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 Witness: Michael P. Gorman
 Type of Exhibit: Rebuttal Testimony
 Sponsoring Parties: Public Counsel and Missouri Industrial Energy Consumers
 Case No.: GR-2017-0215 & GR-2017-0216
 Date Testimony Prepared: October 17, 2017

FILED
 December 28, 2017
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 Service Commission

**BEFORE THE PUBLIC SERVICE COMMISSION
 OF THE STATE OF MISSOURI**

**In the Matter of Laclede Gas Company's
 Request to Increase its Revenues for Gas
 Service**

Case No. GR-2017-0215
 Tariff No. YG-2017-0195

**In the Matter of Laclede Gas Company d/b/a
 Missouri Gas Energy's Request to Increase
 its Revenues for Gas Service**

Case No. GR-2017-0216
 Tariff No. YG-2017-0195

Rebuttal Testimony and Schedules of

Michael P. Gorman

On behalf of

**The Office of Public Counsel and
 Missouri Industrial Energy Consumers**

October 17, 2017

File No. _____
 Date _____
 Reporter _____
 Exhibit No. _____



BRUBAKER & ASSOCIATES, INC.

Projects 10453 & 10453.1

08C Exhibit No. 414
 Date 12-11-17 Reporter DH
 File No. GR-2017-0216

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Case No. GR-2017-0216
Tariff No. YG-2017-0196

STATE OF MISSOURI)

) SS

COUNTY OF ST. LOUIS)

Affidavit of Michael P. Gorman

Michael P. Gorman, being first duly sworn, on his oath states:

1. My name is Michael P. Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by the Office of Public Counsel and the Missouri Industrial Energy Consumers in this proceeding on their behalf.

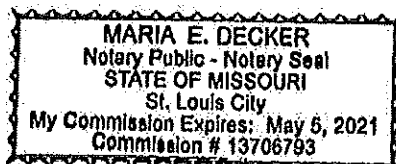
2. Attached hereto and made a part hereof for all purposes are my rebuttal testimony and schedules which were prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. GR-2017-0215 and GR-2017-0216.

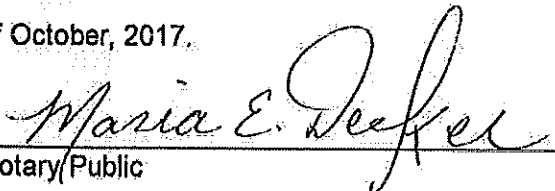
3. I hereby swear and affirm that the testimony and schedules are true and correct and that they show the matters and things that they purport to show.



Michael P. Gorman

Subscribed and sworn to before me this 17th day of October, 2017.





Notary Public

**BEFORE THE PUBLIC SERVICE COMMISSION
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)
)

Rebuttal Testimony of Michael P. Gorman

1 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 **A Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,**
3 **Chesterfield, MO 63017.**

4 **Q WHAT IS YOUR OCCUPATION?**

5 **A I am a consultant in the field of public utility regulation and a Managing Principal with**
6 **Brubaker & Associates, Inc., energy, economic and regulatory consultants.**

7 **Q ARE YOU THE SAME MICHAEL P. GORMAN WHO FILED DIRECT TESTIMONY**
8 **ON BEHALF OF OFFICE OF THE PUBLIC COUNSEL ("OPC") AND THE**
9 **MISSOURI INDUSTRIAL ENERGY CONSUMERS ("MIEC")?**

10 **A Yes, I am.**

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1 Q WHAT IS THE SUBJECT MATTER OF YOUR REBUTTAL TESTIMONY?

2 A In my rebuttal testimony, I will respond to Laclede/MGE witnesses Glenn Buck and
3 Pauline Ahern on capital structure, and respond to Ms. Ahern's return on equity
4 recommendations.

5 **I. SUMMARY**

6 Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS.

7 A My conclusions and recommendations are summarized as follows:

- 8 1. The Companies' filed capital structure including a common equity ratio of 57.2% is
9 unreasonable for ratemaking purposes.
- 10 2. A capital structure with an excessive amount of common equity unnecessarily
11 increases costs to retail customers relative to a more balanced capital structure
12 that will maintain the utilities' credit standing and financial integrity, and preserve
13 their access to capital. Laclede/MGE's proposed filed capital structure in this
14 proceeding has substantially more common equity in their capital structure than
15 needed to meet this objective.
- 16 3. The Companies' filed capital structure may overstate the capital structure at the
17 true-up period because the Companies did not include an estimated amount of
18 long-term debt expected to be issued to refinance short-term debt. This
19 \$170 million debt issue alone will reduce the Companies' filed capital structure
20 common equity ratio from 57.2% down to 52.5%.
- 21 4. My proposed capital structure reflects the long-term debt issuance of \$170 million
22 and excludes the goodwill balance of \$210 million, which results in a common
23 equity ratio of 47.2% and an overall rate of return of 6.52%, as shown on my
24 Schedule MPG-R-1.
- 25 5. Ms. Ahern's return on equity estimates do not support the Companies' requested
26 return on equity in this proceeding of 10.35%. Ms. Ahern's methodologies
27 overstate a fair return on equity for Laclede/MGE, and her proposal for 35 basis
28 points of return on equity adds for flotation costs and business risks is without
29 merit and should be denied. Reasonable adjustments to Ms. Ahern's market cost
30 of equity estimates support my conclusion that a fair return on equity based on the
31 current marketplace for Laclede/MGE is no higher than my recommended return
32 on equity of 9.20%.

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1 **II. CAPITAL STRUCTURE**

2 **Q WHAT IS THE COMPANIES' PROPOSED CAPITAL STRUCTURE?**

3 A Laclede/MGE's witnesses Ms. Pauline Ahern and Mr. Glenn Buck sponsor the
4 Companies' proposed capital structure, which is shown below in Table 1. The
5 proposed capital structure is based on the test year period ending on December 31,
6 2016.

<u>Description</u>	<u>Weight</u>
Long-Term Debt	42.80%
Common Equity	<u>57.20%</u>
Total Regulatory Capital Structure	100.00%

Source: Schedule PMA-D1.

7 **Q DO THE COMPANIES PROVIDE AN EXPLANATION OF THEIR PROPOSED**
8 **CAPITAL STRUCTURE?**

9 A Yes. Laclede/MGE witness Mr. Glenn Buck states at page 3 of his testimony that the
10 Companies' proposed capital structure is based on end-of-year 2016 balances, and
11 excludes short-term debt. He states that short-term debt was excluded because the
12 average balance of short-term debt is less than the combined balance of construction
13 work in progress, propane inventory, margin calls on hedging programs, and deferred
14 gas costs to subject to Purchased Gas Adjustment ("PGA") carrying charges. He also
15 comments that a portion of short-term debt during the test year is subject to a forward
16 placement of \$170 million long-term debt maturity that is scheduled to be funded by

1 September 15, 2017. Importantly, Mr. Buck provides no justification for treatment of
2 \$170 million of short-term debt set aside to fund a maturity of long-term debt in
3 September of 2017.

4 A consultant for Laclede and MGE also provided testimony related to the
5 Companies' proposed capital structure. Ms. Pauline Ahern provides three reasons
6 why she believes the Companies' requested capital structure is appropriate: (1) the
7 requested capital structure is an "actual" pro forma capital structure for Laclede; (2)
8 MGE is a division of Laclede; and, (3) the requested capital structure is consistent
9 with the capital structure ratios maintained by her Natural Gas Proxy Group. (Ahern
10 Direct at 17).

11 **Q DO YOU HAVE ANY OVERALL COMMENTS ABOUT THE COMPANIES'**
12 **PROPOSED CAPITAL STRUCTURE?**

13 **A** Yes. The Companies' capital structure included in their initial filing appears to have
14 significantly more equity than the capital structure that one would reasonably expect
15 to be filed at the true-up period. Mr. Buck's recognition that \$170 million of short-term
16 debt was excluded from the capital structure, because it would be refinanced with
17 long-term debt in September of this year, results in a significant change to the capital
18 structure compared to the Companies' filed capital structure.

19 Based on public documents, the \$170 million of long-term debt was issued in
20 September of this year. Reflecting this long-term debt issue alone will significantly
21 reduce the common equity ratio in Laclede's capital structure from 57.2% down to
22 52.5% as shown in my Schedule MPG-R-2. However, even that capital structure
23 appears to have an unreasonable common equity component for ratemaking
24 purposes. I state this because a significant amount of common equity in Laclede is

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1 used to support its investment in a goodwill asset. Excluding the goodwill asset,
2 Laclede's capital supporting its investment in utility plant and equipment has a
3 structure as shown in Table 2 below.

<u>Description</u>	<u>Weight</u>
Long-Term Debt	52.8%
Adjusted Common Equity	<u>47.2%</u>
Total Capital	100.0%

Source: Schedule MPG-R-1.

4 **Q DOES LACLEDE/MGE'S PROPOSED CAPITAL STRUCTURE IN THIS CASE**
5 **REASONABLY REFLECT ITS ACTUAL CAPITAL STRUCTURE OVER RECENT**
6 **YEARS?**

7 **A** As shown on my Schedule MPG-R-3, page 1, Laclede/MGE's actual capital structure
8 over the last five years has been consistently around 50%, including short-term debt.

9 Further, excluding the common equity supporting the \$210 million of goodwill
10 on Laclede's balance sheet, Laclede's actual common equity ratio supporting
11 investments in utility plant and equipment is no higher than 45% including short-term
12 debt, and 52% excluding short-term debt.

