BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's)
Tariff to Revise Natural Gas Rate Schedule) Case No. GR-99-315

AFFIDAVIT

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

John E. Olson, of lawful age, being first duly sworn, deposes and states:

1. My name is John E. Olson. My business address is Suite 3100, Chase Tower, Houston, Texas 77010; and I am Senior Vice President – Securities Research of Sanders Morris Mundy.

2. Attached hereto and made part hereof for all purposes is my direct testimony, consisting of pages 1 to 20, inclusive; and Schedules 1 to 2, inclusive.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded and the information contained in the attached schedules are true and correct to the best of my knowledge and belief.

John E. Olson

Subscribed and sworn to before me this 9 day of March, 1999.

DENISE DEBORAH CARDOZO
NOTARY PUBLIC, STATE OF TEXAS
MY COMMISSION EXPIRES
JAN. 24, 2000

Exhibit No.:
Issue: Return on Equity
Witness: John E. Olson
Type of Exhibit: Direct Testimony
Sponsoring Party: Laclede Gas Company
Case No.: GR-99-315

LACLEDE GAS COMPANY

GR-99-315

DIRECT TESTIMONY

OF

JOHN E. OLSON

DIRECT TESTIMONY OF JOHN E. OLSON

Q. Please state your name and business address.

A. My name is John E. Olson, My business address is: Sanders Morris Mundy, 3100 Chase Tower, Houston, Texas 77002.

Q. By whom are you employed and in what capacity?

A. I am a Senior Vice President-Securities Research, of Sanders Morris Mundy.

Q. Please describe Sanders Morris Mundy's business.

A. Sanders Morris Mundy is a major private placement and regional securities firm in Houston, Texas.

Q. Please describe your responsibilities at Sanders Morris Mundy, focusing particularly on your experience with the public utility industry.

A. My primary responsibility at Sanders Morris Mundy is to analyze natural gas equities and to make recommendations as to their fundamental outlook and relative valuations. I am currently covering about 20 natural gas stocks, and have spent my 30 year career involved with natural gas companies at all levels having previously been employed by Merrill Lynch as senior natural gas analyst.

Q. What is the purpose of your testimony in this proceeding?

A. I have been asked by Laclede Gas Company to provide the Commission with the investment community's perspective

on what I believe is one of the most critical issues facing both regulators and local distribution companies (LDCs) such as Laclede. This is the compelling need to reexamine and adjust how returns on equity are established for LDCs in light of the capital attraction demands imposed by today's unprecedented financial and operational environment. I hope this perspective will assist the Commission in recognizing why the return on equity analysis presented by Laclede witness McShane in this proceeding, including her use of the Comparable Earnings Method and her straight-forward, mathematically correct adjustment to the Discounted Cash Flow (DCF) Method, represents a crucial, albeit modest, first step in fashioning such returns. I also hope it will engender serious consideration of other alternative methods for meeting this goal, including the indexing proposal which I will discuss later in my testimony.

Q. Why, in your view, is this reevaluation of ROE methods necessary?

A. As any observer of both the stock market and the regulatory process knows, Corporate America has restored its profitability to much higher sustainable levels than those traditionally awarded by regulators to gas utilities. This has diminished the relative attraction of utility equities generally, resulting in chronic underperformance in recent years.

Unfortunately, cost-of-capital models such as the DCF method, as traditionally calculated and applied, have recognized neither competitive investing realities, nor the rapidly changing business and increasing financial risk exposures in the open-access world now engulfing the natural gas industry. Their application has resulted in a subsidization of ratepayers by stockholders in many jurisdictions. In investing terms, this has had three consequences. First, LDC equities have generally under-performed other equities. Second, LDCs have had to raise their payout ratios in order to deliver enough yield to compensate for the attrition in underlying growth rates, relative profitability and investment quality. Third, both of these factors has led to another unfortunate reality; namely, the fact that investments in LDC equities have become conceptually harder to justify. Why should equity investors buy an 11% Return on Equity (ROE) investment in an industry which is low growth, increasingly risky, yet still regulated, when they can buy an 18%-20% ROE today in Corporate America? This makes no investing sense. Yet, regulatory staffs continue to use the outdated and inappropriate cost-of-capital models, without any effort to adjust or modify them to account for these new realities.

