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PUBLIC SERVICE COMMISSION

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Evidentiary Hearing

October 27, 2009
Jefferson City, Missouri
Volume 9

In the Matter of Missouri Gas)
Energy and its Tariff Filing to)
Implement a General Rate)File No. GR-2009-0355
Increase For Natural Gas Service)

RONALD D. PRIDGIN, Presiding,
SENIOR REGULATORY LAW JUDGE.

ROBERT M. CLAYTON III, Chairman,
JEFF DAVIS,
TERRY JARRETT,
KEVIN GUNN,
ROBERT KENNEY,
COMMISSIONERS.

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P R O C E E D I N G S

JUDGE PRIDGIN: All right. Good morning. We're on the record. This is the second day in the rate case hearing, ER-2009-0355. I understand on today's schedule is cost of capital, first witness being Mr. Hanley for MGE, Mr. Murray for Staff will follow, Mr. Lawton from Public Counsel will be the final cost of capital witness. And I believe that's all that's on the schedule for today.

Is there anything counsel needs to bring to my attention before Mr. Hanley takes the stand?

MR. SWEARENGEN: Judge, Jim Swearengen for Missouri Gas Energy. I was planning to make what I hope turns out to be a brief opening statement on this issue, if that would be okay.

JUDGE PRIDGIN: That's certainly fine. And I think we had discussed that yesterday and every party has the option to make an opening statement at the beginning of every topic if you wish.

MR. SWEARENGEN: Thank you.

JUDGE PRIDGIN: Certainly. Mr. Poston?

MR. POSTON: I just had a clarification about yesterday on the -- my motion that -- to have official notice of the customer notices. And was it -- what you were saying was that MGE should file its objections and then I would have an opportunity to file --

JUDGE PRIDGIN: Yes, sir.

MR. POSTON: -- ours?

JUDGE PRIDGIN: Yes, sir.

MR. POSTON: Okay. Well, I don't need to file anything until I've heard their -- their objection. Okay.

JUDGE PRIDGIN: That was my intention, yes.

MR. POSTON: Okay. Just clarifying. Thank you.

JUDGE PRIDGIN: You're welcome. Anything else before Mr. Hanley takes the stand?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Mr. Hanley, if you will come forward to be sworn, please.

MR. SWEARENGEN: Well, I'm going to go ahead, your Honor.

JUDGE PRIDGIN: Oh, I'm sorry, Mr. Swearengen, you just told me. The coffee hasn't kicked in. Whenever you're ready, sir.

MR. SWEARENGEN: That's okay. Thank you, your Honor. Good morning, Commissioners, Judge Pridgin. May it please the Commission, I am Jim

Swearengen appearing today on behalf of Missouri Gas Energy.

The issue before you this morning concerns the cost of capital, and as the Commission knows, with any rate case you have traditional cost of capital issues which involve generally the capital structure of the utility that you're regulating and the cost components of that capital and you look at those items for purposes of setting rates.

I have lifted from our file statement of position on the issues a document that I think summarizes the parties' positions on this, and I'm going to hand that out. I think that document may be helpful this morning as we go through this -- this issue.

The first cost of capital issue that I want to talk about and that we're going to deal with involves capital structure. And that issue simply concerns how the particular utility that we're looking at, in this case Missouri Gas Energy, is capitalized. And by that we mean how much debt does it have on its books, how much equity does it have on its books.

And normally, that's not a difficult question to answer if you're looking at a public utility. The parties pick a particular point in time, they look at the books of the company at that point in time and see how much equity it has, how much long-term debt, how much short-term debt, maybe it's got preferred stock, what have you. And it's usually not a real -- a big issue to determine the components.

With Missouri Gas Energy, however, it's not that simple and that's because Missouri Gas Energy, as you know, is not a standalone public utility, it's an operating division of Southern Union Company. And consequently, Missouri Gas Energy does not have an independent capital structure. It doesn't issue debt, it doesn't issue equity. So in every rate case I've been in involving this company, when we get into the question about what capital structure should be used for ratemaking purposes, if you go back and look at the past cases, at least the last couple of cases where this issue has come up, you'll see that the Commission has decided to use the actual Southern Union Company corporate capital structure for ratemaking purposes.

And if you read those decisions, what you see is the Commission said, well, we're going to do that because that's -- if you want to buy stock in

Missouri Gas Energy, you've got to buy Southern Union, and Southern Union's management has decided to capitalize itself in a certain fashion and so that's what we're going to use for ratemaking purposes.

Now, I think working beneath all of this is the fact that Southern Union historically and to this day has been thinly capitalized from an equity standpoint, particularly when compared to the normal natural gas company. And that's to say that the amount of equity in Southern Union's capital structure when you look at it is significantly lower than the equity you would find in a gas company that's comparable to Missouri Gas Energy.

And because equity is normally more expensive than debt, the less equity that's in the capital structure for ratemaking purposes, the lower the revenue requirement. So I think the temptation has always been there for the Commission to use that corporate capital structure where it's thin in equity in order to hold down the revenue requirement in a rate case. And of course, we don't think that approach is consistent with sound economic theory.

We believe that sound economic theory would indicate that because Southern Union Company is in no way representative of a local gas distribution company, its actual capital structure and cost components are also unrelated to a normal natural gas distribution company and you shouldn't use that corporate capital structure for ratemaking purposes.

So what do you do? Well, we say there are two ways to deal with that. One -- and that's -- an economic theory would support this. One is do what the company and the Staff are suggesting in this case and that is use a more balanced or representative capital structure, a hypothetical capital structure.

The other way to do it which is probably politically less palatable is to use the Southern Union capital structure but adjust the rate of return that you authorize in order to compensate for that thin equity which would cause you to be awarding in this case a pretty significant ROE. So we think the most appropriate approach would be to use a hypothetical capital structure.

In any event, that issue is going to be in front of you today. Mr. Hanley is the company witness, Mr. Murray is the Staff witness on this topic and the other cost of capital topics and Mr. Lawton is the Public Counsel witness.

The position of the parties, I think,

are accurately reflected on that document that I've handed to you. If you look over on the left-hand side, you'll see the various ratios of the capital structure components. The first one is Missouri Gas Energy's proposal. We recommend 41 percent long-term debt, 10.94 percent short-term debt and a 48 percent common equity ratio. The Staff's position follows immediately and they're at 40 percent long-term, 8-plus short-term, and the Staff recommends a 51 percent common equity ratio.

Now -- so you can see that on capital structure, the company and the Staff are fairly close. Both the company and Staff have based their proposed hypothetical capital structures on a study of a proxy group of what they believe to be comparable gas companies, companies that are comparable to Missouri Gas Energy.

While the company and Staff differ somewhat as to what the exact ratios ought to be as well as their cost, both parties recognize that MGE is an operating division of Southern Union Company, and for ratemaking purposes you should use a capital structure for MGE that's based on capital structures of comparable companies and not based on Southern Union's capital structure.

The Public Counsel, if you look down, you can see the Public Counsel is an outlier on this issue and the Public Counsel is urging that you do what you did in the past, use the Southern Union corporate capital structure. And the Public Counsel's reason for this is primarily that's what you have done in the past if you read his testimony.

Once you decide what capital structure you're going to use, you must then decide the cost of the various components. If you look again at the exhibit, moving over to the next column under cost, you can see that with regard to long-term debt, there's not a great difference among the parties with MGE's at 6, Staff 5.92, Public Counsel 6.25.

There's an argument, however, as to the cost of common equity component. The company's testimony on this issue -- and this is usually a tried issue in these cases -- the company's position is that a 10.5 percent return on equity would be appropriate. Interestingly on this one, if you look down at the Staff's position on this, if you -- if you read the Staff's testimony, you'll see that the Staff's study is based on a nine-company proxy group and it actually supports a cost of equity range of 9 and a quarter on the low side to 10.25 on the high side.

But the Staff witness, and he'll explain why, apparently elected to ignore this and instead is using a range of 9.25 to 9.75 with a 9.5 midpoint, and that's reflected on the exhibit. And the Public Counsel has a range of 9.5 to 10.5 and he has settled on the midpoint of 10.

Now, in most of the cases I've tried, the spreads are usually different than this. They're really not that far apart. We've got the company at 10.5 depending what the range you look at. For the Staff, they may be at 10 and a quarter, and I think the Public Counsel witness will say that the high side of their range is appropriate. So it's not that great a difference here in terms of percentages that we've seen in past cases.

With regard to short-term debt cost, there's an issue. If you look at the exhibit again, you'll see that, consistent with its position that the corporate capital structure ought to be used, Public Counsel is supporting the actual short-term debt cost of Southern Union which is 4.92 percent. MGE's evidence supports a 5.42 percent prospective short-term rate. And the outlier on the short-term debt issue then is the Staff.

If you look at the -- the exhibit and read the Staff's testimony, you'll see that the Staff relies on a spot short-term cost rate based upon a study of only two companies. And based on that, the Staff concludes a short-term debt cost rate of only .89 percent should be used for setting rates in this case.

Now, on -- on the exhibit and I think on the Staff's statement of position, they rounded that up to 1 percent, and that's what is reflected on the document. So the -- really, the only debt issue here is this argument between the company and the Staff as to the appropriate short-term debt cost.

Another cost of capital issue that's not shown on this exhibit concerns the question as to whether or not the Commission's adoption of the straight fixed variable rate design issue which you're going to hear later, whether or not the adoption of that rate design will reduce Missouri Gas Energy's risk which in turn should cause the Commission to make a downward adjustment in the company's revenue requirement. At least that's how we understand the issue from the Public Counsel's prepared testimony.

If you look at the Public Counsel's

statement of position on the issues, you'll see that the Public Counsel has given you an alternative approach. You can either reduce the revenue requirement by $1.8 million or reduce the return on equity by 50 basis points. We don't think that this -- this reduction of the ROE is something that the Public Counsel has really preserved in his direct testimony, but in any event, we don't believe that there is factual support for either type of adjustment, either a revenue adjustment or a cost of equity adjustment should you authorize the straight fixed variable rate design in this case.

Both MGE and I think the Staff will tell you that -- and the evidence will show that any risk reduction that results from the straight fixed variable rate design is already reflected in the calculation of the appropriate return on common equity. For example, the company suggested 10.5 ROEs based on a proxy group of gas companies that already have in place a rate design or decoupling provisions that are similar to the straight fixed variable rate design. And thus, any reduced risk is already accounted for when you calculate their cost of equity.

