capital structure for
22 Liberty Midstates, the only logical targeted capital structure would be one that is consistent

1 with LUCo on a consolidated basis since Liberty Midstates' business risk is similar to that of
2 LUCo and LUCo is the only "investable" capital structure.

3 Q. Given the still low interest rate environment and the availability of LUCo's
4 credit facility, does Staff know the quantifiable financial and investment justification for
5 LUCo's decision to allocate higher percentage levels of equity versus debt to certain
6 subsidiaries/operations?

7 A. No. However, Staff notes that Liberty Midstates has not had any debt capital
8 assigned to it since LUCo issued capital to acquire the operations. If Liberty Midstates were
9 a stand-alone entity, its capital structure would at least reflect an outstanding short-term debt
10 balance that supports its working capital needs or inventory-related costs that the Company
11 currently seeks to recover through rate base. All else equal, inclusion of short-term debt in
12 the capital structure would reduce the Company's equity ratio and cost of capital.

13 As LUCo is currently organized, it is LUCo management's judgment and prerogative
14 to assign capital based on a subjective process that can't be audited or verified.
15 Consequently, there is no quantifiable financial and investment justification for assigning
16 higher equity capital percentages to Liberty Midstates.

17 Q. Given a combination of the existing low interest rate environment and
18 LUCo's current/ ongoing acquisitive mode, do you believe Staff's recommended ratemaking
19 capital structure (LUCo's consolidated capital structure) represents a long-term capital
20 structure position for LUCo?

21 A. Yes.

22 Q. What, therefore, is Staff's capital structure recommendation?

1 A. Staff recommends that the Commission use LUCo's consolidated capital
2 structure for purposes of determining customer rates in this case.

3 **EMBEDDED COST OF DEBT**

4 Q. Would you please explain the differences between Robert Hevert's and Staff's
5 embedded cost of debt recommendations?

6 A. Robert Hevert sponsored an embedded cost of debt of 4.78 percent, which is
7 based on the debt allocated to Liberty Midstates' capital structure.[2]

8 Because the allocation of the cost of debt capital suffers from the same problems as
9 the allocation of the amount of debt for a capital structure, Staff recommended the use of a
10 consolidated embedded cost of debt based on LUCo's consolidated capital structure.

11 However, due to the limited data that was available at the time Staff developed
12 this recommendation, Staff's debt cost was based on stated interest rates rather than
13 embedded costs. Embedded rates ensure recovery of long-term debt issuance expenses;
14 stated rates do not.

15 **EMBEDDED COST OF DEBT UPDATES**

16 Q. Did Staff make any embedded cost of debt updates in this testimony?

17 A. Yes. In light of the additional information the Company provided in response
18 to Staff Data Request No. 0177.2, Staff's updated cost of debt increased to * * percent
19 from * * percent.

20 Q. Did this embedded cost of debt update impact Staff's overall rate of return
21 recommendation?

[2] Liberty Midstates Cost of Service Schedules: Schedule COS-9.

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1 A. Yes. Staff's recommended rate of return increased from 6.34-6.80 percent to
2 6.39-6.85 percent.

3 **COST OF EQUITY**

4 Q. Would you please state and explain Robert Hevert's cost of equity
5 recommendation?

6 A. Robert Hevert recommended a 10.50 percent return on common equity based
7 on his estimated cost of common equity range of 10 – 10.50 percent. Robert Hevert, on
8 page 46 of his direct testimony, suggests that a 10 – 10.50 percent cost of common equity
9 range represents a spectrum of required rate of returns that are currently anticipated by
10 natural gas utilities' equity investors.

11 Staff will discuss in this section of its testimony how Robert Hevert's cost of equity
12 model inputs, which are diametrically contrary to existing practical investment expectations,
13 inflated the results of his cost of equity models.

14 Q. Would you please explain Staff's understanding of Robert Hevert's basis for
15 his 10 – 10.50 percent estimated cost of common equity range?

16 A. Robert Hevert's estimated cost of equity range is primarily based on **(1)** three
17 versions of a Discounted Cash Flow (DCF) model *(Quarterly Growth DCF, Constant DCF*
18 *and Multi-Stage DCF)*, **(2)** Capital Asset Pricing Model (CAPM) and **(3)** a Bond Yield Plus
19 Risk Premium Approach.

20 Q. Would you please express Staff's opinion of Robert Hevert's proposed cost of
21 equity range and the cost of equity methodologies upon which the range is premised?