1 Q IS LACLEDE/MGE'S CAPITAL STRUCTURE COMPARABLE TO THEIR PARENT
2 COMPANY, SPIRE?

3 A No. Spire's balance sheet actually represents a more leveraged company,
4 particularly when recognition is made for the amount of goodwill recorded on its
5 balance sheet. As shown on my attached Schedule MPG-R-2, page 2, Spire's
6 common equity ratio over the last five years has been approximately 42%. However,
7 when the balance sheet is adjusted to remove the common equity supporting the
8 goodwill asset, Spire's actual common equity ratio supporting its investment in its
9 utility subsidiaries has been lower than 22%, including short-term debt and 26%
10 excluding short-term debt.

11 Q HAVE CREDIT RATING AGENCIES COMMENTED ON THE SIGNIFICANT DEBT
12 LEVERAGE AT SPIRE AND THE RESULTING IMPACT ON ITS GAS UTILITY
13 AFFILIATES' CREDIT STANDING?

14 A Yes. In a December 2016 report on Spire, Moody's made the following comments on
15 the credit rating outlook of Laclede's parent company:

16 **Outlook**

17 Spire's stable rating outlook reflects our expectation that Spire's overall
18 operating performance going forward will remain at levels consistent with
19 its current rating, such that its ratio of CFO pre-W/C to debt will be in the
20 mid-teens range. The stable outlook also reflects our view that the credit
21 supportive regulatory jurisdictions of Missouri and Alabama will continue
22 to maintain the credit quality of its larger regulated utility subsidiaries
23 (Laclede and Alagasco) and that Spire will not undertake aggressive
24 shareholder friendly debt-financed activities that will be a detriment to the
25 risk profile of its utilities.¹

26 I also note that in Standard and Poor's ("S&P") most recent credit report on
27 Laclede Gas Company, it awarded Laclede an anchor rating, or a stand-alone credit

¹Moody's Investors Service: "Rating Action: Moody's assigns a Prime-2 short-term rating to Spire Inc.'s commercial paper program," December 22, 2016.

1 rating, of "A", which is a full notch higher than the actual published bond rating of "A-".
2 In describing how Laclede's bond rating is impacted by its parent company, S&P
3 stated the following:

4 **Group Influence**

5 Laclede Gas Co. is subject to our group rating methodology criteria.
6 We assess Laclede Gas Co. as a core subsidiary of parent Spire Inc.
7 because we think that Laclede Gas Co. is highly unlikely to be sold,
8 has a strong long-term commitment from senior management, is
9 successful at what it does, and contributes meaningfully to the group.
10 Because there are no meaningful insulation measures in place that
11 protect Laclede Gas Co. from its parent, the issuer credit rating on the
12 company is 'A-', in line with the group credit profile of Laclede of 'a-'.²

13 **Q WHY IS IT APPROPRIATE TO ASSUME THAT GOODWILL IS FINANCED WITH**
14 **ONLY COMMON EQUITY IN ASSESSING THE BALANCE SHEET STRENGTH OF**
15 **LACLEDE/MGE AND SPIRE?**

16 **A** Goodwill is a paper asset that is recorded at the time of acquisitions. Essentially, it
17 represents the amount of acquisition premium that Spire or Laclede/MGE have paid
18 for other utilities above their prevailing book value. It essentially represents a
19 transaction between Spire or Laclede/MGE's investors, and the investors of the entity
20 which is being acquired. This acquisition premium recorded as goodwill does not
21 represent capital received from investors and used to invest in utility plant and
22 equipment. Rather, it represents acquisition premiums for transactions between utility
23 shareholders.

24 From a credit rating perspective, a goodwill asset has no economic value. A
25 goodwill asset, unlike infrastructure investments that are included in a utility's rate
26 base, produces no cash flow. Therefore, the existence of a goodwill asset cannot be

²Standard & Poor's RatingsDirect: "Summary: Laclede Gas Co.," July 19, 2017 at 5, emphasis added.

1 funded by debt because it cannot produce cash flows adequate to meet the debt
2 service obligations on a debt security. Therefore, these premium payments that
3 represent transactions between shareholders, can only prudently and reasonably be
4 financed by utility common equity. It would be imprudent to finance a goodwill asset
5 with debt, because the goodwill asset would default on the obligations to meet the
6 debt service obligation of a debt, and would cause significant distress on the utility's
7 credit standing, and ability to operate as a financially sound going concern.

8 Additionally, the goodwill asset is subject to annual impairment tests. If the
9 impairment test indicates the book value of the goodwill asset overstates its
10 perceived value, the utility must take an impairment charge down to the value
11 indicated by the test. This charge, or writedown, directly impacts other
12 comprehensive income, and common equity capital. Debt is not impacted by an
13 impairment charge.

14 **Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S SUPPORT FOR**
15 **THE COMPANIES' PROPOSED CAPITAL STRUCTURE?**

16 **A** Yes. Ms. Ahern's comments that the Companies' proposed capital structure reflects
17 an actual pro forma capital structure does not support the reasonableness of the
18 Companies' actual capital structure for ratemaking purposes. The Companies' capital
19 structure is managed at the discretion of the Companies' management. As such, the
20 Companies' actual capital structure must be shown to be reasonable for ratemaking
21 purposes. I suggest that a reasonable capital structure is one that places no more
22 cost burden on customers than necessary to support the credit standing and financial
23 integrity of the utility. As outlined below, the Companies' proposed capital structure is
24 far more expensive than necessary to achieve this objective.

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1 Further, Ms. Ahern's comments that the proposed capital structure is
2 consistent with the capital structure ratios maintained by her natural gas proxy group
3 are without merit. Indeed, the Companies' proposed capital structure contains far
4 more common equity than typically allowed by a regulatory commission for
5 establishing an overall rate of return for a regulated natural gas utility company.
6 Indeed, while credit reports indicate electric utilities are somewhat more risky than
7 natural gas, the Companies' proposed capital structure contains far more common
8 equity than generally used to set an overall rate of return for a regulated electric or
9 gas utility company. In other words, a less risky company needs a thinner equity level
10 to support utility operating, not the other way around. All of this clearly shows that the
11 Companies' proposed capital structure contains an excessive amount of common
12 equity, and therefore is not reasonable for ratemaking purposes.

13 Further, concerning Ms. Ahern's comments about capital structures for the
14 proxy group companies, I would note that when short-term debt is included, as shown
15 on my Schedule MPG-3 (Column 3) to my direct testimony, the proxy group
16 companies have an average capital structures of approximately 51% debt and 49%
17 equity. Further, as shown on my Schedule MPG-R-4 to this testimony, the regulatory
18 approved capital structure for the operating utility subsidiaries of the publically traded
19 proxy group companies predominantly have awarded common equity ratios in the
20 range of 44% to 55% common equity, with an approximate median of 52%.

21 **Q WHY IS A CAPITAL STRUCTURE THAT IS OVERLY WEIGHTED WITH COMMON**
22 **EQUITY UNREASONABLE FOR SETTING RATES?**

23 **A** A capital structure too heavily weighted with common equity unnecessarily increases
24 Laclede/MGE's claimed revenue deficiency because common equity is the most

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1 expensive form of capital and is subject to income tax expense. For example, if
2 Laclede/MGE's authorized return on equity is set at 9.0%, the revenue requirement
3 cost to customers would be approximately 14.4%, which includes the 9.0% after-tax
4 return and the related income expense of 5.4%, which is based on the tax conversion
5 factor of approximately 1.6x. (9.0% times 1.6x less 9.0%). In contrast, the cost of
6 debt capital is not subject to an income tax expense. Laclede/MGE's proposed
7 embedded cost of debt is approximately 4.159%. Common equity is more than twice
8 as expensive on a revenue requirement basis than debt capital.

9 A reasonable mix of debt and equity is necessary in order to balance
10 Laclede/MGE's financial risk, support an investment grade credit rating, and permit
11 Laclede/MGE access to capital under reasonable terms and prices. However, a
12 capital structure too heavily weighted with common equity will unnecessarily increase
13 its cost of capital and revenue requirement for ratepayers.

14 **II.A. Capital Structure Reasonableness**

15 **Q IS THE COMPANIES' PROPOSED CAPITAL STRUCTURE REASONABLE FOR**
16 **RATEMAKING PURPOSES?**

17 **A** No. Laclede/MGE's proposed capital structure is not consistent with industry norms
18 which have supported very strong credit standing and access to capital for the
19 industry as a whole. Further, their proposed capital structure contains more common
20 equity than necessary to support their stand-alone bond rating. As such, the capital
21 structure is more expensive than necessary to maintain Laclede/MGE's credit rating
22 and access to capital.

1 Q PLEASE DESCRIBE WHY YOU BELIEVE LACLEDE/MGE'S PROPOSED
2 CAPITAL STRUCTURE IS INCONSISTENT WITH NORMAL PRACTICES IN
3 SETTING AND APPROVING CAPITAL STRUCTURES FOR RATEMAKING
4 PURPOSES FOR REGULATED UTILITY COMPANIES?

5 A The reported common equity ratios of the capital structures used to set rates of return
6 for regulated natural gas companies by regulatory commissions are summarized in
7 Table 3 below. As shown in this table, the gas utility industry average and median
8 common equity ratios have generally fallen around 51% over the period 2010-2017.
9 The industry medians generally support common equity ratios of around 49.90% up
10 to 52.45%. This trend in the industry illustrates just how excessive Laclede/MGE's
11 proposed common equity ratio is in this proceeding.