I think of interest on this point is the fact that we believe the Commission has looked at the same conceptual issue previously in the last rate case involving Union Electric Company where the company had requested a fuel adjustment clause, and I believe the Commission awarded that to the company.

There was an argument that the ROE for Union Electric should be reduced because of that, but the Commission concluded in that case with regard to Ameren that if the proxy companies had similar mechanisms to cover fuel costs, any reduced risk that the fact of that was already reflected in the calculation of the appropriate return on equity and therefore no downward return on equity adjustment needed to be made. And we think we have the same concept in this case and think that that should be the result.

Those conclude my -- my opening comments and I can call our witness Mr. Hanley at this time.

JUDGE PRIDGIN: Mr. Swearengen, thank you. Anything further from counsel before Mr. Hanley takes the stand?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Mr. Hanley, if you'd come forward and be sworn, please.

(The witness was sworn.)

JUDGE PRIDGIN: Please take a seat, sir. Mr. Swearengen, when you're ready.

MR. SWEARENGEN: Thank you, Judge.

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Mr. Hanley, would you state your name for the record, please.

A. Frank J. Hanley, H-a-n-l-e-y.

Q. And by whom are you employed and in what capacity?

A. I am employed by AUS Consultants, I am a principal and director.

Q. Have you caused to be prepared for purposes of this rate proceeding before the Missouri Public Service Commission certain direct, rebuttal and surrebuttal testimony in question-and-answer form?

A. Yes, I have.

Q. And do you have copies of that testimony in front of you?

A. I do.

MR. SWEARENGEN: For the record, I believe your direct testimony had been marked as Exhibit 13 and your rebuttal has been marked as Exhibit 14 and your surrebuttal as Exhibit 15. Your Honor, does that --

JUDGE PRIDGIN: That's what I show, yes.
MR. SWEARENGEN: Thank you.
BY MR. SWEARENGEN:
Q. Mr. Hanley, let me ask you first of all with regard to your direct testimony, are there any changes or corrections that you need to make to that?
A. Yes, I have -- in the direct I have one minor correction, a footnote is incorrect. At page 29 at footnote 8 is incorrect. It was certainly a reference to a Morin text which was previously mentioned, so the footnote 8 should read, "Id., at pp 428, 430-431." And that would be the only correction to the direct testimony.
Q. With regard -- thank you. With regard to your rebuttal testimony, are there any changes that need to be made?
A. Yes, again, very minor. That would be at -- I'm sorry -- not in the rebuttal, I misspoke. No corrections to the rebuttal. There is --
Q. Okay. How about your surrebuttal?
A. -- on -- on -- on the surrebuttal. On Exhibit 15, schedule FJH-37, that consists of two pages. In the caption it -- on each page it reads -- it presently reads "Missouri Gas Eastern." Eastern is incorrect. It should read "Missouri Gas Energy."

It was a spreadsheet formatting it, got confused with Panhandle Eastern. And that would be true on pages 1 and 2. Those are the only corrections.

Q. Pages 1 and 2 of your schedule 37?

A. 37, yes, sir.

Q. Okay. And with those corrections, Mr. Hanley, if I asked you the questions in Exhibits 13, 14 and 15, would your answers today under oath be the same?

A. Yes, they would.

Q. And would they be true and correct to the best of your knowledge, information and belief?

A. Yes.

MR. SWEARENGEN: With that, your Honor, I would offer into evidence Exhibits 13, 14 and 15 and tender Mr. Hanley for cross-examination. Thank you.

JUDGE PRIDGIN: Mr. Swearengen, thank you. 13, 14 and 15 have been offered. Any objections?

(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, 13, 14 and 15 are admitted.

(EXHIBIT NOS. 13, 14 AND 15 WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE

RECORD.)

JUDGE PRIDGIN: Mr. Hanley is ready for cross-examination. Mr. Poston, do you have questions?

MR. POSTON: Yes.

JUDGE PRIDGIN: I see no other parties here. I see only Staff and OPC, so --

MR. POSTON: Yes.

CROSS-EXAMINATION BY MR. POSTON:

Q. Good morning, Mr. Hanley.

A. Good morning, sir.

Q. First I'd like to ask if -- if an investor wants to invest in MGE, they need to invest in Southern Union; is that correct?

A. Yes.

Q. And I'd like -- if you could please -- well, your recommendation in your direct testimony, you recommended an 11.25 percent return on equity; is that correct?

A. Yes, that was correct at the time early in the year. Of course, then in the rebuttal testimony, I did an update which reflects more current market conditions.

Q. Okay. Can you tell me the total revenue increase MGE requested in its initial filing?

A. Gee, I don't recall the exact number, no, and I -- I -- nor could I tell you what the difference is as a result of the update.
Q. Okay.
A. But clearly, the update is lower.
Q. Okay. And so now you said you're recommending a 10.5 percent. And does this mean all of your calculations in market data in your direct testimony has been superseded by your rebuttal?
A. Yes, sir, that's correct.
Q. Has the company revised its rate request downward to reflect the fact that you lowered your ROE?
A. Well, I -- I don't know exactly how to answer that. I don't know whether they've filed new exhibits, but I think by virtue of their acknowledgment of my updated cost of common equity capital, that certainly they -- they would -- they recognize that the -- all else equal, that the revenue requirement would be lower.
Q. If you could please turn to your -- let's see, it's your direct testimony, your schedule FJH-15 on page 6 of 9.
A. Okay. I'm there.
Q. And on line 4, that line says,

"Forecasted three- to five-year total annual market return"; is that correct?

A. Yes, sir.

Q. And the number you gave is 28.85 percent, right?

A. Yes.

Q. Can you explain what is that, what does that number represent? That's what investors expect in a three- to five-year period, the return to be?

A. Based upon the Value Line forecast of capital market appreciation, that -- at that point in time represented what the annual total return could have been expected.

Q. According to your calculations?

A. No. According to Value Line. This -- I've simply taken the Value Line three- to five-year data and reduced it to a single -- what a single year is. So mine is a mathematical determination from the Value Line data, and that's what it was at that time. And I might add for Commission's point of interest that at least for the first year, that was very conservative because the market has recently increased by more than 50 percent since February.

Q. Mr. Hanley, if I could interrupt, you probably would be better served just to answer the question and not volunteer any information. That will avoid an objection and it will avoid irritating the Commission and will make me happy.

And that -- that number, you -- you didn't like that number, did you? You ended up giving it a 20 percent weight on that footnote; is that right?

A. Well, I wouldn't characterize it as I didn't like it. I felt that over the three- to five-year period that it would recede. And I believe that more recent data confirms that that -- that was an accurate assumption on my part.

Q. And where have you shown that 20 percent weight? Have you provided any analysis to show how you came up with that?

A. No, there -- there could be no analysis. It was a judgment in my attempt to -- to be conservative.

Q. Okay. Would 21 percent have been a -- an okay number to use as well?

A. Well, it would have been a peculiar number. I certainly wouldn't use something like a 21 percent, but...

Q. 15 percent, would that have been a good number to use?

A. I think that would have been too conservative, frankly, and I think something much higher than 20 percent would have been -- been not realistic over the longer term.

Q. Something much higher than 20 percent would not have been?

A. (Nodded head.)

Q. Okay. If you could please turn to -- this is your rebuttal testimony. You've got schedule FJH-21, and looking at page 39 of 55?

A. Yes.

Q. And this is a revision, is -- is it not, of the schedule we just looked at, right?

A. It -- it's -- yes, it's an -- it's an update, reflects the more current data, correct.

Q. And now on line 4 you're saying that a market investor expects a 17.09 percent return; is that right?

A. I'm saying that that is the annual rate of total return from the Value Line forecast, yes.

Q. And the weight you give this number now is 40 percent, right?

A. Yes.

Q. And that's different than the weight you gave the -- the prior number in your direct

testimony, right?
A. It is.
Q. And where are the analysis -- where is the analysis that provides this 40 percent number in your testimony?
A. Well, again, as with the -- the prior one, because I didn't think that the 28 percent was realistic on a going-forward basis, I think by giving this 40 percent weight, which is a judgment call to be sure, that it -- it tempered because the -- there has been a lot of market appreciation already this year. Expectations would certainly have declined on the part of investors. And so rather than giving equal weight along with the historical data, I just simply -- my judgment gave it a 40 percent weight.
Q. What about a 30 percent weight, would that have been appropriate weighting to give this since it's just a judgment call?
A. No, I don't think so, because the closer we get to what could reasonably be considered a norm I think under more normal kind of conditions investors would be inclined to give equal weight to the historical as well as the forecast data.
Q. So if this -- the -- the line 4 were to change again, your weighting may change as well,

right?

A. Well, yes, it would certainly depend upon the market conditions, although I would hope that they wouldn't be extreme as they were late last year or the early part of 2009.

MR. POSTON: I think that's all I have. Thank you.

JUDGE PRIDGIN: Mr. Poston, thank you. Mr. Thompson?

MR. THOMPSON: Thank you, your Honor.

CROSS-EXAMINATION BY MR. THOMPSON:

Q. Good morning, Mr. Hanley.

A. Good morning.

Q. My name is Kevin Thompson and I represent the Staff. Now, Mr. Hanley, your resume or your CV in your direct testimony indicates you've testified over 300 times; is that correct?

A. Yes.

Q. And I wonder if you could tell me how many of those times you've testified on behalf of a company that is seeking a rate increase?

A. Well, I couldn't give you an exact count, but the majority of the times.

Q. So most of the time you work for companies?

A. Yes.
Q. But you've also worked for commissions, haven't you?
A. I have on a few instances, yes.
Q. And -- and for the staff of a commission from time to time?
A. Yes.
Q. Okay. Have you ever worked for a public counsel or consumer representative?
A. No, I've -- I have not.
Q. Okay. Now, I wonder if you could tell me what -- what exactly is the goal of financial analysts when you're -- when you're attempting to determine a cost of common equity? Isn't it true that you're trying to determine what investors expect in terms of a return?
A. Yes, sir.
Q. Okay. And that's something that can change from moment to moment, is it not?
A. It -- it does change. It's -- it's in a constant state of change, yes.
Q. Okay. Now, it's true, isn't it, that there's a -- there's a fundamental philosophical difference of approach between you and Mr. Murray, Staff's expert; isn't that correct?