Q. Where would you suggest a public service commission begin in setting ROEs at levels necessary to attract capital to natural gas utilities?

A. The investing rationale for owning regulated utility equities has been made increasingly more tenuous by: (1) the resurgence in Corporate America profitability; (2) the continuous failure of the regulatory cost-of-capital models, as traditionally applied and calculated, to provide the necessary relief; (3) the continuing under-performance of LDC equities; and, perhaps most importantly, (4) the increasingly competitive environment LDCs must face. There has been little to no relief from declining regulatory ROEs for ten years. Even without considering the changing business environment, falling growth rates, higher payout ratios and/or zero dividend growth are the unfortunate mutations of this process. Something needs to be done to reverse this downward spiral and to provide investment incentives to LDC stockholders. Indeed, the opportunity costs of being invested in a portfolio of LDC stocks over the past five years have been substantial. For example, an investor could have realized the following average annual total returns since year end 1992: (1) 22.3% in the Standard & Poor's 500 (Wall Street's proxy for Corporate America); (2) 8.2% in the Small LDC sector; (3) 9.1% for Laclede Gas Company. The facts are that an investor would have

made about 224% cumulatively on his year end 1992 investment in the S&P 500, and only about 53% on his money in the Small LDC sector. The S&P 500 gave positive total returns every year. The LDCs had a down 1994 because they are also subjected to interest rate cycles as a result of their higher yields and payout ratios. They also had a poor 1998 owing to noncompetitive profitability. Indeed, a large part of this relative under-performance can be ultimately traced to ratemaking that regularly validates mediocre profitability of 11%-12% ROEs or less, while the real world caravan has moved on and settled in the 18%-20% area.

Q. But wouldn't utility ROEs more in line with Corporate America break new ground and be too controversial?

A. From a Wall Street point of view, not at all; nor should it be from a larger social context. If Missouri companies (i.e., Corporate America) are making 18% ROEs, Missouri utilities should not be too far behind. While there is perhaps some residual economic argument that utilities still enjoy some natural monopoly and should not earn monopoly returns, these arguments do not justify LDC returns that are 600 or 700 basis points lower than those earned by unregulated firms. This is particularly true in light of the degree to which operational, regulatory, and competitive risks have increased for LDCs following wholesale

unbundling. Besides, ROEs more in line with the returns earned by Corporate America, are hardly monopoly returns. Investors do not distinguish much any more between investing in a gas utility, GENERAL ELECTRIC, or CITIGROUP; nor are investors usually too concerned how a company makes its money - just as long as it earns competitive profitability, grows accordingly and keeps its books in order. In the case of regulated LDCs, however, investor perceptions about ROEs have become particularly polarized because of their rigidity and the evident lack of offsetting profit opportunities available, for instance, to pipelines. After watching allowed gas ROEs drop in tandem with interest rates for the past ten years, while Corporate America ROEs have cycled up to the 20%-21% level since 1991, equity investors have simply become tired of waiting. They have a wealth of choices in the equity markets, with superior investing credentials, and this is making LDC investing increasingly irrelevant. Something will be needed to counter this unfortunate momentum away from utility investing.

Q. Please continue.

A. There will never be a satisfactory ROE "solution" to completely please all parties. However, the status quo of regulatory cost-of-capital models has become outdated in the eyes of front-line Wall Street

analysts. Virtually nobody outside of regulatory commissions uses these models to determine mainstream stock market valuations for LDCs or pipelines. The FERC is attempting to flank the issue with incentive ratemaking, a process which no doubt will take years of effort and hundreds of filings. In the interim, open-access and head-to-head competition is emerging on all fronts, providing little incentive for rational investors to own a gas utility. Within this growing vacuum, some fresh thinking and experimentation should be urged on all fronts.

Q. Do you have anything to propose?

A. Yes. Regulators should follow their own logic. The logic that created the newly competitive marketplace requires reasonably competitive ROEs. Rate cases should reflect this with the filing of Comparable Earnings methodologies so as to see just how much subsidies or economic rents are being given away to the end users by the employment of the old models. Indeed, I believe that ideally Comparable Earnings rate filings should supplant DCF, Risk Premium, and Capital Asset Pricing Model (CAPM) in order to properly reconfigure gas ROEs within a competitive marketplace.