22 A. Upon reviewing Robert Hevert's cost of equity study, Staff established that
23 the perpetual growth rate assumptions and inputs used in Robert Hevert's DCF models were

1 inflated. Robert Hevert's perpetual growth rate assumptions and inputs far exceed those that
2 are reported and used in practice by equity analysts and financial advisors performing
3 valuation analyses for purpose of mergers and acquisitions. Staff, therefore, recommends
4 that Robert Hevert's proposed cost of equity range and his recommended return on common
5 equity be rejected.

6 Q. What is the primary basis for the growth rate inputs used in Robert Hevert's
7 cost of equity study?

8 A. The growth rate inputs are based on an average of four growth estimates
9 ((1) Zacks Earnings Growth, (2) First Call Earnings Growth, (3) Value Line Earnings
10 Growth and (4) Sustainable Growth). ***Caveat –these are 3-5 year growth estimates in***
11 ***earnings per share, not perpetual growth rates investors use to project dividends using the***
12 ***dividend discount model (the more specific description of what is commonly referred to as***
13 ***the discounted cash flow model in utility regulatory ratemaking).***

14 However, before dissecting the anatomy of Robert Hevert's growth rate input, Staff
15 would like to respond Robert Hevert's suggestion that investors who buy utility stocks are
16 largely influenced by expectations of growth in earnings and not dividends.[3]

17 Q. Would you please express Staff's opinion of this suggestion?

18 A. Staff believes such a suggestion disregards the sacrosanct fundamental
19 understanding that investors in utility stocks are largely influenced by dividends. Not only do
20 utility stock investment analysts recognize this basic characteristic of regulated utility stock
21 investments, but it is frequent fodder on investment blogs. It is clearly acknowledged that
22 utility stocks are viewed as (1) "widow and orphan" investments, (2) "flight to safety"

[3] Robert Hevert direct testimony: page 14, lines 1-19 and page 15, lines 1-7.

1 investments and/or (3) an alternative to bond investments because of their stable and
2 predictable dividend payments.

3 Some characterize utility stocks as "widow and orphan" investments because that
4 class of the investment community is viewed as conservative and risk-averse. Simply put,
5 this class of investors is primarily driven to invest in utility stocks because of the stable cash
6 flows experienced by utility companies, *especially regulated utilities*, and the predictable and
7 stable dividends paid thereof.[4]

8 Utility Stocks are also referred to as "flight to safety" and alternatives to bond
9 investments because of the ability to pay relatively high and stable income (dividend yields)
10 at a time when treasury yields are low due to recessionary and other macro-economic
11 climatic conditions. This notion seems to hold true in the current environment where the
12 Federal Reserve has, for a considerably lengthy period of time, implemented monetary
13 policies that have helped keep long-term interest rates considerably low.

14 To that extent, below is an excerpt that reveals how the markets are truly viewing
15 utility stocks from a practical investment standpoint (Forbes: Investing - 4/28/2014):

16 **Dividends Are No Antidote To Overvaluation In Utilities**

17 Good utility stocks are hard to find because dividend-seeking
18 investors have bid the prices up well beyond their fair
19 valuations. Too often, investors evaluate stocks primarily based
20 on dividend yield rather than looking at the underlying
21 fundamentals first. This habit causes them to miss potential red
22 flags. If the stock is overvalued, it will likely underperform,
23 even with the dividend.[5]

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[4] http://www.investmentu.com/article/detail/33793/abandon-utility-stocks#.U7sIRk0o_cs.

[5] http://www.forbes.com/sites/greatspeculations/2014/04/28/dividends-are-no-antidote-to-overvaluation-in-utilities/.

1 Q. In light of this undeniable practical evidence, please express Staff's opinion of
2 Robert Hevert's use of earnings growth estimates to represent the perpetual growth rate input
3 in the DCF model?

4 A. Besides establishing the fact that the price valuation of utility stocks is largely
5 influenced by stable dividends, and not earnings growth estimates, Staff also notes that the
6 use of 3-year and 5-year earnings growth estimates as a proxy for the perpetual growth rate
7 input inflates the ultimate results of the DCF model in which such assumptions are imputed.
8 Staff will further expound this issue in the following subsection of this testimony.

9 ***Quarterly Growth DCF and Constant DCF Models***

10 Q. What is the basis for the perpetual growth rate input used by Robert Hevert for
11 purposes of determining his Quarterly and Constant DCF model results?

12 A. Robert Hevert's perpetual growth rate input relies exclusively on an average
13 of 3–5 year earnings growth rate estimates from Zacks, First Call and Value Line; and also
14 on his individual computation of a retention growth rate estimate.