A. I would say so, yes.
Q. For example, Mr. Murray relies on the discounted cash flow model or DCM, right?
A. He does.
Q. Now, you do use that model?
A. I do.
Q. But your approach is to use that together with other methodologies?
A. Yes, sir.
Q. Okay. I wonder, Mr. Hanley, if you can tell me what sources you relied on to determine the growth rate that you used in your discounted cash flow analysis.
A. Forecasted, analyst-forecasted earnings per share growth.
Q. Do you recall which analyst?
A. Well, I used Value Line and Reuters. Individual analysts aren't identified, but they're an assemblage of different analysts.
Q. Okay. So those were the companies that the analysts worked for when you say Reuters and Value Line?
A. I -- I don't understand. Those were the companies?
Q. Well, as you said, individual analysts

aren't identified by name; rather, by the institution that employs them, correct?

A. Right.

Q. Okay.

A. Right.

Q. Okay. And you believe, do you not, that investors rely on those growth rates for purposes of evaluating investment opportunities?

A. Yes.

Q. Okay. And when we say "investors," we mean both individual and institutional investors, don't we?

A. True.

Q. Okay. And institutional investors might be pension funds or insurance companies, correct?

A. They might be.

Q. Okay. And do you believe that investors research the support or basis for growth rate forecasts; for example, the ones you cited on page 1 of schedule FJH-14?

A. If investors research?

Q. Right. In other words, do they accept them at face value or do they try to look beyond them to determine where the analysts came up with them and how sound they might be?

A. Well, I don't -- honestly don't believe there's any way to know with an absolute certainty, but my sense tells me is, is that by and large, at least individual investors don't. They would be inclined to be influenced by them, would not look further because I don't think they would have -- they wouldn't presume to have a greater level of knowledge and expertise than the analysts making the forecast.

Q. Okay. What about institutional investors?

A. Well, I -- I -- I don't know. I -- I suspect that they -- they look and seriously consider those forecasts and in some instances perhaps make their own as well. I -- again, there's no way to know with any absolute certainty.

Q. Okay. How about you, did you research the basis for those forecasts?

A. No, beyond accepting them what they are or where there is like in the -- in the circumstance of Value Line, of course, you can get a sense of what they're thinking in their forecast by their write-up. In other instances, you only have the forecasted rate of growth, not their rationale.

But we do know that the -- the analysts take into account both the historical performance as well as an -- an idea about the future expectation because they're in constant communication with the managements and so forth so they have an idea of -- of what's going on, what's happening and what's likely to happen.

Q. Okay. Now, with respect to your schedule FJH-14 and the projected growth rates that you show there in column 2, do you happen to know what analysts provided those growth rates?

A. No. As I indicated in a prior response, their identities aren't revealed. We simply know the number of analysts --

Q. Okay.

A. -- in each instance.

Q. Do you know the companies that -- that these --

A. No.

Q. -- forecasts came out of?

A. No.

Q. Okay. Now, with respect to the analyst reports of forecast costs of common equity that Mr. Murray reviewed, you testified in your surrebuttal testimony that they should not be relied on; isn't that correct?

A. Yes, sir.

Q. Do you have an opinion as to -- as to which equity research reports should be relied on and which should not be?

A. Well, yes, I -- actually I -- I -- well, not the equity research reports. I don't think any of those should be relied on. And if you'd like to know why, I can tell you, but --

Q. I would like to know why.

A. Okay. May I tell you now?

Q. Yes, sir. Yes, sir.

A. Okay. There -- number one, under the efficient market hypothesis, information has to be either freely or very inexpensively readily available. Such -- those reports are not. They don't meet that requirement. Second of all -- oh, and I should interject at this point that in contrast to the analysts' forecasts, they're free and at no cost available on the Internet to investors. And the Value Line, of course, is a very inexpensive subscription, but also it only takes a trip to the business reference section of better libraries anywhere for access to -- to the Value Line data.

But then going back to the equity reports, they do not explain at all how they do what they do, what their inputs are. And I don't think it takes a great level of expertise to come to the conclusion that something is wrong when they project the same rate of return on common equity for different companies with vastly different credit ratings. Whether it's a double A-rated company, they show maybe 9 percent, and for a single A or a triple B company, they show the same cost of equity. Common sense says that won't be so.

Q. Okay. Now, isn't it possible that some of the growth rates that you relied on, you said you don't know the source of those, may have been provided from those analysts?

A. Well, that's the problem with the equity research reports. We don't know. We don't know what they rely on, we don't know the inputs. They don't reveal what they do or how they do it. And as I said, the end result, the bottom line intuitively is -- is just crazy. And I looked at some of those results, and when they're the same for companies with vastly different credit ratings, it tells me something is seriously wrong.

Q. Okay. Now, you've heard of Goldman Sachs; isn't that correct?

A. Yes, sir.

Q. And would you agree with me that Goldman

Sachs is an influential investment company?

A. It's an important investment company.

Q. And it's reasonable to believe, is it not, that Goldman Sachs has institutional clients?

A. I think so, yes.

Q. Okay. And the other companies that Mr. Murray cited also have institutional clients, do they not?

A. One would assume, yes, sir.

Q. Okay. Do you happen to know what percentage of the stock of your comparable companies are owned by institutions?

A. Well, just a little bit over half.

Q. Okay. Now, would it surprise you if I told you that an institutional investor that is a client of any of the asset managers cited by Mr. Murray would be given access to equity research reports?

A. No, that wouldn't surprise me at all. The other almost half wouldn't have access to it, and frankly, they're just as important. But even if they're given access to the report, I think their assessment would have to follow mine regardless of how influential one may think Goldman Sachs or some other similar firm may be when they project the same common equity cost rate for different companies with vastly different credit ratings.

Q. Now, the risk premium method and the capital asset pricing method are both very sensitive to the estimation of the equity risk premium; isn't that correct?

A. That's -- that's -- well, that's true, yeah, sure.

Q. I mean, that's a crucial input --

A. Sure. Sure.

Q. -- to both of those? So if an analyst were to get the equity risk premium wrong, then the results of the analysis would be wrong; isn't that correct?

A. Well, yes, but, you know, frankly, that's true with any of the models.

Q. Okay.

A. And the discounted cash flow model, you get the -- the growth rate wrong, and you get -- you got the wrong answer.

Q. So it's true, then, that for any of these techniques, the results are only as good as the inputs?

A. True, but that's also why one should use multiple models and not rely upon a single one, especially the discounted cash flow methodology.

Q. Now, with respect to your proxy companies, you would agree with me, would you not, that -- that you and Mr. Murray and Mr. Lawton all used essentially the same proxies? I mean, you used a few more than Mr. Murray, and Mr. Lawton used more yet; isn't that correct?

A. Well, we apparently all tried to use -- get what we believe their representative gives distribution companies, yes, sir.

Q. Okay. So there's a lot of identity between the three different lists?

A. Yes.

Q. Okay. And isn't it true that your proxy companies all have unregulated operations?

A. Yes -- well, yes, that is true.

Q. And does that not increase their risk?

A. Well, not necessarily. It -- I mean, it really depends on the success or lack of success of unregulated operations. That's sort of consistent with portfolio theory --

Q. Okay.

A. -- if -- if there's a balancing or not.

Q. All right. Well, would you agree that the straight fixed variable rate design, if it's adopted and implemented by the Commission in this case, would decrease MGE's business risk?

A. Well, it does, it has, but no deduction from common equity should be appropriate in this case because the proxy companies, particularly my proxy companies, overwhelmingly have decoupled mechanisms.

Q. But on the other side of that coin, you have proposed an adder if, in fact, the straight fixed variable rate design is not adopted; isn't that correct?

A. Yes. And the reason that I have is, it's because if the straight fixed variable rate design goes away, then there is an increase now in Missouri Gas Energy's business risk, whereas, previously there was a decrease by the -- by its implementation. And if the proxy companies have -- overwhelmingly have these similar-type mechanisms, their reduced risk is there. And so any common equity cost rate derived from those proxy companies reflects a lower level of risk than Missouri Gas Energy would have absent the straight fixed variable rate design.

Q. Okay. So leaving aside the question of any adjustment up or down, I think we're in agreement, are we not, that with the straight fixed variable rate design, there's less risk than there is without it?

A. True.

Q. Okay. Now, isn't it true that Mr. Murray reviewed the investment expectations of the Missouri State Employees Retirement System as a test of reasonableness?

A. That's true, he did.

Q. And he -- and he found, did he not, that MOSERS' expectation for large capitalization domestic equities is only 8.5 percent?

A. Yes, he did.

Q. Okay. Now, you criticized his reliance on MOSERS, did you not?

A. I did, and I do.

Q. Okay. Now, would you agree that a -- a pension fund necessarily has a long-term investment horizon?

A. It depends on how you define it. Now, let me explain.

Q. Okay.

A. Mr. Murray relies exclusively to get where he does, and I think you've pretty much acknowledged that by your prior line of questioning on the discounted cash flow. And the method that he uses is the constant growth infinite horizon model.

Now, that -- infinity, we have no conception of -- that means without end, forever and ever and ever. And in practical terms, however, with the discounted cash flow concept, when you discount at whatever the -- the rate is that you do, it -- it oftentimes takes you something in the magnitude of like 40 years to get pretty close to zero present value, 40 years.

And -- and vis-à-vis, that discounted cash flow infinite horizon, ten years is not a long-term horizon. And so when I refer to that in my testimony, that it's a relatively short horizon, that was the context that I talked about compared to the infinite assumed horizon in the discounted cash flow method.

Q. Okay. Do you know of any investors that invest on a 40-year horizon?

A. Well, for those who believe in the discounted cash flow methodology, everyone who does because the presumption of the model is infinity.

Q. Okay. Now, you updated your study in your rebuttal testimony, did you not?

A. I did, yes, sir.

Q. And you reduced your recommendation from

11.25 percent to 10.5 percent, correct?
A. That's correct, yes, sir.
Q. And you explained, did you not, that at the time of your original study, the market was at a historic low?
A. I did.
Q. Okay. And there was therefore a huge potential for appreciation?
A. Yes.
Q. Okay. And when you updated, you pointed out that the market, in fact, has increased by 46.71 percent, so there is no longer quite such a potential for huge appreciation, would you agree?
A. That's correct.
Q. Okay. And you filed your rebuttal testimony in September; is that right?
A. I believe that's correct, yes, sir.
Q. And your direct testimony was prepared in March?
A. I think that's correct, yes.
Q. Okay. So a six months -- six months had passed?
A. Well, probably closer to seven because I think it was using a lot of February data --
Q. Okay.