Q. How should this Comparable Earnings approach be implemented?

A. At a minimum, I believe the Commission should adopt the recommendation of Laclede witness McShane. Not only

does her recommendation give significant weight to a Comparable Earnings Analysis, but it also relies on a DCF Analysis that has been corrected to eliminate one of its major flaws -- namely, the mixing of apples and oranges which occurs when returns derived from the use of stock market values are applied to the book value of the Company's rate base. Another alternative is to adjust utility ROEs to the business cycle through use of a broad-based ROE index such as The Standard & Poor's 500 Index (S&P 500 Index). Under this approach, returns could be set at 80%-90% of the S&P Index so as to impute a value to any residual LDC natural monopoly. This would allow equity investors to share fairly in both the ups and downs of the economy, as opposed to the slow ROE deflation evident since 1984. It would also recognize that if ROE "ceilings" need to be employed for political reasons, so should there be "floors".

Q. What, in your view, are the benefits of such an approach?

A. Such an approach has a number of particular virtues: (1) it is easy to implement; (2) it should allow an untold amount of savings of regulatory time, effort and money for all parties, not to mention possible years of litigation in which only the litigators make money; and, equally important, (3) it can restore a sense of objectivity to an analytical process that has become

largely captive to unverifiable judgments. Why is such an approach easy to implement? A number of states (and Canada) already reset ROEs based on external indexes, albeit with the wrong connection - namely interest rates. Interest rate indexing, per se, is an anachronism created by a zealous adherence to the Risk Premium model, something which is likely to vanish as investors continue to disinvest in bond-equivalent kinds of regulatory returns. Every rate case, regulators can take a known and measurable benchmark, like the S&P 500 Index (either the latest twelve-month figure, or even a five-year moving average), and then index it and price it right into the overall return calculation. This would solve a lot of controversies by being objective, competitive and largely apolitical.

Q. Why is it appropriate to use the S&P 500 Index for this purpose?

A. Wall Street uses the S&P 500 Index and its related database as the basic proxy for Corporate America for two reasons. The first reason is because the database is vast and objective. There is no "cooking of the books". It provides a panorama of American business conditions; and, secondly, because Wall Street portfolio management salaries are almost always tied directly to their success or failure relative to the S&P 500 Index. Thus, there is a very vested interest in finding superior investing credentials (i.e., growth

rates, ROEs and related capital structures, yields and related payout ratios) to compare against the S&P 500 Index. Please note that there is no performance tie on the part of equity portfolio managers to any bond market index. Why should there be? It may be a truism, but equity investors invest in stocks and not bonds. This fact of life ultimately drives a wooden stake through the hearts of the Risk Premium and Capital Asset Pricing methods of deriving utility ROEs.

Q. Why do you believe these latter methods for determining utility ROEs are so inadequate?

A. The proof is most evident in the substantial and growing disparity between the returns earned in Corporate America and those authorized for utilities. As I stated earlier, Corporate America has restored its profitability, reaching new peaks. All of this is shown in a full blown description of the relevant S&P 500 Index data in Schedule 1. The reader should concentrate on several line items: (1) Return on Average Equity (Reported); (2) Leverage; (3) EPS Growth Rates; and (4) Payout Ratios. The Reported ROE data show a 1989-1992 plateau of about 13.2%, before cycling up to 20%-21% levels in 1997-1998. Indeed, even with Wall Street's "top down" expectation that corporate profits may decline 1.7% in 1998, the S&P 500 ROE should still be 19.4% last year and 18.0% this year.