TABLE 3					
Trends in State Authorized Common Equity Ratios (Industry)					
Line	Year (1)	Natural Gas		Electric	
		Average (2)	Median (3)	Average (4)	Median (5)
1	2010	49.25%	49.90%	49.49%	49.79%
2	2011	52.49%	52.45%	49.09%	49.10%
3	2012	51.13%	51.47%	51.45%	52.00%
4	2013	51.16%	50.43%	50.12%	51.03%
5	2014	51.90%	51.99%	50.28%	50.00%
6	2015	49.79%	50.33%	50.24%	50.48%
7	2016	51.85%	51.35%	49.70%	49.99%
8	2017	50.06%	50.50%	49.71%	49.49%
9	Average	50.95%	51.05%	50.01%	50.23%
10	Min	49.25%	49.90%	49.09%	49.10%
11	Max	52.49%	52.45%	51.45%	52.00%
12	Midpoint	50.87%	51.17%	50.27%	50.55%
13	Laclede/MGE Proposed		57.2%		
14	Gorman Proposed		47.2%		

Source and Notes:
SNL, downloaded 8/29/2017
Data through June 2017
Excludes Arkansas, Florida, Indiana and Michigan

1 As shown in Table 3 above, the Companies' proposed capital structure at
2 57.2% common equity contains far more common equity than that of other utility
3 companies for ratemaking purposes. Importantly, as I discussed in my direct
4 testimony, the utility industry generally is able to access large amounts of capital to
5 support its capital investment programs, and its bond rating has improved. Therefore,
6 this comparison of Laclede/MGE's proposed capital structure to those of the utility

1 industry strongly supports my conclusion that the Companies' capital structure
 2 contains an unreasonably high amount of common equity.

3 **Q DOES LACLEDE/MGE'S PROPOSED CAPITAL STRUCTURE SUPPORT CREDIT**
 4 **METRICS NEEDED TO MAINTAIN THEIR BOND RATING?**

5 **A** No. Again, their capital structure contains more common equity than needed to
 6 support their bond rating. This capital structure was based on the 2016 actual capital
 7 structure. In 2016, Laclede/MGE's actual capital structure, including all investor
 8 capital, and reflecting off-balance sheet debt obligations indicates that Laclede/MGE's
 9 adjusted debt ratio at my proposed capital structure is 54.2% and reasonably
 10 consistent with industry median adjusted debt ratio range for other utilities with
 11 Laclede/MGE's current A- bond rating of 52.2%.

TABLE 4				
Operating Subsidiaries				
<u>Regulated Utilities</u>				
(Industry Medians)				
Adjusted Debt Ratio				
<u>Rating</u>	<u>Median</u>	% Distribution		
		<u>< 50</u>	<u>50 to 55</u>	<u>> 55</u>
AA-	42.9%	100%	0%	0%
A	49.0%	67%	33%	0%
A-	52.2%	37%	39%	24%
BBB+	52.4%	26%	48%	26%
BBB	53.4%	25%	38%	38%
BBB-	54.4%	10%	50%	40%
At Laclede/MGE Proposed			44.5%	
Source:				
S&P Capital IQ, downloaded September 28, 2017.				

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1 However, at the Companies' proposed common equity ratio of 57% implies an
2 imputed adjusted debt ratio in this case of around 44.5%, as shown on Schedule
3 MPG-R-5, page 2. This adjusted debt ratio is substantially less than adjusted debt
4 ratios that have proven to be supportive of strong investment grade credit ratings for
5 regulated utility companies as shown in Table 4 above. This is clear evidence that
6 the Companies' proposed capital structure has far too much common equity, and not
7 enough debt, to support their bond rating. As such, the capital structure is far more
8 expensive than necessary to support Laclede/MGE's credit rating and access to
9 capital.

10 **Q ARE YOU PROPOSING TO ADJUST LACLEDE/MGE'S PROPOSED CAPITAL**
11 **STRUCTURES?**

12 **A Yes. I recommend the Commission reject Laclede/MGE's proposed capital structure**
13 **because it includes an excessive amount of common equity capital. I recommend a**
14 **projection of Laclede/MGE's capital structure at the true-up date reflecting a**
15 **\$170 million bond issue used to retire short-term debt, and also to adjust the common**
16 **equity balance to remove the capital supporting the goodwill asset. The resulting**
17 **capital structure as shown in Table 5 below, results in a common equity ratio of**
18 **47.2% and is adequate to support their current investment grade bond rating, but at a**
19 **much lower cost than the capital structure proposed by Laclede/MGE. Also, this is**
20 **the capital structure mix used to fund utility rate base investments, excluding**
21 **short-term debt. Therefore, it most accurately reflects Laclede/MGE's cost of service**
22 **for retail Missouri operations.**

23 My recommended capital structure to use for ratemaking purposes for
24 Laclede/MGE is shown below in Table 5.

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TABLE 5

Gorman's Proposed Capital Structure
(December 31, 2016)

<u>Description</u>	<u>Weight</u>
Long-Term Debt	52.8%
Common Equity	47.2%
Total Regulatory Capital Structure	100.0%

Source: Schedule MPG-R-1.

1 Q IF THE COMMISSION ADOPTS YOUR PROPOSED CAPITAL STRUCTURE
2 ADJUSTMENT, WILL THAT PREVENT LACLEDE/MGE FROM EARNING THEIR
3 AUTHORIZED RETURN ON EQUITY?

4 A No, not if Laclede/MGE respond to the Commission's findings on a reasonable capital
5 structure for rate-setting purposes, and adjusts their projected test year capital
6 structure to conform to what the Commission finds to be appropriate. This rate-
7 setting discipline in a regulated industry is comparable to what deregulated
8 companies face if their cost of capital cannot be recovered at prevailing market
9 prices. In deregulated markets, a company must adjust its actual cost of service in
10 order to achieve its profit outlooks while taking market prices.

11 Q PLEASE SUMMARIZE WHY YOU BELIEVE YOUR PROPOSED ADJUSTMENT TO
12 THE COMPANIES' CAPITAL STRUCTURE IS REASONABLE FOR RATEMAKING
13 PURPOSES?

14 A I believe my recommended capital structure is reasonable for ratemaking purposes
15 for the following reasons:

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- 1 1. The Companies have discretion to adjust their capital structure mix based on what
2 the Commission finds to be appropriate for rate-setting in this proceeding.
3 Competitive companies often have to modify their cost of service to align with
4 their profitability goals while accepting market prices. Hence, reasonable prices
5 should be set based on reasonable and efficient cost of service, and the
6 Companies should modify their actual capital structure cost to align with what is
7 reasonable for ratemaking purposes.
- 8 2. The capital structure I recommend is adequate to maintain the Companies'
9 investment grade credit metrics. Customers should not pay higher capital costs in
10 order to support financial obligations of the parent company that are unrelated to
11 its cost of providing regulated utility service in the state of Missouri.
- 12 3. The Companies' proposed capital structure should be rejected because it creates
13 an excessive cost burden on customers, without a demonstration of any benefit to
14 customers. My capital structure mix supports a bond rating that is reasonably in
15 line with the industry median bond ratings. Industry median bond ratings are
16 supported with more reasonable capital structures with a common equity balance
17 approaching 50% of total capital.

18 **III. RESPONSE TO WITNESS PAULINE AHERN**

19 **Q WHAT RETURN ON COMMON EQUITY IS LACLEDE/MGE PROPOSING FOR**
20 **THIS PROCEEDING?**

21 **A** Ms. Ahern estimates a return on equity of 10.00% based on her market models –
22 DCF, risk premium, and CAPM. However, she increases her recommended return on
23 equity to 10.35%³ for Laclede/MGE, by adding a business risk adjustment of 20 basis
24 points, and a flotation cost adder of 16 basis points to her 10.00% proxy group
25 return.⁴

26 **Q IS MS. AHERN'S ESTIMATED RETURN ON EQUITY REASONABLE?**

27 **A** No. Ms. Ahern's estimated market return of 10.0% for her proxy group companies is
28 significantly overstated based on her use of overstated risk premium estimates for

³Recommended Return: 10.0% + 0.20% + 0.16% = 10.36%, rounded to 10.35%.

⁴Ahern Direct Testimony at 5.

1 both her risk premium and CAPM models. Further, her proposed return on equity
2 adders totaling 36 basis points are unjustified and should be rejected.

3 **Q PLEASE DESCRIBE MS. AHERN'S METHODOLOGY SUPPORTING HER**
4 **RETURN ON COMMON EQUITY.**

5 **A** Ms. Ahern estimates a return on equity for Laclede/MGE based on the DCF model, a
6 Risk Premium ("RP") model that she calls the Predictive Risk Premium Model™
7 ("PRPM"), a bond yield plus risk premium model, as well as the traditional and
8 empirical forms of the CAPM. Ms. Ahern then attempts to corroborate her results by
9 applying the same models to a proxy group of non-price regulated companies.

10 **Q PLEASE SUMMARIZE MS. AHERN'S RESULTS.**

11 **A** Ms. Ahern's results are summarized in Table 6 below.