A. -- at the time.
Q. Now, you also testified that MGE rate cases come at three-year intervals; isn't that correct?
A. Well, I said from the last one, and it's a reasonable assumption.
Q. Okay.
A. I mean, I didn't say it like it's etched in stone, but I think it's a reasonable assumption.
Q. So the task facing the Commission in this case, would you agree, is to set a rate that will be reasonable now and for three years into the future?
A. Well, that's precisely -- yes, and that is precisely why I made some of the judgments that I did in order to temper that market appreciation.
Q. Okay. So I guess what I'm trying to understand is the recommendation you made in March is no longer valid in September, six or seven months later, yet the Commission's task is to set a rate that will be valid for three years. Is it possible that you didn't temper your recommendation quite enough?
A. Which -- what -- you're talking about my updated recommendation or the -- I -- I don't

understand the question.

Q. Well, what if this hearing had been held five months ago? What if the Commission had adopted your original recommendation, the one that you yourself threw out when the time came to file your rebuttal testimony? Does that mean that the Commission would have been led into setting a rate that was too high?

A. Well, you know, all one can do, including commissions, is to look and analyze the market data that is available at the time and utilize the best judgment. We could say perhaps it's unfortunate that the financial crisis arose when it did and it was, you know, pretty much near its valley at the -- at the time of the gathering of this -- of the original data, but I don't think at that time no one knew whether some of these measures would work, how quickly they would work or if they would work at all.

So it seems that they are certainly working and the markets are -- are clearly recovering and we look at what we could do. There is not among us, I think, a Nostradamus that can predict with any great degree of certainty the terms these markets will take. We -- in other words, we utilize the data we have, we make the best judgments that we can based on those data.

Q. Okay. Now, have you reviewed Mr. Murray's corrected schedules 20-1 through 20-7?

A. I have.

Q. And it's true, is it not, that on those schedules he presents equity analysts' predictions for your proxy companies?

A. Well, there are a number of them. They're -- I don't think they're all of them, but --

Q. Maybe for his proxy companies?

A. -- as I recall. For his proxy companies, I think, because there's seven, yeah.

Q. Okay. And would you have any reason to disagree with me if I told you that the average of those 30 forecasts is 8.24 percent?

A. No, it wouldn't surprise me. And what also surprises me is, is that -- well, of course, I wish I had it in front of me. Is -- could -- is it possible?

Q. What do you need, sir?

A. If you want me to comment on Mr. Murray's schedules, I don't have them here with me.

MR. THOMPSON: I think we can get them

for you. May I approach, your Honor?

JUDGE PRIDGIN: You may.

MR. THOMPSON: Here you are, sir.

THE WITNESS: Thank you. Yeah, one of the things that I did have in memory in corrected schedule 20-1 -- this is Mr. Murray's schedule I'm looking at -- I notice the comments that I said previously still apply, that there -- that these results are counterintuitive. We don't know exactly what they do or the inputs into them.

And you talk about updating. Well, if you believe Goldman Sachs is so sophisticated, and I've suggested that since early in this year common equity cost rates have gone down.

Another counterintuitive here is, is they showed 8.5 percent on March the 9th, which was in the -- if you will, the belly of the beast of the market. And lo and behold, as of August 31, they show an increase up to 9 percent, a counterintuitive movement, although their -- I -- so I -- I think their base was wrong and I think their movement is wrong and in the wrong direction.

So I -- I -- for the reasons I've stated, I -- I don't really put much stock in these. I don't think anyone really would. They're just counterintuitive.

BY MR. THOMPSON:

Q. Okay. Now, with respect to capital structure, you and Staff both propose a hypothetical capital structure, is that not correct?

A. It is, yes, that's correct.

Q. And that is based on the characteristics of your proxy group?

A. Yes.

Q. Okay. Now, with respect to long-term debt, isn't it true that you did not update your embedded cost of long-term debt?

A. Well, it -- it is true, but had I done so, frankly, it would have increased -- and I can tell you because it did it after the point was raised because I didn't think it made any difference -- it increased it by one basis point. Instead of 6.08 as of June, it would be 6.09 percent.

Q. Okay. With respect to short-term debt, your corrected cost of short-term debt is 5.492 percent; is that right?

A. It is, yes, sir.

Q. Okay. And how did you determine the cost of short-term debt?

A. Well, that would be as -- give me just a moment. That would be as shown on schedule -- this is part of Exhibit 15, the surrebuttal schedule FJH-32 in footnote 3. And that was derived based upon, as indicated there, an average rate of the previous projected three-month LIBOR rate 2 percentage points or 200 basis points upfront fee and 2 and five-eighths percent or 262.5 basis points spread over the LIBOR rate based upon the credit rating of the proxy group.

Q. Okay. Now, isn't it true that since you've used a hypothetical proxy -- or a hypothetical capital structure, excuse me, that all of the components should be based upon that -- the averages of the proxy group?

A. No, and let me explain why. Here we are talking about the short-term debt rate which is a -- a variable rate. When we talk about the long-term debt cost rates, those rates are locked in for extended periods of time and do not change. The common equity cost rate is a forward-looking rate and is to be representative over a future period of time.

The short-term debt rate is -- is going to fluctuate, and as I indicated, that Missouri Gas Energy does not have access to a commercial paper market. In fact, at this point in time, even

Missouri Gas Energy would not in its credit -- I mean, I'm sorry I misspoke -- Southern Union Gas does not also want -- and once its current credit agreement runs out in May of 2010, with the current market conditions as they are, commercial paper is only available, the market available to the very largest and highest rated companies, double A- and triple A-rated companies.

So this as shown in schedule FJH-32 is what I believe is the best representation of the likely rate that would have to be experienced on average in the future by a company such as Missouri Gas Energy which I presume to have the credit standing equivalent to the proxy group, my proxy group.

Q. Okay. Well -- but Mr. Murray testified that, in fact, seven out of your nine proxies issued commercial paper; isn't that correct?

A. Yeah. The point is, is they were --

Q. Excuse me, sir. Thank you. Laclede Gas Company is one of your proxies, is it not?

A. It is.

Q. And would you be surprised to learn that Laclede issues commercial paper?

A. No.

Q. And would you be surprised to learn that according to Laclede's most recent 10Q, its cost of short-term debt is only 0.4 percent?
A. No.
Q. And Laclede has only an A rating; isn't that correct?
A. I believe that's correct. Without checking, I'll accept it, yeah.
Q. Okay. And if I were to tell you that Laclede has only 630,000 customers, would you have any reason to disagree?
A. No.
Q. And New Jersey Natural Gas is also one of your proxies, correct?
A. It is.
Q. And would you be surprised to learn that New Jersey Natural Gas issues commercial paper?
A. No.
Q. And New Jersey Natural Gas has only 484,000 customers; is that correct?
A. Sounds about right.
Q. Okay. And that's smaller, is it not, than MGE?
A. Well, it's pretty close. I mean, half a million, it's plus or minus a little bit.

Q. Okay.
A. About the same.
MR. THOMPSON: Okay. Thank you very much, sir. May I retrieve my exhibit?
JUDGE PRIDGIN: You may.
MR. THOMPSON: Thank you, Mr. Hanley.
THE WITNESS: Yes, sir.
JUDGE PRIDGIN: Mr. Thompson, thank you. Time for bench questions. Commissioner Davis?
COMMISSIONER DAVIS: I'll pass for a moment.
JUDGE PRIDGIN: Thank you. Commissioner Jarrett?
COMMISSIONER JARRETT: I don't have any questions.
JUDGE PRIDGIN: Commissioner Kenney?
COMMISSIONER KENNEY: No, thank you.
QUESTIONS BY COMMISSIONER DAVIS:
Q. Good morning, Mr. Hanley.
A. Good morning, Commissioner.
Q. Mr. Hanley, if I ask you what two plus two is, what is the answer?
A. Four.
Q. Okay. So do you know the difference when I ask you what two plus two is and when I ask

you to explain something?

A. Yes, sir.

Q. Okay. So we're clear?

A. Yes, sir.

Q. Okay. I guess I want to start, Mr. Hanley, by saying my impression from reading your direct testimony is that you plug in a bunch of numbers, you don't like the results, so then you make subjective adjustments to those numbers to achieve the desired outcome. How do you respond to that?

A. I would respond by saying that any expert witness has to use informed expert subjective judgment, and I did that to the best of my ability given my sense of the market conditions at that time.

Q. Okay. Now, do I recall correctly that you testified most recently that your ROE recommendation is now 10 and a half percent; is that correct?

A. Correct, yes, sir.

Q. And do I also recall you saying that absent a -- a straight fixed variable rate design, it would be 10.75 percent?

A. Yes.

Q. And how do you come up with that additional 25 basis points?

A. Well, again, your Honor, that's -- that's a subjective judgment. I don't believe anyone can precisely quantify the value of such a clause. I mean, it's just impossible to get inside investors and be able to dissect the collective prices investors pay and attribute some portion with any degree of specificity to a single thing such as a decoupling mechanism.

I just don't think that's possible. And it is -- it is a matter of subjective judgment, informed expert judgment, but it is just that, your Honor, a judgment because nobody could precisely quantify it.

Q. Okay. But what in your analysis, DCF, CAPM, ECAPM, risk premium, comparative earnings that you discarded, what -- what gets me to -- what -- what gets this Commission to 10.75?

A. Well, I -- I hope that looking at all of the -- the inputs -- looking at all of the inputs in -- in terms of the update that was contained in the -- in the rebuttal Exhibit 14, that seeing that the range of -- of data or the indicators there in two of the models clustered closer up into the high tens and the DCF model down in the -- in the nines, the lower part of the nine now, looking at the average of those models puts it in around 10.32.

And then there's the -- the small size adjustment which I believe is appropriate, a very conservative adjustment, 19 basis points. That would put it up to 10.5.

And as I indicated, when you consider the awards around the country, you know, that -- that hover in the tens or -- or in the low tens, and take into account the relatively small size of Missouri Gas Energy, I think something around 10.5 is appropriate, especially when compared to the proxy companies, again, who in my opinion have over -- overwhelmingly do enjoy the benefits of -- of decoupling, some only partial.