15 Q. What specific issues does Staff have with the use of such a growth rate input
16 to represent perpetual growth rate?

17 A. On average, the perpetual growth rate estimates imputed by Robert Hevert are
18 much higher than the publicly available long-term growth rate estimates of the United States'
19 overall economy. Accepting the use of such exorbitant growth rates as a perpetual growth
20 rate inputs would, therefore, suggest that the regulated natural gas utilities are expected to
21 infinitely outgrow the economy of the country/ region in which they operate.

22 Q. Would you please explain, with the use of specific numbers, how
23 Robert Hevert's Quarterly and Constant DCF perpetual growth rate assumptions are

1 unreasonably higher than the long-term economic growth rate expectations of the
2 United States' overall economy?

3 A. Yes. Based on the most recent publication of the Annual Energy Outlook
4 2014, the long-term forward-looking real growth of the economy through 2040 is expected to
5 be approximately 2.45 percent. For purposes of illustrating Robert Hevert's inflated estimate
6 for real GDP growth, Staff will add Robert Hevert's suggested 2.35 percent inflation rate
7 (most projections for inflation for GDP are approximately 2.0 percent) on page 22 of his
8 direct testimony. Based on using these inputs, **the suggested forward-looking compounded**
9 **nominal growth rate estimate of the U.S economy would be approximately 4.86 percent**
10 **((1.0235*1.0245)-1).**

11 To put Robert Hevert's DCF results into perspective, Robert Hevert imputed an
12 average perpetual growth rate estimate of 5.34 percent, which is 48 basis points over the
13 projected long-term growth of the U.S economy using Robert Hevert's inflation rate or
14 84 basis points using a projected GDP inflation rate of 2.0 percent. Consequently, Staff
15 recommends that the Commission reject all the DCF results based on growth rate inputs that
16 imply that U.S regulated natural gas utilities will outgrow the U.S economy into perpetuity.

17 Q. Is there an instance where 3-5 year growth rate estimates, *which are higher*
18 *than the overall economy growth rate estimates*, may be acceptable for purposes of
19 determining cost of equity using the DCF models?

20 A. Yes. It is Staff's position that the use of 3-year to 5-year earnings growth
21 estimates may be acceptable and reasonable to the extent that they are used to represent the
22 average growth rate input for the first stage of a multi-stage DCF model.

1 ***Multi-Stage DCF Model***

2 Q. What specific issue does Staff have with the growth rate inputs imputed by
3 Robert Hevert in his Multi-Stage DCF model?

4 A. The perpetual growth rate used in the last stage of Robert Hevert's
5 Multi-Stage DCF model is approximately 91 basis points higher than the published
6 projections for the long-term growth rate for the United States' overall economy.

7 Q. How did Staff determine the 91 basis?

8 A. It is the difference between Robert Hevert's Multi-Stage DCF assumption that
9 the United States' economy will grow at 5.71 percent into perpetuity and the 4.80 percent
10 explained above.

11 Staff recommends that Robert Hevert's multi-stage results be dismissed for the very
12 same reasons Staff explained in the previous subsection.

13 ***Practical analyses of Robert Hevert's perpetual growth rate inputs***

14 Q. Please explain if Staff is aware of any equity analysts and/or financial advisors
15 to mergers and acquisitions that assume or impute perpetual growth rates that are consistent
16 with any of Robert Hevert's average perpetual growth rate assumptions, which are all greater
17 than 5.30 percent?

18 A. Staff unreservedly notes that Robert Hevert's growth rates diametrically
19 contradict the reality of practical investment assumptions made by investors and investment
20 advisors in regulated utilities. Staff has over time reviewed confidential asset and equity
21 valuation reports that were provided in the context of merger, acquisition and other
22 financial/investment advisor roles; and Staff has never seen growth rates greater than
23 4 percent being imputed in any of those analyses. Staff would be highly enlightened if

1 Robert Hevert can provide equity valuation reports or analyses for APUC that show
2 perpetual growth rates of anywhere close to 5.71 percent.

3 ***Capital Asset Pricing Model***

4 Q. What specific issues does Staff have with Robert Hevert's CAPM analysis
5 and results?

6 A. Staff notes that the risk premiums, *which are inflated,* imputed in
7 Robert Hevert's CAPM analysis are based on a DCF approach that Staff rebutted earlier in
8 this testimony. Again, for as long as Robert Hevert is using 3-year to 5-year earnings growth
9 rate estimates to represent perpetual growth rates in his DCF analysis, his DCF results are
10 going to be inflated.