TABLE 6

Summary of Ms. Ahern's Return on Equity Estimates

<u>Model</u>	<u>Ahern Estimate</u> (1)	<u>Corrected Estimate</u> (2)
<u>I. Market Models:</u>		
DCF	8.68%	8.68%
RP	10.57%	8.80%
CAPM	9.11%	8.80%
Non-Price Regulated Companies	<u>10.45%</u>	<u>Reject</u>
Indicated Return on Equity	10.00%	8.80%
<u>II. Adders:</u>		
Business Risk Adjustment	0.20%	Reject
Flotation Cost Adjustment	<u>0.16%</u>	<u>Reject</u>
Total Adders	0.36%	
<u>III. Recommended Return on Equity</u>	10.35%	8.80%

Sources:
Ahern Direct Testimony at 5.

1 For the reasons outlined below, reasonable adjustments to Ms. Ahern's return
 2 on equity estimates reduce her findings from 10.0%, excluding the unnecessary
 3 adders, down to approximately 8.80%. My recommended return of 9.20% is
 4 reasonable and conservative in comparison to this corrected study by Ms. Ahern.

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1 **III.A. Ahern Proposed Size Adjustment Adder**

2 **Q PLEASE DESCRIBE THE RETURN ON EQUITY ADDER PROPOSED BY MS.**
3 **AHERN FOR INCREASING HER RETURN ESTIMATE.**

4 **A** Ms. Ahern proposes to add a return on equity premium of 20 basis points to her proxy
5 group return to reflect Laclede/MGE's alleged greater risk relative to that of her proxy
6 group companies, due to the difference in its hypothetical market capitalization.⁵

7 **Q HOW DID MS. AHERN ESTIMATE THIS 20 BASIS POINT ADDER?**

8 **A** Ms. Ahern approximates a market value for Laclede/MGE, in comparison to the actual
9 market value capitalization weights for her proxy group. Based on this hypothetical
10 market capitalization, Ms. Ahern estimates that the proxy group market capitalization
11 is about 1.3 times larger than the market capitalization Ms. Ahern estimates for
12 Laclede/MGE.

13 She then compares the actual market weights of the proxy group and her
14 estimated market capitalization for Laclede/MGE to a market capitalization size index
15 published by Duff & Phelps.

16 She relies on Duff & Phelps estimated CAPM return difference for companies
17 that fall within market capitalization size deciles. Ms. Ahern estimates that the proxy
18 group market capitalization size puts them in the approximate 4th to 5th decile of
19 returns as estimated by Duff & Phelps. She states that her approximation for
20 Laclede/MGE's market capitalization weight puts it in the 5th to 6th decile size return
21 category. The difference in size premiums between the 4th-5th decile and the 5th-6th
22 deciles requires an increased return on equity of around 0.32%. However, using her

⁵Ahern Direct Testimony at 50-52.

1 judgment, Ms. Ahern recommends a return on equity premium for Laclede/MGE of 20
2 basis points. (Ahern Direct at 52).

3 **Q IS MS. AHERN'S PROPOSED 20 BASIS POINT RETURN ON EQUITY PREMIUM**
4 **FOR LACLEDE/MGE SIZE REASONABLE?**

5 A No. There are several fundamental errors and flaws in Ms. Ahern's quantitative
6 estimate and logic. First and foremost, Laclede/MGE is not a publicly traded
7 company. For this reason, Ms. Ahern's hypothetical market capitalization for the
8 Companies is purely conjecture. Her approximation simply is not meaningful and
9 cannot be used to make an accurate measurement of a size premium if one is so
10 justified, which it is not.

11 Secondly, and probably most significantly, Laclede/MGE enters into a service
12 agreement with Spire, Inc (via Spire Shared Services) in order to receive services
13 from its parent company structure. The service agreement and the costs related to
14 this affiliate transaction mitigate Laclede/MGE's stand-alone investment risk.
15 Specifically, Laclede/MGE witness Thomas Flaherty testifies about Laclede/MGE's
16 service company relationship between Laclede/MGE and Spire Shared Services,
17 both owned by Spire, Inc.

18 These service company transactions mitigate Laclede/MGE's stand-alone
19 small company risk from a standpoint of management expertise, access to capital,
20 and technical expertise such as legal, engineering, financial and IT. Further, the
21 public shareholders of Spire, Inc. benefit from the diversity of Spire subsidiaries that
22 operate across regions. Therefore, this diversity in operations can mitigate small
23 company risk of the operating performance of the subsidiaries impacts on Spire's
24 financial results.

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1 Customers pay for the risk mitigation of Laclede/MGE by paying rates that
2 recover Laclede/MGE's service company fees and charges from Spire Shared
3 Services. Therefore, the service company fee structure is designed to support
4 Laclede/MGE and their stand-alone risk, and provide economies of scale and
5 revenue diversity which Laclede/MGE could not have achieved on their own.

6 Ms. Ahern's proposal for a return on equity premium ignores this service
7 company relationship, and the costs incurred by retail customers of Laclede/MGE for
8 the costs and benefits of this holding company structure. The holding company
9 structure is designed to mitigate operating affiliates' stand-alone investment risk. For
10 these reasons, Ms. Ahern's proposed small company risk adder to the return on
11 equity should be rejected.

12 **Q ASSUMING THAT THE SMALL SIZE ADJUSTMENT WAS SHOWN TO BE**
13 **REASONABLE, IS MS. AHERN'S PROPOSED SMALL COMPANY RETURN ON**
14 **EQUITY FOR LACLEDE/MGE BASED ON AN ACCURATE RISK RETURN**
15 **ASSESSMENT AS PROPOSED BY DUFF & PHELPS?**

16 **A** No. Ms. Ahern's source, Duff & Phelps, proposes to adjust returns for a company's
17 size based on market capitalization, but to also account for the company's industry
18 risk in arriving at an appropriate risk adjusted return. The industry risk more than
19 offsets the market capitalization risk for Laclede/MGE.

20 In its 2016 Valuation Handbook, Duff & Phelps recommends an industry risk
21 premium in the range of -2.93% to -4.04% for natural gas delivery utilities with SIC
22 Code 4924. Ms. Ahern's proposed small size adjustment to the equity return fails to
23 also reflect the industry risk.

1 If the Commission is persuaded that Laclede/MGE be awarded a small size
2 adjustment, then I urge it to also implement the downward adjustment for the low-risk
3 nature of the natural gas delivery industry as recommended by Duff & Phelps. In this
4 case, the small size equity return adder would be completely offset by a regulated
5 utility low risk reduced return on equity adjustment – the two risk adjustments would
6 cancel each other out.

7 **III.B. Ahern Proposed Flotation Cost Adder**

8 **Q SHOULD MS. AHERN'S PROPOSED 16 BASIS POINT RETURN ON EQUITY**
9 **ADDER FOR FLOTATION COSTS BE INCLUDED IN A RETURN ON EQUITY?**

10 **A**No, it should not. Ms. Ahern estimates a flotation cost adder by manipulating the
11 stock price DCF model to account for the flotation costs incurred by Laclede/MGE.
12 Specifically, Ms. Ahern estimates that three issuances of common equity conducted
13 by Laclede/MGE over the period May 2013 through May 2016 netted in total flotation
14 costs of around \$58.68 million. She estimates that these accounted for
15 approximately 5.43% of the total gross proceeds in those stock sales. She then
16 approximated a 16 basis point return on equity adder by reducing the stock price in
17 the DCF formula by a factor of 1 minus this flotation cost adder of 5.43%. This
18 resulted in a DCF return of 8.82% accounting for flotation costs, compared to 8.66%
19 when flotation costs are not accounted for. Thus, she concludes that the flotation
20 cost adder of 16 basis points is appropriate. (Schedule PMA-D8).

21 **Q IS MS. AHERN'S 16 BASIS POINT FLOTATION COST ADDER REASONABLE?**

22 **A**No. This is not reasonable, particularly in the way she has constructed it.
23 Specifically, she neglects to consider that not all common equity for Laclede/MGE

1 American is derived from public stock issuances. Rather, a significant amount of
2 equity is built through retained earnings, and certain transactions that increase
3 common equity do not incur public stock issuance costs. As such, the percentage of
4 market capitalization of Laclede/MGE's common stock of \$3.0 billion (Schedule PMA-
5 D3 at 9) in relationship to flotation costs of \$58.68 million would produce a flotation
6 cost adjustment of around 0.06%. Reflecting a flotation cost adjustment to the price
7 of the DCF formula, would produce a DCF return of 8.72%, rather than Ms. Ahern's
8 8.82%. This alternative would produce a flotation cost adder of around 0.6 basis
9 points.

10 Ms. Ahern's use of Laclede/MGE common stock issuance cost justifies my
11 reasons in rejecting the small company adder. Laclede/MGE is not a stand-alone
12 small company. Rather, it is a subsidiary of a larger company, Spire, Inc. The
13 importance of rejecting the small company adder is emphasized by reviewing Ms.
14 Ahern's proposed method for developing a flotation cost adder to arrive at her
15 proposed return for Laclede/MGE. It is based on Spire's access to equity markets,
16 not Laclede/MGE's.

17 Further, correcting Ms. Ahern's flotation cost methodology supports a flotation
18 cost adder of no more than 0.6 basis points, and her recommended flotation cost
19 adder of 16 basis points should be rejected.

20 III.C. Ahern's DCF

21 Q PLEASE DESCRIBE MS. AHERN'S DCF ANALYSIS.

22 A Ms. Ahern performed a constant growth DCF analysis on her proxy group. She relied
23 on analysts' earnings growth rate projections from *Value Line*, Reuters, Zack's, and
24 Yahoo! Finance. The average growth rate for her proxy group is 5.80%. (Schedule

1 PMA-D3, page 1). She used an annualized dividend and a 60-day average stock
2 price to calculate the proxy group's dividend yield. The mean and median results of
3 her DCF analysis are 8.65% and 8.70%, respectively. It is Ms. Ahern's practice to
4 take the midpoint of the mean and median results, which produces a DCF return of
5 8.68%.