But for the most of them, they also have decoupling that relates to changes in customer usage as well. It promotes conservation which is, I think, a good thing. And they overwhelmingly have that. And so I don't see any need at all for any downward reductions, so I think we should be pretty close around 10.5 percent.

Q. Okay. You use 3.38 percent for your -- your risk-free rate; is that correct?

A. That was the original, your Honor, yes, sir.

Q. Okay. So what are you -- what are you -- what are you using now?

A. Well, that would be 4.67, and it has -- they have gone up considerably since early in the year. If you remember, your Honor, that when this financial crisis sort of mushroomed last fall --

Q. Uh-huh.

A. -- investors had an absolute panic and there was this flight to quality. That flight to quality drove the yields to governments very low --

Q. Right.

A. -- extraordinarily low. Well, their -- that -- that panic is abating and the yields have been going back up. And the 4.67 percent which is set forth in my update at schedule FJH-21, pages 50 and 51 of 55, there can be determined that the -- it's an average of the forecasted blue chip economists' average yield for the six quarters ending with the fourth quarter of 2010 which would be 4.67.

Q. All right. All right. I've had -- I've had enough, Mr. Hanley, okay. So you use a forecasted rate, correct?

A. Yes, sir.

Q. Okay. Mr. Murray does not, correct?

A. He does not.

Q. He takes an average of the last three months, correct?
A. I -- I -- I think that that's correct.
Q. Or -- I mean --
A. It's some recent --
Q. -- if we average -- if we average the three most recent months, we get approximately 4.3 percent, is that roughly correct?
A. It may well be, your Honor. I don't know just off the top of my head.
Q. Okay.
A. Somewhere around there.
Q. Okay. Now, in -- you also use a -- a forecast for your risk premium, correct? Isn't that where you get these --
A. Well -- well, it's -- it's -- it's -- it's a blend. I -- I consider the forecast, I rely on this long-term historical adjusted by beta, and I also have a study of the returns on the S&P utility index over a long historical period of time as well.
Q. Okay.
A. So there's more history than there is forecast in my risk premium, let's put it that way.
Q. Okay. So you rely at least in part on the Ibbotson book, do you not?

A. Yes, sir.
Q. And Ibbotson did an update in June, correct? Were you aware of that?
A. Well, there -- the -- the -- well, the book -- you mean bring it through 2008, which I incorporated?
Q. Right. And then they -- then they do -- at some point thereafter they do it -- like a six-month update? Are you aware of that? If you're not, I --
A. I'm not. I haven't seen it.
Q. All right. So does -- does Ibbotson make a recommendation about what is the appropriate percentage to be used in a CAPM analysis?
A. I don't think specifically, no. Not -- not any specific recommend -- I don't think there is a hard core.
COMMISSIONER DAVIS: Judge, can I get an exhibit marked?
JUDGE PRIDGIN: Certainly.
(EXHIBIT NO. 94 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)
BY COMMISSIONER DAVIS:
Q. Okay. Mr. Hanley, can you turn to page 200, please? What does -- what does page 200

say?

A. Table C-1, "Key variables in estimating the cost of capital."

Q. Okay. And -- and just for the record, this is the -- the book that you rely on in preparing your rebuttal and your surrebuttal testimony?

A. Yes, sir.

Q. Okay. And so what does Table C-1 say for those key variables? Do you want me to -- do you want me to read it to you?

A. Long -- long -- "Long-term 20-year U.S. treasury coupon bond yield 3.0."

Q. Okay. Keep going.

A. "Equity risk premium long horizon expected. Equity risk premium historical large company stock total returns minus long-term government bond income returns, 6.5."

Q. Okay.

A. Keep reading?

Q. So you don't -- you don't think that's a recommendation?

A. No. No, honestly I don't, sir. I mean, there are lots -- lots of things to read in here and they talk about forward-looking and whatnot, and clearly, why they would say to use 3 percent when we know that it's well over 4 percent and likely to be well over 4 percent, would -- just wouldn't make any sense.

I -- I don't think that they're saying that this is something that one uses. I -- I think what this indicates is things that they've done -- as a matter of fact, I think that may be the long-term average. I'm trying to find that.

Q. All right. Mr. Hanley, you're -- can we move on here? Can you hand the book back to me, please?

Now, is it your recollection for your -- from your recent review of this text that Table C-1 is, quote, the key variables in estimating the cost of capital?

A. That's --

Q. That is your -- your recollection?

A. Yes, sir.

Q. And it said, "The long horizon expected equity risk premium historical large company stock total returns minus long-term government bond income returns is 6.5," correct?

A. Yes, sir, I -- that was part of my analysis, that 6.5 in my update.

Q. You don't see anything in there about

20 percent or 30 percent or 40 percent or 400 percent or any other numbers, do you?

A. No, sir. They're --

Q. Okay.

A. -- they're -- they -- but they do analyze the long-term historical, the total returns of capital appreciation.

Q. Right.

A. And if we believe that investors have expectations of the future, then they are influenced as by what they might reasonably expect over a future period of time.

Q. Are you aware that the Ibbotson book contains a formula for calculating CAPM?

A. Yes, sir.

Q. And did you follow that formula in your testimony when using their data?

A. Yes, sir.

Q. Did you follow it strictly or loosely?

A. Well, the standard CAPM is -- I -- it is --

Q. Is the sky blue, Mr. Hanley?

A. Yes, sir, I followed the standard.

Q. You followed it -- you followed it strictly?

A. As to the formula, yes, sir.
Q. And what about the inputs into the formula?
A. Well, no, I didn't follow --
Q. Okay. Thanks -- thank you, Mr. Hanley, thank you.
Now, Mr. Hanley, let me go back here. Give me just a second. You do make reference to this book in your rebuttal testimony, correct?
A. Yes, sir.
Q. And for the record, that was pages 59 and 60. Were those included?
A. I'm sorry, sir --
Q. Was that the portion on arithmetic versus geometric mean?
A. Yes, sir.
Q. You included -- you included those pages, correct?
A. Yes, sir.
Q. Would you say that we have an issue here in front of this Commission as to whether it is most appropriate to use the arithmetic or the geometric mean when calculating CAPM?
A. Yes, sir.
Q. Okay. You agree with that. And it's

your recommendation that -- or it's your recollection that Ibbotson recommends use of the arithmetic mean, correct?

A. Yes, when estimating the cost of capital.

Q. And why is that?

A. That's because the whole concept of risk relates to the issue of volatility. In other words, the more variable an investment is likely to be, the more risk there is and perceived by investors. And only the arithmetic mean takes into account all of the data. If one looks at historical data and historical returns, that gives you the best expectation of a single period likely result.

In contrast, the geometric mean only takes into account the initial and the terminal period data and then constitutes -- calculates a constant rate of growth which provides no insight into the variability and therefore no insight into risk.

Q. Okay. Now, Mr. Hanley, you make reference in your testimony to the work of Dr. Roger Morin; is that correct?

A. Yes, sir.

Q. Okay. Are you familiar with his book,

New Regulatory Finance?
A. Yes, sir.
Q. Okay. Is it an authoritative source in the field of utility regulation?
A. I believe so. I -- quoted by many people often.
Q. Okay. I'm going to read some passages to you from that book and I'd like for you to tell me if you agree or disagree. Can you do that?
A. Yes, sir.
Q. Okay. "The geometric mean answers the question of what constant return you would have had to achieve in each year to have your investment growth match the return achieved by the stock market. The arithmetic mean answers the question of what growth rate is the best estimate of the future amount of money that will be produced by continually reinvesting in the stock market. It is the rate of return which, compounded over multiple periods, gives the mean of the probability distribution of ending wealth."
A. I agree.
Q. Do you agree with that statement?
A. I do, yes.
Q. "While the geometric mean is the best

estimate of performance over a long period of time, this does not contradict the statement that the arithmetic mean compounded over the number of years that an investment is held provides the best estimate of the ending wealth value of the investment.

"The reason is that an investment with uncertain returns will have a higher ending wealth value than an investment which simply earns with certainty its compound or geometric rate of return every year. In other words, more money for terminal wealth is gained by the occurrence of higher than expected returns than is lost by lower than expected returns." Do you agree with that statement?

A. I do, yes, sir.

Q. Okay. "In capital markets where returns are a probability distribution, the answer that takes account of uncertainty, the arithmetic mean is the correct one for estimating discount rates and the cost of capital."

A. I agree.

Q. Do you agree? "While the geometric mean is appropriate when measuring performance over a long time period, it is incorrect when estimating a risk premium to compute the cost of capital."

A. I agree.

Q. Okay. That was page 133. All right. On page 135, it indicates what academics have to say. "What is the superior measure of investment performance, the arithmetic average or the geometric average? The geometric average has considerable appeal because it represents the constant rate of return we would need to earn in each year to match actual performance over some past investment period. It is an excellent measure of past performance" -- with past being in italics -- "however, if our focus is on future performance, then the arithmetic average is the statistic of interest because it is an unbiased estimate of the portfolio's expected future return assuming, of course, that the expected return does not change over time.

"In contrast, because the geometric return over a sample period is always less than the arithmetic mean, it constitutes a downward-biased estimator of the stock's expected return in any future year." Is that correct?

A. I -- I agree with that statement.

Q. Do you agree with that?

A. Yes, I do.

Q. "Another way of stating the Bodie, Kain, Marcus argument in favor of the arithmetic mean is that it is the best estimate of the future value of the return distribution because it represents the expected value of the distribution." Do you agree with that?

A.   I agree with that, yes, I do.

Q.   "Brigham and Ehrhardt, 2005, in their widely used corporate finance text, point out that the arithmetic average is more consistent with CAPM theory as one of its key underpinnings assumptions is that investors are supposed to focus in their portfolio decisions upon returns in the next period and the standard deviation of this return." Do you agree with that statement?

A.   I do, yes, sir.

Q.   "To the extent that this next period is one single year, the preference for the arithmetic mean which derives from a set of single one-year period returns follows." Do you agree with that?

A.   Yes, sir.

Q.   Okay. Brealey, Myers and Allen in their leading graduate textbook in corporate finance opt strongly for the arithmetic mean. The authors illustrate this distinction between arithmetic and geometric averages and conclude the arithmetic averages are appropriate when estimating the cost of capital."