Balance sheet leverage data is not as current as we would like, but the S&P 500 debt/equity capital structure looks like about 45%-55%. Looking at the S&P 400 Industrials capital structures, however, makes more data available. These capital structures have run 40%-60% debt/equity consistently throughout the 1990s. In contrast, the gas utility ROE experience in recent years has been far from encouraging. According to Regulatory Research Associates (RRA) data, the American Gas Association and individual commission reports, allowed ROEs have edged sideways to down, staying mostly in the 11%-12% area. In fact, Laclede's current ROE is at the low end of this range. This is evidenced in Schedule 2. In the opinion of most independent Wall Street observers, inadequacies in the models typically employed (DCF, Risk Premium and CAPM) by state commissions to set these returns, such as those identified by Ms. McShane, are responsible for this growing and unsustainable disparity. Indeed, they believe such models are: (1) outdated at best; (2) no longer employed in mainstream investment decision making; and (3) are often abused in both spirit and practice.

Q. Why are these methods unreliable in establishing the cost-of-common-equity capital?

A. These methods are deficient on numerous grounds. They rely largely on academic premises and idealized test

tube conditions that all but ignore the everyday valuation efforts of real world practitioners and investors on Wall Street. They almost invariably track interest rates instead of competitive returns on equity in Corporate America. The models give counter-intuitive results in tight money recessions. Worse yet, they have had contrary and offsetting results in business cycle expansions. Each of these models is premised on the "self-imprisonment fallacy," namely that utility investors have no alternatives. They employ risk measures that are not only dim abstractions of financial variance, but some of which have been declared moot even by some of their creators. As one result, investors have begun to see how shortchanged they are by these models. Furthermore, public policies toward natural gas at both state and federal levels have been intended to encourage natural gas usage for both environmental and trade deficit reasons. Beyond the rhetoric, however, there have been no financial incentives to put these policies into practice. Thus, it has become very hard for equity investors to see any satisfactory risk/reward relationship emanating from the use of these models by state PUCs. They simply do not care about methodology. It is the result upon which they make their investment decision. In short, the issue will always come down to this - why (again) should

investors buy a regulated equity with a presumed 11%-12% allowed ROE when they can currently buy 18%-20% ROEs in Corporate America, along with better growth rates, balance sheets and competitive markets?

Q. Please elaborate on the deficiencies of the individual models.

A. Each model has its own set of shortcomings which, unless addressed through adjustments such as those proposed by Laclede witness McShane, will lead to unrealistic and unreliable ROE results. Their uniform and cardinal fallacy is that they are only models. This has caused unending theoretical debates to arise about their practical applicability. It has also meant a considerable waste of time and money for ratepayers and investors alike. While no one has any particular difficulty with the academic theory behind these models, the theory does not fit either the changing facts of natural gas company life, nor the everyday needs of the investing marketplace. The use of these models generally precludes any hard look at the actual growth and realized profitability of the utility assets in question. Worse, the remarkably close correlation between ROE rewards and long-term interest rates also strongly infers that, whatever the model, PUC commissioners tend to treat equity investors like debt investors. The presumption is that if interest rates decline, so should allowed ROEs. Nothing could be

farther from the truth in Corporate America. Please note in Schedule 2 the widening spread between S&P 500 ROEs and the 30-year Treasury Bond yield. As for the *models per se, their more egregious shortcomings* can be briefly itemized:

The Discounted Cash Flow Model: wherein the theoretical ROE is equated to the sum of the current dividend yield ("d"), plus the expected long-term earnings growth rate ("G"). This is simply another way of saying that an investor's total return (dividend yield + expected growth) should equal the ROE. If only this were true in practice! A major problem here, as described by Ms. McShane, is the application of an ROE, which is calculated based on market prices, to an original cost, or book value, rate base. This approach is simply mixing apples and oranges and is fundamentally flawed. This is especially critical now that utility stocks, like the rest of the market, are trading significantly above book value. The controversy over DCF also arises in the presumed growth rates - whether long-term (i.e., 50 years or more), or two stage (short-term and long-term). There is nothing scientific, known or measurable, about the choice of utility or corporate samples, about the phases of growth or the sources thereof, and there is no distinction between rate base growth and growth from diversification. And the use of "consensus" five-year

earnings growth forecasts made by Wall Street analysts (including this one) is particularly objectionable because they typically reflect third party hopes rather than any hard-and-fast corporate action plan. Finally, the DCF model ignores comparable earnings and dividend trends, ROEs and capital structures, yields and payout ratios, or even growth rates available in Corporate America, a classic example of the self-imprisonment fallacy. It is a methodology that simply cannot be solely relied upon to determine a reasonable ROE in today's markets.