6 **Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S DCF RETURN**
7 **ESTIMATES?**

8 A Yes. Similar to my DCF model, her proxy group's average DCF return is based on a
9 growth rate of 5.80%, which is substantially higher than the consensus economists'
10 projected growth rate for the economy (4.2%).⁶ Therefore, her DCF analysis
11 produces reasonable high-end DCF results.

12 **Q DID MS. AHERN EXPRESS CONCERNS WITH THE RESULTS OF HER DCF**
13 **ANALYSIS?**

14 A Yes. At pages 22-26, Ms. Ahern opines that the DCF understates the current
15 investor required rate of return on equity by approximately 490 basis points because
16 of the concurrent rise in market prices, the use of accounting measures as proxies for
17 capital appreciation, and the dramatic rise in interest rates and capital costs.

18 **Q PLEASE RESPOND TO MS. AHERN'S STATEMENTS ON AND CONCERNS WITH**
19 **THE RESULTS OF HER DCF ANALYSIS.**

20 A First, as shown on my Schedule MPG-2 in my Direct testimony, there has not been a
21 "dramatic rise in interest rates" in response to Federal Reserve ("Fed") comments and

⁶*Blue Chip Financial Forecasts*, June 1, 2017 at 14.

1 actions as Ms. Ahern would have us believe. On my Schedule MPG-2, I show the
2 four times the Fed raised its target for the Federal Funds Rate. For each time the
3 Fed raised its target, I also show the contemporaneous 30-Year Treasury bond yield,
4 the A-rated utility bond yield, and the corresponding utility over Treasury spread. As
5 evidenced on that Schedule MPG-2, capital costs have remained flat, to declining,
6 over time since July 2015, even in the wake of Fed actions and comments.

7 Second, I believe the application of a DCF analysis produces reasonable and
8 accurate estimates of the current market cost of equity for the utility companies of
9 similar investment risk. More specifically, I disagree with Laclede/MGE witness Ms.
10 Ahern's suggestion that the DCF model is understating the current market cost of
11 equity. (Ahern Direct at 22-26).

12
13 **Q PLEASE EXPLAIN WHY YOU BELIEVE THE DCF MODELS PRODUCE A**
14 **REASONABLE ESTIMATE OF THE COMPANIES' MARKET COST OF COMMON**
15 **EQUITY.**

16 **A** The results of the DCF model are economically logical in comparison to alternative
17 income investments and exhibit robust growth outlooks.

18 The DCF results generally produce economically logical results by comparison
19 of the two major components of the DCF return: (1) the dividend yield, and (2) the
20 growth rate. The utility stock investments are both income investments and growth
21 investments. Hence, the stock yield component of the DCF model can be compared
22 to alternative income investments of comparable risk to assess how it compares to
23 alternative market investments.

24 On my Schedule MPG-R-6, I show a comparison of natural gas utility stock
25 dividend yields compared to A-rated utility bond yields. This is an approximate risk

1 comparable investment for the income component of a utility stock DCF return. As
2 shown on this schedule, utility stock yields are currently around 2.6%, which
3 compares to A-rated utility bond yields of around 4.1%. This spread of around 150
4 basis points is in line with the 12-year average shown on this schedule. A high utility
5 stock yield relative to an A-rated utility bond yield is an indication that the DCF model
6 yield component is higher than normal and thus is a robust income return relative to
7 alternative similar risk income investments.

8 From a DCF growth perspective, utility stocks are also producing strong
9 growth outlooks relative to the past. The industry historical growth in dividends has
10 been around 4.4%. (Schedule MPG-R-7). This compares to outlooks for future
11 growth in utility dividends and earnings of around 5.8% (Schedule PMA-D3) to 6.1%
12 (Gorman Direct Testimony, Schedule MPG-5). As such, a DCF return on utility
13 stocks reflects a yield component and a growth component that both reflect robust
14 return outlooks for utility stock investors, and are economically logical in comparison
15 to alternative investments of comparable risk.

16 For these reasons, Laclede witness Ahern's contention that the DCF model is
17 not producing reasonable results simply is without merit and should be disregarded.

18 **III.D. Ahern Risk Premium**

19 **Q PLEASE DESCRIBE MS. AHERN'S RISK PREMIUM ANALYSIS.**

20 **A** Ms. Ahern estimated a risk premium return of 10.57% based on the results of a
21 PRPM™ risk premium (11.62%) and prospective utility risk premium (9.51%).
22 (Schedule PMA-D4).

1 Q PLEASE DESCRIBE MS. AHERN'S PRPM™ RISK PREMIUM STUDY.

2 A First, she derived an equity risk premium using the "PRPM™." The PRPM™ model
3 estimated a proxy group average equity risk premium of 7.78%. She then added a
4 forecasted risk-free rate of 3.65%, to produce an average and median cost of equity
5 of 11.43% and 11.81%, respectively, with a midpoint PRPM™ risk premium estimate
6 of 11.62%. (*Id.*, page 2).

7 Q PLEASE DESCRIBE MS. AHERN'S UTILITY RISK PREMIUM STUDY.

8 A Ms. Ahern's utility risk premium model is based on a projected utility bond yield of
9 4.89%, and an average equity risk premium of 4.62%.

10 The 4.62% risk premium used by Ms. Ahern is the result of three separate risk
11 premium studies that produce risk premiums of 4.46%, 4.26% and 5.15%. The first
12 risk premium study produced an average beta-adjusted equity risk premium of 4.46%
13 and was developed on page 8 of Schedule PMA-D4. This risk premium was based
14 on an Ibbotson equity risk premium estimate (5.52%), PRPM™ estimate using
15 Ibbotson data (6.38%), a regression on Ibbotson data (7.40%) *Value Line* equity risk
16 premium estimate (4.60%), and a S&P 500 DCF derived equity risk premium using
17 Bloomberg data (8.40%). The average of these five risk premium estimates of
18 6.46%, which was then adjusted by her proxy group average beta of 0.69, to produce
19 a risk premium estimate of 4.46%.

20 The second risk premium of 4.26% was based on the average of a historical
21 equity risk premium of the S&P Utility Index of 3.85%, Ms. Ahern's PRPM of 4.34%,
22 regression of a historical risk premium of 5.50% and the forecasted equity risk
23 premium of the total returns of the S&P Utility Index of 3.36% using Bloomberg data.
24 (Schedule PMA-D4, Page 11 of 12)

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1 Q IS MS. AHERN'S PREDICTIVE RISK PREMIUM MODEL ("PRPM") STUDY
2 RESULT OF 11.62% REASONABLE?

3 A No. Ms. Ahern's PRPM™ measures the volatility of risk premiums based on return
4 volatility of a stock index "total" return, less bond "income" return. This method of
5 measuring risk premium and its volatility is flawed and biases the risk premium up,
6 and distorts its volatility.

7 Specifically, a significant component of return volatility on stock is created by
8 capital gains and losses. Without recognizing capital gains and losses, stock return
9 volatility and bond return volatility would be muted significantly. This is a significant
10 distinction because Ms. Ahern reflects the increased return volatility for stocks based
11 on capital gains and losses, but ignores this significant investment return component
12 for bond yields. Therefore, Ms. Ahern has not accurately measured the level of the
13 risk premium, nor accurately characterized the volatility across time caused by market
14 factors. Importantly, both stock and bond returns will be impacted by the capital
15 gains and losses created by market factors that influence stock prices and bond
16 prices. Ms. Ahern has significantly understated the return volatility of investing in
17 bonds, and inflated the equity risk premium. This methodology simply is not
18 balanced, and does not reflect an accurate measurement of a market risk premium.

19 Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S UTILITY RISK
20 PREMIUM?

21 A Yes. This risk premium result of 9.51% was based on a projected prospective bond
22 yield of 4.89% and an equity risk premium of 4.62%. This return on equity is
23 substantially overstated for several reasons. First, her prospective bond yield of
24 4.89% overstates current observable A-rated utility bond yields of 4.16%. (Schedule

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1 PMA-D4). Overstating the bond yield overstates her risk premium by approximately
2 73 basis points. In fact, more recent data shows that the 13-week average A-rated
3 utility yield is approximately 3.90%, which is approximately 100 basis points lower
4 than Ms. Ahern estimate of 4.89%. (Schedule MPG-R-8).

5 **Q CAN MS. AHERN'S RISK PREMIUM MODELS BE USED TO ESTIMATE A FAIR**
6 **RETURN FOR LACLEDE/MGE?**

7 A Only generally. Reflecting her current observable A-rated utility bond yields of 4.16%
8 (Schedule PMA-D4) and Ms. Ahern's equity risk premium estimate of 4.62% would
9 imply a return on equity for Laclede/MGE in this case of approximately 8.80%.

10 **III.E. Ahern CAPM**

11 **Q HOW DID MS. AHERN DERIVE HER CAPM RETURN ESTIMATE FOR**
12 **LACLEDE/MGE?**

13 A Ms. Ahern developed her CAPM return estimate on her Schedule PMA-D5. As
14 shown on that schedule, she relied on a proxy group beta of 0.69, which was the
15 average of the mean and median beta published by Bloomberg and *Value Line* for
16 her proxy companies, a market risk premium of 7.53%, and a risk-free rate of 3.65%.
17 Her CAPM methodology produces a traditional CAPM return of 8.81%.