Here's a quote: "The proper use of arithmetic and compound rates of return from past investments are often misunderstood. Therefore, we call a brief time out for a clarifying example. Suppose that the price of big oil's common stock is $100. There is an equal chance at the end of the year the stock will be worth $90, $110 or $130. Therefore, the return could be minus 10 percent, plus 10 percent or plus 30 percent. We assume that big oil does not pay a dividend.

"The expected return is one-third times negative ten, plus ten, plus 30 equals 10 percent. If we run the process in reverse and discount the expected cash flow by the expected rate of return, we obtain the value of big oil stock. Present value would equal 110, divided by one dollar or 1.1 percent" -- 1.10 percent, I guess -- "equals $100. The expected return of 10 percent is therefore the correct rate at which to discount the expected cash flow from big oil stock. It is also the opportunity cost of capital for investments which have the same degree of risk as big oil.

"Now, suppose that we observe the returns on big oil stock over a large number of years. If the odds are unchanged, the return will be minus 10 percent in a third of the years, plus 10 percent in a further third and plus 30 percent in the remaining years. The arithmetic average of these yearly returns is minus ten, plus ten, plus 30 divided by three equals plus 10 percent. Thus, the arithmetic average of the returns correctly measures the opportunity cost of capital for investments of similar risk to big oil stocks.

"The average compound annual return on big oil stocks would be .9 times 1.1, times 1.3" -- I'm going to call that to the one-third power, it looks like -- "minus 1 equals .088 or 8.8 percent less than the opportunity cost of capital. Investors would not be willing to invest in a project that offered an 8.8 percent expected return if they could get an expected return of 10 percent in the capital markets. The net present value of such a project would be net present value equals, minus 100, plus 108.8 divided by 1.1 which equals negative 1.1.

"Moral: If the cost of capital is estimated from historical returns or risk premiums, use arithmetic averages, not compound annual rates returns," in parentheses, "geometric averages." Do you agree with that analogy?

A. I do, yes, sir.

Q. Okay. Then it goes on to cite Ibbotson which you've already included in your testimony. And then it states, "Lastly, on the practical side, Bruner, Eades, Harris and Higgins have found that 71 percent of the text in trade books in their extensive survey of practice supported use of an arithmetic mean for estimation of the cost of capital." Do you agree with that statement?

A. I do, yes, sir. I recall it.

Q. Are you aware of any public utility commission in the country that has relied on a geometric average setting a rate of return?

A. Not that I can recall offhand, your Honor, no, sir. I mean, oftentimes they don't really specify. You know, it's unfortunate a lot of orders aren't terribly specific about certain things, but I cannot recall where one has said we specifically rely upon a geometric average, for instance. I -- I don't recall a single instance of that.

Q. Okay. Mr. Hanley, you've reviewed Mr. Lawton's testimony, his rebuttal and his surrebuttal testimony, haven't you?

A. Yes, sir.

Q. Now, my recollection is that he seemed to take issue with you for -- for using Value Line data for -- for some of your forecasts and not -- maybe you and Mr. Murray, that you didn't -- didn't use a broad enough spectrum. Do you -- do you recall that criticism?

A. Sort of, I think. Probably, I think, because I didn't use maybe Zacks or some -- some --

Q. Right, right.

A. I think that's --

Q. You didn't -- you didn't use Zacks?

A. Yeah.

Q. Okay. Now, you're -- you're a founding member of SURFA, aren't you?

A. I am, yes, sir.

Q. That's right. Mr. Murray, he's on the board now, isn't he?

A. He is, and I -- and I am not, so he outranks me.

Q. Right. Do you know Dave Parcell?

A. I do indeed, yes, sir.

Q. Are you familiar with his book The Cost of Capital: A Practitioner's Guide?

A. Very much so, yes, sir.

Q. It was -- it was prepared for the Society of Utility and Regulatory Financial Analysts,

wasn't it?
A. Yes, sir.
Q. And would you agree with me that Mr. Parcell's book is an authoritative source in the cost of capital in the field of utility regulation?
A. Yes, I would say so.
Q. Okay. I'm going to read to you a statement from that book. I want to see if you agree with this. This is from page 8-28, No. 3. "Whose projections are best? Finally a number of studies have commented on the relative accuracy of various analysts' forecasts. Brown and Rozeff, 1978, found that Value Line was superior to other forecasts. Chatfield, Payne or Hein and Moyer, 1990, page 438 found further Value Line to be more accurate than alternative forecasting methods and that investors place the greatest weight on the forecasts provided by Value Line.
"Finally, Collins and Hopwood, 1980, concluded that Value Line predictions are more accurate than competing models as they produce fewer and smaller extreme errors." Do you agree with Mr. Parcell's statement there?
A. Well, I -- I -- I think they're all true on those studies. Certainly that what you've read I

think is an accurate depiction from that -- that book, yes, sir.

Q. Okay. Now, do you recall that Mr. Murray used seven companies in his proxy group, correct?

A. Yes, sir.

Q. You used nine?

A. Yes.

Q. And Mr. Lawton used 12?

A. Yes, he did.

Q. Okay. Which group is more susceptible to selection bias?

A. Well, that's really difficult to say. I -- I -- I do think that in Mr. Lawton's group, several of the companies, they're -- and I understand that they're -- they are in the -- from the Value Line --

Q. Uh-huh.

A. -- group, the -- yes, distribution group. And I -- frankly, I'm a little puzzled. Maybe they have no better place to put them, but on a couple of the companies, UGI being one, I forget off the top of my head the other, but at least two of those companies have very small -- low percentages of their assets and their operating income derived from gas distribution operations, well below 50 percent.

I don't recall the -- off the top of my head the exact percentages, but I really don't think that they are truly representative to be, you know, in the group. Could I argue, frankly, that there's anything wrong with Mr. Murray's group of nine? No. My -- my selection was --

Q. Nine or seven?

A. Oh, I think seven is the -- has the best based on my selection criteria, but there is -- there is judgment. I think that -- because of the most representative, I picked -- I mean, I picked the seven that I think were -- were best. And I'm -- I'm also surprised that he doesn't include Laclede in the group which is a -- is a company from this state. I found that rather surprising.

Q. Okay. Well, you're familiar -- are -- you've been doing this longer than -- than I have. You're familiar with that whole argument that you shouldn't include utilities from the same state because you have that problem with circular reasoning, are you familiar with that argument?

A. Not when it comes to market-determined cost rates, no. I think they're as good to include as -- as -- as anyone else. If you talk about what was allowed on Laclede as some -- by -- by this Commission as a basis for Missouri Gas Energy, yeah, but I'm looking at market-determined cost rates.

Q. Okay. Mr. Hanley, would you agree with me that your DCF analysis contemplates that the -- the dividends or earnings are all paid at the end of the first year?

A. No, no, I wouldn't. It recognizes that they're -- that they're paid quarterly, but I don't use a quarterly compound model. What I've tried to do is what they refer to as the one-half convention which tends to be conservative, assume that the -- excuse me, I'm sorry -- assume that the dividends are paid midway -- you know, midway through the period rather than doing a quarterly compounded like Dr. Morin who writes that text, for example, that you referred to advocates a quarterly compounding model which would produce a higher result. I've taken what I think is a more conservative approach.

Q. But you used a semiannual approach?

A. Yes, sir.

Q. Is that anywhere in your testimony? Did I just miss that?

A. I believe it's in there, yes, sir.

Q. Okay. Now, Mr. Hanley, both you and

Mr. Murray cite a -- a 2002 article by Drs. Fama and French. Do you recall that? I think it's cited for different reasons.

A. Yeah, I recall, and yes, you're correct.

Q. Do you have a copy of that article by chance?

A. I do, but not with me at this -- at -- at the stand. May I retrieve it?

Q. Uh-huh.

A. May I --

Q. Uh-huh.

A. I have it, your Honor.

COMMISSIONER DAVIS: Okay. Can we get this exhibit marked?

JUDGE PRIDGIN: This will be 95.

(EXHIBIT NO. 95 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

BY COMMISSIONER DAVIS:

Q. Mr. Hanley, are you familiar with the work of Drs. Fama and French?

A. Yes.

Q. Would you agree that this article is an authoritative source in the field?

A. Yes.

COMMISSIONER DAVIS: And Judge, we may

get -- get an objection here, so -- anyway, I don't know, but -- because I only -- we only have -- apparently have one copy right now. But I mean, do any of the -- do any of the parties have an objection to Mr. Hanley submitting a complete copy of that article to this Commission since both he and Mr. Murray have -- have relied on it in their testimony?

MR. SWEARENGEN: The company has no objection.

MR. THOMPSON: No objection from Staff.

COMMISSIONER DAVIS: Okay. All right.

BY COMMISSIONER DAVIS:

Q. And you're citing that article for the proposition -- for the proposition that it's actually -- forecasted earnings are more important than forecasted dividends; is that correct?

A. Yes, sir, that's -- that's a part of my proposition that they study, yeah, yes, sir.

Q. Are you aware -- I mean, is there -- to the best of your knowledge, is there any -- any scholarly support for Mr. Murray's approach of averaging the -- the dividend growth, the earnings growth and the, I guess it's the growth in book value and giving them equal weight?

A. The best I can answer, sir, is that I don't know of any scholarly statements to do that. It's -- it's not uncommon for some witnesses to do that, but I -- but in specific response to your question, I don't know of any scholarly statements that say that's, you know, the way to do it or it produces the best result or anything of that sort.

Q. Mr. Hanley, you testified for MGE in the 2006 rate case here, did you not?

A. I did, sir, yes.

Q. Now, have you had cause to review any of Mr. Murray's testimony in the previous MGE cases and -- and other cases?

A. No. I think I may have reviewed one of his testimonies from another case that one of my associates was involved in. She had to ask me to look at it. And frankly, I don't recall which one it was now, a while ago. But I haven't looked at terribly many of them, but I would say probably a minimum of three or -- you know, three to four, in that range --

Q. Okay.

A. -- of his testimony.

Q. Depending on how you're look -- you look at it, you're aware that Missouri has at least three

investor-owned electric utilities, correct?
A. Yes, sir.
Q. And you're aware that Missouri has at least three investor-owned gas utilities, correct?
A. Yes, sir.
Q. And are you aware that at least one or two -- and -- and you're aware that we have at least one -- one large water utility, correct?
A. Yes, sir.
Q. And are you aware that at least one or two of those utilities are A-rated by S&P?
A. Yes, sir.
Q. Okay. And we also have some utilities that are -- that are triple B, correct?
A. You do.
Q. And we've had at least one electric utility in the past that was below investment grade, correct?
A. I believe that's correct, yes, sir.
Q. And you'd agree that those utilities all have varying capital structures, correct?
A. They do.
Q. And making reference to a statement that you made earlier, I believe it was -- it was on direct, now, do you find it surprising that despite

variations in credit rating, variations in capital structure, that the -- the Missouri PSC Staff has never been able to recommend an ROE above 9 and a half percent for a large investor-owned utility or at least never in at least the last five or six years?