The Risk Premium Method: wherein utility ROEs are awarded based solely on some perceived equity risk premium over long-term interest rates. The selection of the base interest rate is not the real issue. Whether the 30-year government bond, Moody's "AA" industrials, or "Libor plus" is more representative does not matter to equity investors. The original sin is to make a linkage between interest rates and utility ROEs in the first place. Academics have long contended that there is a "risk-free" interest rate to which an equity Risk Premium should be added to compensate equity investors. The application of this "cost plus" formula to gas utility ROEs has led to warped results in both investing and public policy arenas. The experience of the 1980's was especially germane. Government fiscal and monetary policies in the late

Carter/early Reagan administrations resulted in 15% "long bonds," not to mention 20% prime rates. This stratospheric rate structure led to utility ROE awards in the 14%-16% area by 1984. The higher ROEs raised utility costs-of-service at a time when gas prices were already cyclically high, all of which led to another sharp downturn in gas consumption that did not end until 1987. Interest rates then entered a 10-year decline (August 1983-October 1993) which led to another misapplication of the Risk Premium method. With normal rate case rollover, allowed ROEs were ratcheted down as interest rates fell; and, in many instances, the ROE erosion wiped out any rate base growth. Gas investors stared at numerous instances of stagnant earnings and uncomfortably rising payout ratios throughout the LDC industry. But these mediocre results were hatched from premises founded on principles (a risk-free interest rate, for instance), which remain very elusive after all these years. Risk Premium theory retains an academic currency, but it becomes logically dangerous when diluted into making stand-alone, real-world judgments about ROEs. Risk definitions are theoretical and etherial. Further to the point, the strong academic presumption that equity investors are really bond investors looking for a premium really doesn't wash in the cold experience of the trading markets. Falling interest rates typically boost corporate

profits and ROEs, and the converse works just as well. Equity investors do not normally buy equities for their bond-like characteristics. They buy them for growth, profitability and yield. Otherwise, they would simply buy a bond outright. The global trading market has given investors a wealth of opportunities; their choice is not merely to buy either a gas utility stock or an electric utility stock.

The Capital Asset Pricing Model: is another version of the Risk Premium model, dressed up with stock price trading variances in order to give it something more of a market currency. The difficulties here arise from the same slender foundations of the Risk Premium methodology, to which should be added the very debatable applicability of stock price betas as a measure of business or investing risk. Its disuse seems to be growing and I will not over-argue its deficiencies.

Q. What adverse results have occurred as a result of the traditional application of these models?

A. I mentioned earlier how allowed utility ROEs have been trending down in contrast to rising ROEs in Corporate America. Schedules 1 and 2 taken together demonstrate this situation. Gas utilities have to compete for capital in the open capital markets, but their ROE erosion has offset much of their rate base growth. This has meant that LDCs have had to either raise their

payout ratios, or else maintain unusually high existing levels. Clearly, there is a limit as to how long this can be sustained. The current LDC payout ratio now stands at about 75%. The payout ratio for the Standard & Poor's 500 Index is now 40%. The sharply different payout ratios mean much lower retention rates for LDCs, and relatively worse internal growth rates accordingly.

Q. Shouldn't gas utilities earn lower returns than non-regulated companies because of their lower risk?

A. Equity investors have traditionally recognized some normal tradeoff between lower regulated ROEs and presumed lower utility risks. The arrival of FERC Order No. 636, however, substantially increased commodity price volatility; and straight fixed variable pipeline rates appear to have leveraged LDC operating risks higher by a good degree. The continuing deregulation of LDC services is rapidly making the gas utility business very competitive. This increasingly competitive element has not been accounted for by any of the LDC models for ROEs. Indeed, there is no proxy for real business risk in these generic models. Attempted quantifications of stock market (or equity) risks ultimately are synthetic assumptions about investor returns. This is tantamount to putting the cart before the horse. Equity investors look at fundamental risk (operating and financial) before

anything else. They develop a set of investing credentials that must pass muster, and then they look at some of the market risks partially quantified in the generic utility ROE models. To come full circle, the large body of independent investors looking at lower risk/reward tradeoffs in gas utilities have different risk definitions and different return standards than those relatively few people employed in the closed system of ROE "determination" created by use of these models. Corporate America defines the return standard. If regulated companies cannot deliver some reasonably competitive ROEs, they will steadily fall by the wayside. It is just that simple.