18 **Q DO YOU HAVE ANY ISSUES WITH MS. AHERN'S CAPM STUDY?**

19 A Yes. I disagree with her methodology of developing the CAPM inputs. However,
20 because her CAPM result is comparable to mine I will limit my rebuttal to Ms Ahern to
21 models that produce unreasonable or inflated results.

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1 **III.F. Ahern ECAPM**

2 **Q PLEASE DESCRIBE MS. AHERN'S ECAPM ANALYSIS.**

3 A The ECAPM analysis modifies the traditional CAPM equation by including a risk
4 premium weighted by the utility beta, and the overall market beta of 1.0. The original
5 ECAPM analysis was designed to use raw, or unadjusted, regression betas. In Ms.
6 Ahern's ECAPM analysis, she adds two weighted risk premiums to a risk-free rate: a
7 75% weighted risk premium based on a 0.75 utility beta, and a 25% weighted risk
8 premium based on a beta equal to the overall market beta of 1.0. The theory of the
9 ECAPM is that a beta of less than 1.0 will increase toward the market beta of 1.0 over
10 time, which is necessary because the risk of securities will be increasing over time.

11 **Q WHAT ISSUES DO YOU TAKE WITH MS. AHERN'S ECAPM ANALYSIS?**

12 A The ECAPM analysis should be rejected for several reasons. First, the practical
13 result of Ms. Ahern's ECAPM is that the return is based on a beta estimate of 0.77,⁷
14 instead of her actual *Value Line* utility beta of 0.69. The ECAPM analysis significantly
15 overstates a utility company-specific risk premium for use in a risk premium analysis.

16 Second, the ECAPM produces the same mathematical adjustments to the
17 result of a traditional CAPM return estimate as does the use of an adjusted *Value*
18 *Line* beta relative to a raw beta. Theoretical constructs of the ECAPM are based on a
19 raw beta or unadjusted beta. Using a raw beta, the ECAPM will increase the CAPM
20 return estimate when the raw betas are less than 1.0, and decrease the CAPM return
21 estimate when the raw betas are greater than 1.0. This is a redundant CAPM return
22 adjustment, and overstates a fair return for Laclede/MGE.

⁷75% x 0.69 + 25% x 1 = 0.77.

1 *Value Line's* adjusted beta creates the same impact on a CAPM return
2 estimate as the ECAPM. *Value Line's* adjusted betas are produced by giving 35%
3 weight to the market beta of 1.0 and 67% weight to the raw beta estimates. *Value*
4 *Line's* beta adjustment, when used in a traditional CAPM return estimate, will
5 increase a CAPM return estimate when the beta is less than 1.0, and decrease the
6 CAPM return estimate when the beta is greater than 1.0. Therefore, an ECAPM with
7 a raw beta produces the same impact on the CAPM return estimate as does a
8 traditional CAPM using an adjusted beta estimate. Importantly, I am not aware of any
9 research that was subjected to peer review that supports Ms. Ahern's proposed use
10 of an adjusted beta in an ECAPM study. Therefore, Ms. Ahern's proposal to use an
11 "adjusted" beta in an ECAPM is neither based on sound academic principles, nor is it
12 supported by the academic community, and should be rejected.

13 Further, using an adjusted beta in an ECAPM analysis, as Ms. Ahern
14 proposes, double-counts the increase in the CAPM return estimates for betas less
15 than 1.0, and correspondingly decreases the CAPM return estimates for companies
16 that have betas greater than 1.0. Since utility companies have betas less than 1.0,
17 Ms. Ahern's application of an ECAPM with adjusted beta estimates overstates a
18 CAPM return estimate for a utility company.

19 For all these reasons, Ms. Ahern's ECAPM analysis should be rejected.

20 **Q CAN MS. AHERN'S ECAPM ANALYSIS BE REVISED TO PRODUCE A MORE**
21 **REASONABLE RETURN ESTIMATE?**

22 **A Yes.** In her testimony she shows beta estimates based on published adjusted betas,
23 and unadjusted betas. (Schedule PMA-D6). The published *Value Line* adjusted beta
24 for her proxy group decreases from 0.74 down to 0.57 when the beta adjustment is

1 removed. Hence, using an unadjusted beta of 0.57 in her ECAPM study would
2 produce a more reasonable result. Using the information shown on her Schedule
3 PMA-D5, with an unadjusted beta of 0.57 will produce an ECAPM for her utility proxy
4 group of 8.8%.⁸

5 **III.G. Ahern Non-Regulated Companies Analysis**

6 Q IS MS. AHERN'S NON-PRICE REGULATED COMPANIES' EARNED RETURN ON
7 EQUITY ESTIMATE OF 10.45% A REASONABLE METHODOLOGY OF
8 ESTIMATING LACLEDE/MGE'S CURRENT MARKET COST OF EQUITY?

9 A No. Ms. Ahern's non-price regulated return on equity estimate is based on the results
10 from the same cost of equity studies described above on a proxy group of 16 non-
11 price regulated companies. The average result of her mean and median market-
12 based studies on her non-price regulated companies produced her estimated return
13 on equity from this methodology of 10.45% $((10.59\% + 10.30\%) \div 2)$. (Schedule
14 PMA-D7.).

15 Q ARE THERE OTHER REASONS TO DISREGARD THE NON-PRICE REGULATED
16 RISK PROXY GROUP ESTIMATE OF LACLEDE/MGE'S CURRENT RETURN ON
17 EQUITY?

18 A Yes. Ms. Ahern has not proved that these companies are risk comparable to
19 Laclede/MGE. While these companies may have comparable beta estimates, she
20 has not shown that they face comparable business and operating risk to a low-risk
21 regulated gas utility company. To draw a valid comparison between Laclede/MGE
22 and any proxy group, it is necessary to show that these companies have comparable

⁸ $3.65\% + 0.25\% \times 7.53\% + 0.75 \times 0.57 \times 7.53\% = 8.75\%$, rounded to 8.8%.

1 risk factors that are commonly used by investment professionals to compare
2 investment risk between different investment alternatives. Because she has not
3 shown that these companies are indeed risk comparable to Laclede/MGE, her
4 estimated return on this proxy group is not reliable and should be disregarded.

5 Further, the RP and CAPM estimates on Ms. Ahern's non-utility proxy group
6 were flawed and biased for the same reasons described above concerning her utility
7 proxy group. As such, her return on equity estimates based on her non-utility proxy
8 group do not reflect a reasonable risk proxy for Laclede/MGE, and are based on
9 flawed applications of DCF risk premiums, with inappropriate return on equity adders.

10 **Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

11 **A Yes, it does.**

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Laclede Gas Company / Missouri Gas Energy

Rate of Return

<u>Line</u>	<u>Description</u>	<u>Weight</u> (1)	<u>Cost</u> (2)	<u>Weighted</u> <u>Cost</u> (3)
1	Long-Term Debt	52.80%	4.15%	2.19%
2	Common Equity	<u>47.20%</u>	<u>9.20%</u>	<u>4.34%</u>
3	Total	100.00%		6.53%

Source:
Glenn Buck Workpapers.

Laclede Gas Company / Missouri Gas Energy

Capital Structure

<u>Line</u>	<u>Description</u>	<u>Proposed</u>		<u>New Debt</u> (3)	<u>Debt Adjusted</u>		<u>Goodwill</u> (6)	<u>Equity Adjusted</u>	
		<u>Amount</u> (1)	<u>Weight</u> (2)		<u>Adjusted</u> (4) = (1)+(3)	<u>Weight</u> (5)		<u>Adjusted</u> (7) = (4)+(6)	<u>Weight</u> (8)
1	Long-Term Debt ¹	\$ 817,867,771	42.8%	\$170,000,000	\$ 987,867,771	47.5%		\$ 987,867,771	52.8%
2	Common Equity ²	\$ 1,092,994,071	57.2%		\$ 1,092,994,071	52.5%	\$ (210,000,000)	\$ 882,994,071	47.2%
3	Total	\$ 1,910,861,842	100.0%		\$ 2,080,861,842	100.0%		\$ 1,870,861,842	100.0%

Sources and Notes:
Glenn Buck Workpapers.

¹The long-term debt was adjusted for the \$170 million actual new debt issuance.

²The common equity was adjusted to exclude \$210 million of goodwill capital.