A. Well, your Honor, I -- I must say that I -- I am aware of the truth of what you say, and I have noted that it seems to be out of sync with most of the rest of the regulatory world in my view.

Q. You know what the average ROE for an investor-owned gas utility is for the calendar year 2008?

A. I believe it was somewhere in the -- in the vicinity of 10.2 to 10.3, I believe, subject to check. I -- without looking at anything at the moment, I think that's a fair assessment of the range.

Q. Okay. And do you know what the average ROE for a gas utility is in the first three quarters of calendar year 2009?

A. Not the first three quarters, but...

Q. Doesn't AUS publish a newsletter and isn't that information available in it?

A. No. We get that information -- well, no, we get that information from Regulatory Research

Associates.

Q. Hmm. So you have a -- you have a subscription to Regulatory Research Associates?

A. Yes, sir, we do.

Q. And that information is -- is easily provideable to the Commission?

A. It is.

Q. Okay. Can you provide this Commission with an opinion as to what the -- the national average for ROE for investor-owned gas utilities was in the first three quarters of calendar year 2009?

A. Yes, sir, we can do that.

COMMISSIONER DAVIS: Mr. Thompson, is...

MR. THOMPSON: I was going to get this marked and --

COMMISSIONER DAVIS: Okay.

MR. THOMPSON: -- get it in later.

COMMISSIONER DAVIS: Okay. All right.

MR. THOMPSON: I can do it now if you'd prefer.

COMMISSIONER DAVIS: That's all right. Mr. Hanley, thank you. I have no further questions.

JUDGE PRIDGIN: Commissioner Davis, thank you. This looks to be a pretty convenient time for a break, and I understand we'll still have

Mr. Hanley on the stand for recross and redirect. It's 10:20 according to the clock back on the wall. Let's break for about 15 minutes and readjourn about 10:35. Thank you. We're off the record.

(A RECESS WAS TAKEN.)

JUDGE PRIDGIN: All right. We're back on the record. Mr. Hanley is still on the stand, and Mr. Hanley, I'll remind you you're still under oath. It's time for recross-examination. Mr. Poston, any questions based on bench questions?

MR. POSTON: No questions. Thank you.

JUDGE PRIDGIN: Mr. Poston, thank you. Mr. Thompson?

MR. THOMPSON: Why, yes, your Honor, thank you. I have an exhibit I'd like to mark.

JUDGE PRIDGIN: It will be 96.

(EXHIBIT NO. 96 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

COMMISSIONER DAVIS: Thank you, Mr. Thompson.

MR. THOMPSON: I see we have another one if you'd put that for Commissioner Gunn.

COMMISSIONER DAVIS: Commissioner Gunn or Commissioner Kenney?

MR. THOMPSON: I've got one for

Commissioner Kenney right here.

COMMISSIONER DAVIS: Okay. Thank you, sir.

MR. THOMPSON: May I approach, your Honor?

JUDGE PRIDGIN: You may.

RECROSS-EXAMINATION BY MR. THOMPSON:

Q. Mr. Hanley, I'm going to show you an exhibit I've marked as Exhibit No. 96. Could you describe that for me?

A. Yes, sir. It's a publication from Regulatory Research Associates. I'm counting what page. One, two, three -- I seem to have five pages of October 2nd, 2009. It's called "Regulatory Focus Special Study, Major Rate Case Decisions, January-September 2009."

Q. You've only got five pages, sir?

A. I believe so. Maybe I -- maybe a page is stuck together. Let me just count again, please. No, I think that's what happened. Five, six -- I'm sorry. Seven. A couple stuck together. Sorry about that.

Q. That's quite all right. And is that the publication that you referred to when you were answering questions posed by Commissioner Davis?

A. Yes, sir, this is the same thing that we got, yeah.

Q. Okay. And do you, in fact, rely on that report for authorized ROEs to see what's being authorized --

A. To see what's being authorized, yes. Certainly not to form my recommendation --

Q. Right.

A. -- but, yes.

Q. But just to see what --

A. Yes.

Q. -- commissions are doing?

A. Yes, sir.

MR. THOMPSON: Okay. I offer Exhibit 96.

JUDGE PRIDGIN: Exhibit 96 has been offered. Any objections?

MR. SWEARENGEN: (Shook head.)

JUDGE PRIDGIN: Hearing none, 96 is admitted.

(EXHIBIT NO. 96 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. THOMPSON: And I have no further questions. Thank you.

JUDGE PRIDGIN: Mr. Thompson, thank you.

Redirect?
MR. SWEARENGEN: Yes, Judge, I'll just do it from down here if that's okay.
JUDGE PRIDGIN: Certainly.
REDIRECT EXAMINATION BY MR. SWEARENGEN:
Q. Mr. Hanley, let me kind of back up here for a minute. Commissioner Davis was asking you quite a few questions, and he was -- you were having a conversation with him about, I think, the CAPM formula. Do you recall that?
A. Yes, I do.
Q. And he asked you whether or not you -- you, I think, strictly followed that formula. I believe that was his question. Do you recall?
A. I -- yes, I -- I recall that.
Q. Okay. And I think you said yes, you followed the formula. Was that your answer?
A. Yes.
Q. And then he asked you about the inputs and you said, as I recall, that you didn't follow the inputs. Do you recall that answer?
A. I believe, yes. Yes, sir.
Q. And -- and can you explain what you meant by that?
A. Well, sure. I don't follow it with

regard to that particular page with that 3 percent, for example, with the long-term treasury rate. I believe that was some sort of a historical average, whatever.

We -- we clearly know at the present time the -- and based on forecasts, the treasury rate is well above 4 percent. I think I exchanged with Commissioner Davis that currently, based on Mr. Murray's numbers, are in the area of 4.3 percent. And indicators are that it's going to be continually rising over the next year or so. And I think that's much more representative for the simple reason that ratemaking is prospective and the cost of equity capital is prospective.

Other parts of the formula with regard to the return on the market, I do not rely strictly upon the historical, the long-term data from the Ibbotson book, but I also rely in part, as has been discussed with -- with Commissioner Davis, the Value Line forecasted appreciation potential which I believe investors take into account.

So you know, with -- with those exceptions, of course, you know, as to the inputs, why -- but I do use the -- the standard model. I would add I also utilize the empirical capital asset pricing model for the simple reason stated in my testimony and substantiated and supported in the new regulatory finance book by Morin. But that's just simply a derivative of the -- the standard formula which I did utilize.

MR. SWEARENGEN: Now, you mentioned the Ibbotson book. Just so the record is clear, I think that was marked as Exhibit 94; is that correct, your Honor?

JUDGE PRIDGIN: That's correct, Mr. Swearengen.

BY MR. SWEARENGEN:

Q. And Mr. Hanley, you referred to a particular page. Was that page 200 from that exhibit, is that your recollection?

A. Yes, that's my recollection, sir.

Q. Thank you. Now, Mr. Thompson was -- was asking you some questions about the short-term debt cost issue in this case, and I believe he indicated to you that perhaps seven of the nine proxy companies utilized by the Staff in this case issue commercial paper. Do you recall his question to you about that?

A. I remember the -- the general discussion as to specifically seven companies.

Q. Okay.

A. I don't recall -- it may well be, but I do recall the general discussion.

Q. And then you started to say, "The point is," and you did not finish your answer. Mr. Thompson, I think, indicated "Thank you." What -- what point were you trying to make at that particular point in time, do you recall?

A. I actually do recall. The point I was trying to make was that if they're doing that, it would be the same right now, for example, that Southern Union is still able to issue debt under credit agreements that were reached several years back. As those credit agreements expire, they're no longer going to be able -- the smaller and lesser rated companies will not have access in this current market environment to the commercial paper market.

Evidence is overwhelming that there is access now only to the largest companies that have the need to regularly issue commercial paper and with the highest credit rating such as double A or triple A rating. Southern Union itself, its credit agreement expires in May 2010, which is just around the corner, especially in terms of rates that are going to be in effect for a period of time.

If -- with their -- with their bottom of investment grade rating, if they were in a situation where their existing credit agreement expired and they had to go out, their rate would be much higher than the 5.492 percent, I believe, that I estimate for Missouri Gas Energy if it had to go out. Because for Missouri Gas Energy, I assumed the same average bond rating as my proxy group which is much higher and better rating than that of Southern Union which, as I said, is the bottom of investment grade.

So that's the point I was making, that in terms of what we could look forward to in terms of being representative on a going-forward basis.

Q. Okay. Thank you. Now, at one point, I think when Mr. Thompson was -- was asking you some questions, you used the term "Efficient market hypothesis." Could you tell us what that means?

A. Yes. Well, basically what it means is, is that investors are aware of all historical information, current information that's made publicly available and have ready access to on a very -- I hate to use the word cheap -- inexpensive basis or better yet, a free basis. So it's readily available, informative information, inexpensive or at no cost, and that also they are aware and have access to all historical information as well.

Q. Okay. Thank you. Now, also in response to questions from Mr. Thompson, you got into a discussion with him about particular companies, I believe, that are included in the Staff's case that have, at least according to the analysts, similar ROE ratings but they have different credit ratings. Do you recall that?

A. Yes, I do.

Q. And what's -- what's the relationship between credit ratings and return on equity?

A. Well, I mean, as a general rule, the -- the lower the credit or the -- or bond -- or bond rating of -- of the company, it implies certainly more risk to the creditors or the debt holders which implies, generally speaking, to much more risk for the equity holders as well simply because they will have more debt ahead of them in a first claim on assets and earnings of the enterprise, and more risk that their dividends, if there are any, won't be paid timely or might be reduced or eliminated, what have you, that kind of risk. So the greater the risk, the greater would be the required return. That's consistent with the basic financial precept.