Q. Please summarize your testimony.

A. At a minimum, I recommend that the Commission establish an ROE for Laclede in this proceeding on the basis of the analysis performed by Ms. McShane in her testimony. While the 12.75% ROE that results from her approach is below the level that I believe is required to fully meet the increased capital attraction demands imposed by today's financial and operational environment, it clearly moves in the right direction. I believe that this Commission and other state regulatory bodies should also experiment with other methods for determining ROE which, like the S&P 500 Index approach discussed in my testimony, place an even greater emphasis on the equity returns earned by

comparable, non-regulated entities rather than on interest rates.

Q. Does this conclude your testimony?

A. Yes.

Standard & Poor's 500
Earnings Model
Investing Credentials
March, 1999

	S&P 500 Index										*Average*	*Return On*
				Reported	*%*		*%*	*%*	*%*	*Book*	*Book*	*Average*
	High	*Low*	*Average*	*EPS*	*Change*	*DPS*	*Change*	*Yield*	*Payout*	*Value*	*Value*	*Equity*
1989	359.80	275.31	317.56	22.87	-3.7%	11.05	13.6%	3.5%	48%	147.26	144.29	15.9%
1990	368.95	295.46	332.21	21.73	-5.0%	12.32	11.5%	3.7%	57%	153.01	150.14	14.5%
1991	417.09	311.49	364.29	16.29	-25.0%	12.20	-1.0%	3.3%	75%	158.85	155.93	10.4%
1992	441.28	394.50	417.89	18.86	15.8%	12.38	1.5%	3.0%	66%	149.74	154.30	12.2%
1993	470.94	429.05	450.00	21.85	15.9%	12.70	2.6%	2.8%	58%	149.96	149.85	14.6%
1994	482.23	435.86	459.05	29.92	36.9%	13.18	3.8%	2.9%	44%	158.29	154.13	19.4%
1995	621.69	459.11	540.40	33.60	12.3%	13.79	4.6%	2.6%	41%	174.32	166.31	20.2%
1996	757.03	598.48	677.76	38.73	15.3%	14.90	8.0%	2.2%	38%	181.84	178.08	21.7%
1997	983.12	737.01	860.07	39.72	2.6%	15.50	4.0%	1.8%	39%	190.12	185.98	21.4%
1998E	1049.34	927.69	988.52	39.05	-1.7%	16.20	4.5%	1.6%	41%	212.97	201.55	19.4%
1999E	1279.64	1212.19	1245.92	40.55	3.8%	16.38	1.1%	1.3%	40%	237.14	225.06	18.0%
2000E			1236.00	42.05	3.7%	17.50	6.8%	1.4%	42%	261.69	249.42	16.9%

Schedule 1

S & P 500 and Gas Utility ROEs

	S & P 500 % Average ROE	Gas Utilities Avg. ROE	30 Year Gas Yields	Utility Basis Point Spread vs. S & P	Utility Basis Point Spread vs. Bonds
1989	15.9%	12.9%	8.5%	(302)	443
1990	14.5%	12.7%	8.6%	(183)	406
1991	10.4%	12.5%	8.1%	206	432
1992	12.2%	12.0%	7.7%	(19)	434
1993	14.6%	11.4%	6.6%	(325)	476
1994	19.4%	11.4%	7.4%	(805)	398
1995	20.2%	11.4%	6.9%	(877)	455
1996	21.7%	11.2%	6.7%	(1,051)	449
1997	21.4%	11.3%	6.6%	(1,000)	479
1998E	19.4%	11.3%	5.6%	(810)	570
1999E	18.0%	11.3%	5.3%	(670)	600
2000E	16.9%	11.3%	5.3%	(560)	600

Source: Sanders Morris Mundy Forecasts; S&P Analyst Handbook; FRB Bulletin; Regulatory Research Associates, Inc.

Schedule 2