Laclede Gas Company / Missouri Gas Energy

Laclede Gas Historical Capital Structure (Millions)

<u>Line</u>	<u>Description</u>	<u>2012</u> (1)	<u>2013</u> (2)	<u>2014</u> (3)	<u>2015</u> (4)	<u>2016</u> (5)
Actual						
1	Short-Term Debt	\$77.0	\$120.7	\$238.6	\$233.0	\$243.7
2	Long-Term Debt	\$339.0	\$887.7	\$807.9	\$808.1	\$804.1
3	Common Equity	<u>\$491.0</u>	<u>\$973.9</u>	<u>\$1,007.8</u>	<u>\$1,037.8</u>	<u>\$1,068.5</u>
4	Total Capital	\$907.0	\$1,982.3	\$2,054.3	\$2,078.9	\$2,116.3
Including Short-Term Debt						
5	Short-Term Debt	8.5%	6.1%	11.6%	11.2%	11.5%
6	Long-Term Debt	37.4%	44.8%	39.3%	38.9%	38.0%
7	Common Equity	<u>54.1%</u>	<u>49.1%</u>	<u>49.1%</u>	<u>49.9%</u>	<u>50.5%</u>
8	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%
Excluding Short-Term Debt						
9	Long-Term Debt	40.8%	47.7%	44.5%	43.8%	42.9%
10	Common Equity	<u>59.2%</u>	<u>52.3%</u>	<u>55.5%</u>	<u>56.2%</u>	<u>57.1%</u>
11	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%
12	Goodwill	\$0.0	\$247.1	\$210.2	\$210.2	\$210.2
Removed Goodwill Capital						
13	Short-Term Debt	\$77.0	\$120.7	\$238.6	\$233.0	\$243.7
14	Long-Term Debt	\$339.0	\$887.7	\$807.9	\$808.1	\$804.1
15	Common Equity	<u>\$491.0</u>	<u>\$726.8</u>	<u>\$797.6</u>	<u>\$827.6</u>	<u>\$858.3</u>
16	Total Capital	\$907.0	\$1,735.2	\$1,844.1	\$1,868.7	\$1,906.1
Including Short-Term Debt						
17	Short-Term Debt	8.5%	7.0%	12.9%	12.5%	12.8%
18	Long-Term Debt	37.4%	51.2%	43.8%	43.2%	42.2%
19	Common Equity	<u>54.1%</u>	<u>41.9%</u>	<u>43.3%</u>	<u>44.3%</u>	<u>45.0%</u>
20	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%
Excluding Short-Term Debt						
21	Long-Term Debt	40.8%	55.0%	50.3%	49.4%	48.4%
22	Common Equity	<u>59.2%</u>	<u>45.0%</u>	<u>49.7%</u>	<u>50.6%</u>	<u>51.6%</u>
23	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%

Source:
2012 - 2016 Spire Missouri 10-K and 10Q.

Laclede Gas Company / Missouri Gas Energy

Spire, Inc. Historical Capital Structure (Millions)

<u>Line</u>	<u>Description</u>	<u>2012</u> (1)	<u>2013</u> (2)	<u>2014</u> (3)	<u>2015</u> (4)	<u>2016</u> (5)
Actual						
1	Short-Term Debt	\$65.0	\$74.0	\$287.1	\$418.0	\$648.7
2	Long-Term Debt	\$339.0	\$912.7	\$1,851.0	\$1,771.5	\$1,820.7
3	Common Equity	<u>\$602.0</u>	<u>\$1,046.3</u>	<u>\$1,508.4</u>	<u>\$1,573.6</u>	<u>\$1,768.2</u>
4	Total Capital	\$1,006.0	\$2,033.0	\$3,646.5	\$3,763.1	\$4,237.6
Including Short-Term Debt						
5	Short-Term Debt	6.5%	3.6%	7.9%	11.1%	15.3%
6	Long-Term Debt	33.7%	44.9%	50.8%	47.1%	43.0%
7	Common Equity	<u>59.8%</u>	<u>51.5%</u>	<u>41.4%</u>	<u>41.8%</u>	<u>41.7%</u>
8	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%
Excluding Short-Term Debt						
9	Long-Term Debt	36.0%	46.6%	55.1%	53.0%	50.7%
10	Common Equity	<u>64.0%</u>	<u>53.4%</u>	<u>44.9%</u>	<u>47.0%</u>	<u>49.3%</u>
11	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%
12	Goodwill	\$0.0	\$247.1	\$937.8	\$946.0	\$1,164.9
Remove Goodwill Capital						
13	Short-Term Debt	\$65.0	\$74.0	\$287.1	\$418.0	\$648.7
14	Long-Term Debt	\$339.0	\$912.7	\$1,851.0	\$1,771.5	\$1,820.7
15	Common Equity	<u>\$602.0</u>	<u>\$799.2</u>	<u>\$570.6</u>	<u>\$627.6</u>	<u>\$603.3</u>
16	Total Capital	\$1,006.0	\$1,785.9	\$2,708.7	\$2,817.1	\$3,072.7
Including Short-Term Debt						
17	Short-Term Debt	6.5%	4.1%	10.6%	14.8%	21.1%
18	Long-Term Debt	33.7%	51.1%	68.3%	62.9%	59.3%
19	Common Equity	<u>59.8%</u>	<u>44.8%</u>	<u>21.1%</u>	<u>22.3%</u>	<u>19.6%</u>
20	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%
Excluding Short-Term Debt						
21	Long-Term Debt	36.0%	53.3%	76.4%	73.8%	75.1%
22	Common Equity	<u>64.0%</u>	<u>46.7%</u>	<u>23.6%</u>	<u>26.2%</u>	<u>24.9%</u>
23	Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%

Source:

2012 - 2016 Spire Inc. 10-K and 10Q.

Laclede Gas Company / Missouri Gas Energy

Most Recent Authorized Return on Equity and Common Equity Ratios of Proxy Group Subsidiaries

<u>Line</u>	<u>Company</u>	<u>State</u>	<u>Docket Number</u> (1)	<u>Authorized Date</u> (2)	<u>ROE</u> (3)	<u>Common Equity Ratio</u> (4)
<u>Atmos Energy</u>						
1	Atmos Energy Corp.	CO	D-13AL-0496G	3/16/2014	9.72%	52.57%
2	Atmos Energy Corp.	GA	D-30442	3/31/2010	10.70%	47.70%
3	Atmos Energy Corp.	KS	D-14-ATMG-320-RTS	9/4/2014	9.10%	53.00%
4	Atmos Energy Corp.	KY	C-2013-00148	4/22/2014	9.80%	49.16%
5	Atmos Energy Corp.	LA	D-U-21484 (LGS)	4/17/1996	10.77%	53.25%
6	Atmos Energy Corp.	MS	C-U-4728	11/8/1985	12.94%	77.76%
7	Atmos Energy Corp.	TN	D-14-00146	5/11/2015	9.80%	53.13%
8	Atmos Energy Corp.	TX	D-GUD-10170 (Mid-Tex)	12/4/2012	10.50%	<u>51.69%</u>
9	Average					54.78%
<u>New Jersey Resources Corp.</u>						
10	New Jersey Natural Gas Co.	NJ	D-GR-15111304	9/23/2016	9.75%	52.50%
<u>Northwest Natural Gas Company</u>						
11	Northwest Natural Gas Co.	OR	D-UG-221	10/26/2012	9.50%	50.00%
12	Northwest Natural Gas Co.	WA	D-UG-08-0546	12/26/2008	10.10%	<u>50.74%</u>
13	Average					50.37%
<u>South Jersey Industries</u>						
14	South Jersey Gas Co.	NJ	D-GR-13111137	9/30/2014	9.75%	51.90%
<u>Southwest Gas Holdings</u>						
15	Southwest Gas Corp.	AZ	D-G-01551A-16-0107	4/11/2017	9.50%	51.70%
16	Southwest Gas Corp.	CA	A-12-12-024 (SoCal)	6/12/2014	10.10%	55.00%
17	Southwest Gas Corp.	CA	A-12-12-024 (NoCal)	6/12/2014	10.10%	55.00%
18	Southwest Gas Corp.	CA	A-12-12-024 (LkTah)	6/12/2014	10.10%	55.00%
19	Southwest Gas Corp.	NV	D-12-04005 (Southern)	10/31/2012	10.00%	42.74%
20	Southwest Gas Corp.	NV	D-12-04005 (Northern)	10/31/2012	9.30%	<u>59.06%</u>
21	Average					53.08%
<u>Spire</u>						
22	Spire Missouri Inc.	MO	C-GR-99-315	12/14/1999	10.50%	52.66%
23	Missouri Gas Energy	MO	C-GR-2009-0355	2/10/2010	10.00%	38.66%
24	Spire Alabama Inc.	AL	D-18046	7/2/1981	14.00%	37.19%
25	Mobile Gas Service Corp	AL	D-24794	11/27/1995	13.60%	<u>46.99%</u>
26	Average					43.88%
27	Mean				10.44%	51.70%
28	Median				10.05%	52.20%

Source:

SNL Financial downloaded 10/9/17.

Laclede Gas Company / Missouri Gas Energy

Adjusted Debt Ratio **(Gorman Proposed Capital Structure)**

<u>Line</u>	<u>Description</u>	<u>Amount</u> <u>(1)</u>	<u>Weight</u> <u>(2)</u>
1	Long-Term Debt	\$ 987,867,771	51.23%
2	Off-Balance sheet Debt*	<u>\$ 57,460,000</u>	<u>2.98%</u>
3	Total Debt	\$ 1,045,327,771	54.21%
4	Common Equity	<u>882,994,071</u>	<u>45.79%</u>
5	Total	\$ 1,928,321,842	100.00%

Sources:

Schedule MPG-R-1.

*S&P, CreditStats, downloaded October 11, 2017.