11 Q. Would you please explain the basis for Robert Hevert's proposed implied
12 equity risk premiums?

13 A. Robert Hevert's computation of implied equity risk premium estimates are
14 based on the Bloomberg data (Bloomberg estimate) and Value Line data (Value Line
15 estimate). The Bloomberg estimate, which is an average of estimates based on current and
16 projected 30-year treasuries, is approximately 8.63 percent; and the Value Line estimate is
17 approximately 7.53 percent.[6]

18 Q. Please explain Staff's primary concern with such a computation of implied
19 equity risk premium.

20 A. Staff notes that the CAPM results are very sensitive to each witness' choice of
21 equity risk premium. Thus, if rate of return witnesses chose to assume that equity investors in
22 regulated utilities and unregulated corporations require the same equity returns or greater,

[6] Robert Hevert direct testimony: Schedule RBH-7 CAPM.

1 then their reported implied equity risk premiums will obviously be much higher than what is
2 actually expected by regulated utility common equity investors.
3 For instance, Robert Hevert's choice of the inputs that he imputed to derive his DCF
4 results, which in turn determined the equity risk premium that was finally imputed in his
5 CAPM analysis, inflated his CAPM results.
6 Q. Based on Staff's cost of equity and the 30-year treasury (3.87 percent) used by
7 Robert Hevert, what is the implied equity risk premium?
8 A. Based on Staff's estimated cost of equity range of 8.20 percent – 9.20 percent,
9 the implied equity risk premium range would be 4.33 percent to 5.33 percent; and
10 Robert Hevert's implied risk premiums range from 7.53 percent to 8.63 percent.
11 Q. For purposes of checking the reasonableness of Staff's implied equity
12 risk premium range, can you provide any practical investment sources that support
13 Staff's position?
14 A. Based on various cost of equity analyses it reviewed, Duff and Phelps', as
15 reported in its 2014 Valuation Handbook, recommends an estimated market required cost of
16 equity of 9 percent based on an equity risk premium of 5 percent and a normalized risk-free
17 rate of 4 percent.[7]
18 Q. What conclusions would Staff draw from Duff & Phelps's recommendations?
19 A. Staff's cost of equity estimate and the implied equity risk premium are both in
20 check with the realities of practical investment analysis. As for Robert Hevert, his extremely
21 high required market return/ cost of equity and the implied market risk premium estimates
22 are a function of his inflated DCF inputs, assumptions and results.

[7] 2014 Valuation Handbook, Guide to Cost of Capital: Duff & Phelps: pages 3-20 to 3-23.

1 ***Bond Yield Plus Risk Premium Approach***

2 Q. What specific issues does Staff have with Robert Hevert's Bond yield plus
3 risk premium approach?

4 A. Staff notes that the use of allowed Return On Equity (ROE) as the basis for
5 computing equity risk premium used in Robert Hevert's approach is improper. Such a
6 treatment would equate allowed ROE with the cost of equity.

7 Q. What is the difference between the allowed ROE and the cost of equity?

8 A. In light of the practical cost of equity estimates that are reported by equity
9 analysts and merger/ acquisition financial advisors *(which staff discussed earlier in this*
10 *testimony),* the allowed ROE typically is higher than the cost of equity whether done so
11 inadvertently and/or for purpose of providing incentives to utility companies.

12 Q. Did Robert Hevert's use of allowed ROE instead of cost of equity estimates
13 impact his Bond Yield Plus Risk Premium Approach results?

14 A. Yes. It magnified his reported equity risk premium and the resulting implied
15 cost of equity results.

16 Q. Does this conclude your rebuttal testimony?

17 A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

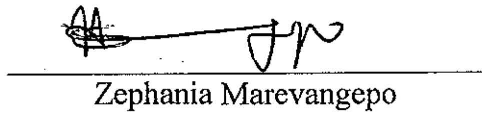
OF THE STATE OF MISSOURI

In the Matter of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities' Tariff Revisions Designed To Implement a General Rate Increase for Natural Gas Service in the Missouri Service Areas of the Company	)))))	Case No. GR-2014-0152

AFFIDAVIT OF ZEHPANIA MAREVANGEPO

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

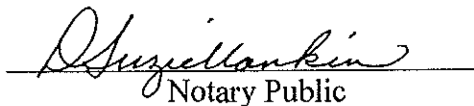
Zephania Marevangepo, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.



Zephania Marevangepo

Subscribed and sworn to before me this 29th day of July, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070



Notary Public