Laclede Gas Company / Missouri Gas Energy

Adjusted Debt Ratio (Buck Proposed Capital Structure)

<u>Line</u>	<u>Description</u>	<u>Amount</u> (1)	<u>Weight</u> (2)
1	Long-Term Debt	\$ 817,867,771	41.55%
2	Off-Balance sheet Debt*	<u>\$ 57,460,000</u>	<u>2.92%</u>
3	Total Debt	\$ 875,327,771	44.47%
4	Common Equity	<u>1,092,994,071</u>	<u>55.53%</u>
5	Total	\$ 1,968,321,842	100.00%

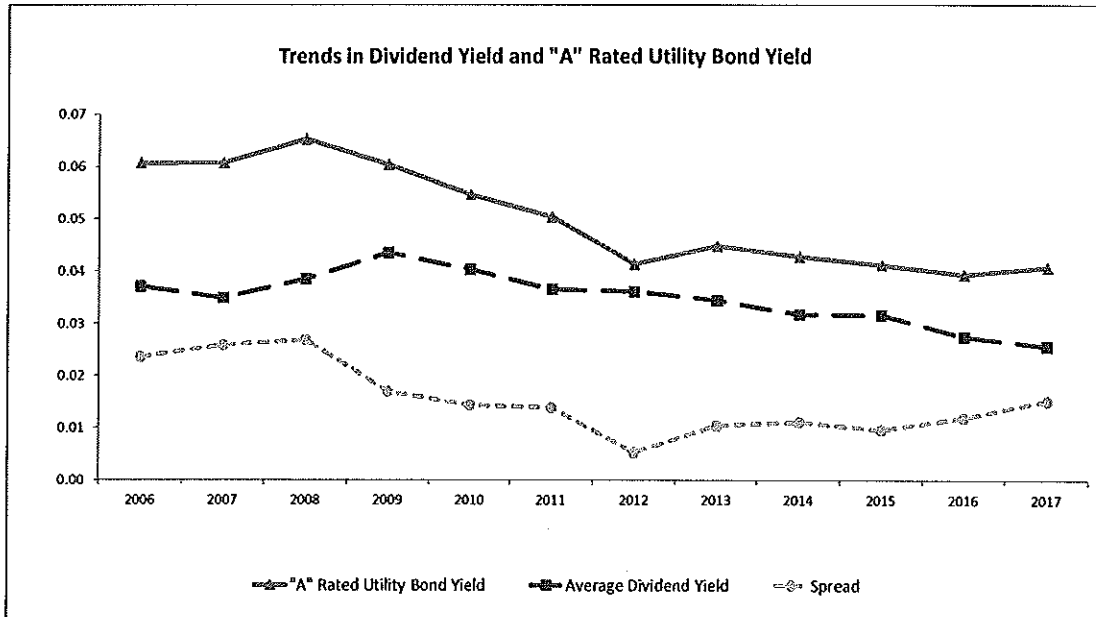
Sources:
Schedule MPG-R-2.

*S&P, CreditStats, downloaded October 11, 2017.

Laclede Gas Company / Missouri Gas Energy

Natural Gas Utilities (Valuation Metrics)

Line	Company	Dividend Yield ¹												
		12-Year Average (1)	2017 ² (2)	2016 (3)	2015 (4)	2014 (5)	2013 (6)	2012 (7)	2011 (8)	2010 (9)	2009 (10)	2008 (11)	2007 (12)	2006 (13)
1	Atmos Energy	3.84%	2.23%	2.39%	2.88%	3.11%	3.53%	4.13%	4.19%	4.70%	5.34%	4.78%	4.16%	4.66%
2	Chesapeake Utilities	3.10%	1.76%	1.91%	2.18%	2.44%	2.87%	3.25%	3.36%	3.91%	4.09%	4.10%	3.62%	3.76%
3	New Jersey Resources	3.27%	2.62%	2.86%	3.14%	3.60%	3.71%	3.38%	3.33%	3.69%	3.46%	3.35%	3.02%	3.19%
4	NSSource Inc.	4.25%	2.87%	2.76%	3.53%	2.69%	3.30%	3.84%	4.53%	5.66%	7.64%	5.69%	4.29%	4.21%
5	Northwest Nat. Gas	3.65%	3.07%	3.28%	4.01%	4.14%	4.22%	3.83%	3.85%	3.63%	3.73%	3.27%	3.12%	3.73%
6	ONE Gas Inc.	2.44%	2.46%	2.32%	2.71%	2.28%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
7	South Jersey Inds.	3.23%	3.15%	3.64%	3.95%	3.40%	3.14%	3.22%	2.81%	3.00%	3.43%	3.08%	2.81%	3.15%
8	Southwest Gas	2.87%	2.49%	2.62%	2.87%	2.72%	2.69%	2.75%	2.78%	3.15%	4.01%	3.19%	2.56%	2.60%
9	Spire Inc.	3.93%	3.01%	3.08%	3.53%	3.78%	3.96%	4.11%	4.31%	4.70%	3.91%	3.94%	4.43%	4.34%
10	UGI Corp.	2.88%	1.96%	2.35%	2.50%	2.61%	3.01%	3.68%	3.30%	3.48%	3.23%	2.85%	2.69%	2.96%
11	WGL Holdings Inc.	3.91%	2.52%	2.94%	3.41%	4.24%	3.94%	3.89%	4.06%	4.37%	4.62%	4.22%	4.19%	4.48%
12	Average	3.48%	2.56%	2.74%	3.16%	3.17%	3.44%	3.61%	3.65%	4.03%	4.35%	3.85%	3.49%	3.71%
13	Median	3.40%	2.52%	2.76%	3.14%	3.11%	3.42%	3.75%	3.60%	3.80%	3.96%	3.65%	3.37%	3.75%
14	"A" Rated Utility Bond Yield ³	5.02%	4.07%	3.93%	4.12%	4.28%	4.48%	4.13%	5.04%	5.46%	6.04%	6.53%	6.07%	6.07%
15	Spread	1.54%	1.51%	1.19%	0.96%	1.11%	1.04%	0.52%	1.39%	1.43%	1.69%	2.68%	2.59%	2.36%



Sources:

¹ The Value Line Investment Survey Investment Analyzer Software, downloaded on June 21, 2017.

² The Value Line Investment Survey, September 1, 2017.

³ www.moodys.com, Bond Yields and Key Indicators, through August 31, 2017.

Notes:

⁴ Based on the average of the high and low price for 2017 and the projected 2017 Dividends Declared per share, published in The Value Line Investment Survey, September 1, 2017.

Laclede Gas Company / Missouri Gas Energy

Dividend Growth (Natural Gas Utilities)

Line	Company	Dividend per Share ¹												
		12-Year Average (1)	2017 ² (2)	2016 (3)	2015 (4)	2014 (5)	2013 (6)	2012 (7)	2011 (8)	2010 (9)	2009 (10)	2008 (11)	2007 (12)	2006 (13)
1	Atmos Energy	1.43	1.80	1.68	1.56	1.48	1.40	1.38	1.36	1.34	1.32	1.30	1.28	1.26
2	Chesapeake Utilities	0.97	1.26	1.19	1.12	1.07	1.01	0.96	0.91	0.87	0.83	0.81	0.78	0.77
3	New Jersey Resources	0.74	1.02	0.98	0.93	0.86	0.81	0.77	0.72	0.68	0.62	0.56	0.51	0.48
4	NiSource Inc.	0.89	0.70	0.64	0.83	1.02	0.98	0.94	0.92	0.92	0.92	0.92	0.92	0.92
5	Northwest Nat. Gas	1.71	1.88	1.87	1.86	1.85	1.83	1.79	1.75	1.68	1.60	1.52	1.44	1.39
6	ONE Gas Inc.	1.28	1.68	1.40	1.20	0.84	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
7	South Jersey Inds.	0.79	1.10	1.06	1.02	0.96	0.90	0.83	0.75	0.68	0.61	0.56	0.51	0.46
8	Southwest Gas	1.25	1.98	1.80	1.62	1.46	1.32	1.18	1.06	1.00	0.95	0.90	0.86	0.82
9	Spire Inc.	1.67	2.10	1.96	1.84	1.76	1.70	1.66	1.61	1.57	1.53	1.49	1.45	1.40
10	UGI Corp.	0.69	0.95	0.93	0.89	0.79	0.74	0.71	0.68	0.60	0.52	0.50	0.48	0.46
11	WGL Holdings Inc.	1.62	2.02	1.93	1.83	1.72	1.66	1.59	1.55	1.50	1.47	1.41	1.37	1.35
12	Average	1.17	1.50	1.40	1.34	1.25	1.24	1.18	1.13	1.08	1.04	1.00	0.96	0.93
13	Industry CAGR	4.44%												

Sources:

¹ The Value Line Investment Survey Investment Analyzer Software, downloaded on June 21, 2017.

² The Value Line Investment Survey, September 1, 2017.

Notes:

CAGR = Compound Annual Growth Rate

Laclede Gas Company / Missouri Gas Energy

Treasury and Utility Bond Yields

<u>Line</u>	<u>Date</u>	<u>Treasury Bond Yield¹</u> (1)	<u>"A" Rated Utility Bond Yield²</u> (3)	<u>"Baa" Rated Utility Bond Yield²</u> (4)
1	10/06/17	2.91%	3.95%	4.30%
2	09/29/17	2.86%	3.92%	4.28%
3	09/22/17	2.80%	3.88%	4.25%
4	09/15/17	2.77%	3.86%	4.23%
5	09/08/17	2.67%	3.78%	4.15%
6	09/01/17	2.77%	3.85%	4.23%
7	08/25/17	2.75%	3.83%	4.20%
8	08/18/17	2.78%	3.85%	4.22%
9	08/11/17	2.79%	3.86%	4.22%
10	08/04/17	2.84%	3.90%	4.27%
11	07/28/17	2.89%	3.97%	4.32%
12	07/21/17	2.81%	3.91%	4.27%
13	07/14/17	2.91%	4.02%	4.40%
14	Average	2.81%	3.89%	4.26%
15	Spread To Treasury		1.08%	1.45%

Sources:

¹ St. Louis Federal Reserve: Economic Research, <http://research.stlouisfed.org>.

² <http://credittrends.moody.com/>.