Q. And -- and how -- how does that relate, then, to -- to the Staff's testimony and the question that was put to you by Mr. Thompson with regard to specific companies and specific ROEs and specific credit ratings?

A. Well, I -- I question the validity of estimates that, first of all, we don't know how they're derived, we don't know the basis of their inputs, and secondly, when you have the same cost rate projected for a company that has a triple B rating or even a single A rating compared to one that has a double A rating, it just is intuitively incorrect.

And in addition, I believe I pointed out that in one of those estimates that I looked at, the direction of their change in a matter of five months was counter to the market. They actually raised their estimate when indications are, during that same period of time as confirmed by my update, covering essentially the same period of time, should be down.

Q. Okay. Finally, Mr. Thompson asked you a series of questions about an entity called MOSERS. Do you recall those?

A. I -- yes, I do.

Q. And what is your understanding -- what -- what is MOSERS?

A. Well, it's a -- it's an acronym for the

Missouri State Employees' Retirement fund, pension investment fund.

Q. Are the returns that are made on those investments, on the MOSERS investments widely known?

A. No. I -- I -- they -- they're not -- they're not widely known. One would have to have a specific interest in it in order to determine what it is. It's certainly not something widely known. It would be of interest, obviously, to an employee of the State of Missouri, but beyond that, I can't imagine anyone else would have an interest in it.

Q. Would there be a relationship between those returns and the efficient market hypothesis?

A. Well, no. I mean, I don't -- I don't think so, since their -- investors wouldn't have this readily available, they would have no knowledge of it. And in addition, they would be cognizant, I believe, that, one, a pension fund like that has a fiduciary responsibility which means they tend to be conservative, it would be a well-diversified portfolio consisting of a number of different kinds of assets.

And again, as I think I mentioned earlier, a ten-year investment horizon is a relatively short horizon compared to the infinite horizon presumed with a common equity return rate in a proceeding such as this.

Q. How would the asset base of MOSERS compare, for example, to the asset base of Missouri Gas Energy?

A. Well, I mean, there's -- there's absolutely no comparison. Missouri Gas Energy, the asset base happens to be what we would call rate base which is primarily investment in gas distribution utility plant and -- and -- and equipment to provide the -- the service. That's compared to a diverse portfolio of investments and a pension fund with a goal to -- and its goals is more of safety consistent with the fiduciary responsibility --

Q. Thank you.

A. -- to preserve those dollars.

MR. SWEARENGEN: Thank you. Could I have an exhibit marked, please?

JUDGE PRIDGIN: Yes, you may. This will be 97.

(EXHIBIT NO. 97 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE PRIDGIN: Mr. Swearengen?

MR. SWEARENGEN: Yes, thank you.

BY MR. SWEARENGEN:

Q. Mr. Hanley, you have in front of you what has been marked for purposes of identification on here as Exhibit 97. Do you have that?
A. I do, yes, sir.
Q. And are -- have you seen this document previously?
A. Yes, I have.
Q. And how did you happen to see it?
A. This was part of response received from Staff to one of the company's data requests.
Q. Okay. Thank you. And what -- what is this document?
A. Well, this is a document that -- for the Missouri State Employees' Retirement System that -- it shows the current assumptions and shows the various asset classes that are in their portfolio and the -- with their ten-year horizon expected rate of return and standard deviation on each of those asset classes.
Q. Now, how does that ten-year horizon compare and contrast to the horizon of the DCF formula you'd utilized by the Staff in this case?
A. Well, as I indicated earlier, it's merely a fraction of it. Even if we want to say, well, infinity is sort of a nebulous term that no one

can comprehend, if we think of discounting a value back to the present where under the -- the -- the theory, you either get actually to zero but get really as close to zero as possible, even if it wouldn't be absolute zero, is probably like 40 years, which would be about four times longer horizon as compared to this ten-year horizon.

Q. Would you characterize a ten-year horizon as a short-term horizon?

A. In the context of the long-term infinite presumed horizon for common equity, particularly one derived from the DCF model, yes, I would say that that's short relatively -- relative to that.

MR. SWEARENGEN: Thank you. That's all I have. I would offer into evidence Exhibit 97.

JUDGE PRIDGIN: Mr. Swearengen, thank you. No. 97 has been offered. Any objection?

(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, 97 is admitted.

(EXHIBIT NO. 97 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

JUDGE PRIDGIN: Any further questions?

MR. SWEARENGEN: I have none.

JUDGE PRIDGIN: All right. Thank you,

Mr. Hanley. Thank you very much, sir. You may step down.

THE WITNESS: Yes, sir, thank you.

MR. SWEARENGEN: And may he be excused? May Mr. Hanley be excused?

JUDGE PRIDGIN: Commissioner Davis?

MR. SWEARENGEN: I'm not sure what his -- what flight he has to catch. That's why I'm asking.

COMMISSIONER DAVIS: Mr. -- Mr. Swearengen, at this point I'm going to object. I mean --

MR. SWEARENGEN: That's fine.

COMMISSIONER DAVIS: -- no disrespect to Mr. -- Mr. Hanley --

MR. SWEARENGEN: No.

COMMISSIONER DAVIS: -- but I'd like to get through the other cost of capital experts before we -- before we release him.

MR. SWEARENGEN: You don't even -- you don't need to object, your Honor, just indicate that you'd like him to stay. He'd be happy to stay. Thank you.

COMMISSIONER DAVIS: Some people would consider that economic development, Mr. Swearengen.

MR. THOMPSON: Your Honor?

JUDGE PRIDGIN: Mr. Thompson.

MR. THOMPSON: Mr. Murray needs to get some water before he goes up. If he could be permitted to go -- to do that. And also, I have a question. Was Exhibit 94 received?

JUDGE PRIDGIN: I don't show that 94 was offered. I think that was a Commission exhibit. I can certainly move that it be admitted.

MR. THOMPSON: I would so move, your Honor.

JUDGE PRIDGIN: Okay. It has been moved.

MR. THOMPSON: And I think all we would need is page 200 with Table C-1.

JUDGE PRIDGIN: All right. That would be -- that specific page, page 200, okay. Exhibit 94 has been offered. Any objections?

(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, it is admitted.

(EXHIBIT NO. 94 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. THOMPSON: And what about Exhibit 95, your Honor?

JUDGE PRIDGIN: Likewise, I don't show it, and I think that was something that --

MR. THOMPSON: That was the Fama and French article.

JUDGE PRIDGIN: -- the Fama and French article, and I think that -- I could be wrong -- I think that MGE was going to get copies of that. I could be remembering that wrong. I don't think it's been -- I don't think it's been offered and I think we're just waiting for copies, but I may remember that incorrectly. Does -- does anyone want to move the admission of 95?

MR. THOMPSON: And we'll move that that be received.

JUDGE PRIDGIN: Okay. Any objections?

(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, it's admitted.

(EXHIBIT NO. 95 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

JUDGE PRIDGIN: I don't know if the bench has copies. I'll just ask that some parties supply copies sometime today if that's possible. If not, just late-file it. And I'm sorry. Mr. Murray needs some water before he takes the stand.

MR. MURRAY: Is that okay?

JUDGE PRIDGIN: Certainly.

MR. MURRAY: Be right back.

MR. THOMPSON: Thank you, your Honor.

JUDGE PRIDGIN: We're still on the record. Is there anything further from counsel before Mr. Murray is sworn?

MR. THOMPSON: No, sir.

MR. MURRAY: Thank you.

JUDGE PRIDGIN: You're welcome. I'm sorry. Mr. Thompson?

MR. THOMPSON: Staff would like an opportunity to do a brief opening.

JUDGE PRIDGIN: Yes, absolutely. Whenever you're ready.

MR. THOMPSON: May it please the Commission.

JUDGE PRIDGIN: Mr. Thompson.

MR. THOMPSON: I'm not going to take very much of your time. We're here today to do what is always one of the most hotly contested and important aspects of any rate case, which is to determine the cost of common equity. There are some additional issues that you're also hearing today which would include the capital structure, the cost of debt, both short-term and long-term. These are the things that the parties dispute.

And what is cost of common equity? We talk about it in these cases and briefs, and it's actually several different things. It depends on who you are and what you're talking about it for. If you're an investor, we heard from Mr. Hanley, it's your expected return or as they sometimes say, your required return.

If I'm going to invest in a company, I'm going to hopefully have some idea of what I expect out of that investment, and I may use analytical techniques such as these analysts have used in order to try to calculate what I can expect. And assuming I'm a rational investor, then I'm going to put my money where I can get the best bang for my buck.

If you're the company, though, common equity is profit, or should I say a component of profit. Because after all, let's remember the ratemaking formula. The ratemaking formula is prudently incurred operating and maintenance expenses as regularized and annualized for the test year, plus, plus accumulated depreciation subtracted from rate base, right? And then you multiply that by the rate of return.

And the rate of return is the weighted average cost of capital. It is an amount of money in addition to operating expenses sufficient to serve, or service I guess they say, each of the components of the company's capital structure. Part of that is debt and part of that is equity.

So your job, then, is to decide what is the profit that the shareholders will receive for operating this company over a year. And in doing that, you look to expert testimony. And you have heard already from Mr. Hanley who is the company's expert, you're about to hear from David Murray, the Staff expert, and later today you'll hear from Mr. Lawton who is the expert retained by the Office of Public Counsel. And each of these three experts has come up with a slightly different recommendation for you.

Mr. Murray's recommendation is 9.5 percent and Mr. Lawton's recommendation is 10.0 percent and Mr. Hanley's recommendation is 10.5 percent. It's rare that we get the recommendations sort of lined up like that, like -- like bowling pins. And I haven't seen a reconciliation, so I can't tell you what each basis point is worth in this case.

But remember, this rate of return is multiplied by the net rate base, and that amount of money is added to the revenue requirement. It becomes part of the money that is recovered or paid in by customers in exchange for the service they receive. So the decision you make will have actual financial consequences; consequences for the company, consequences for the shareholders, consequences for the ratepayers.

Each of the experts has used well recognized and unremarkable formuli that are -- that are frequently encountered in financial analysis, the discounted cash flow model, the capital asset pricing model and the risk premium model. And each of them has its particular weaknesses and its particular strengths.

There is -- as we brought out in cross of Mr. Hanley, there's a philosophical divide between Staff on the one hand and the other two witnesses on the other in that Staff relies on the discounted cash flow model. Staff believes that that is the -- the best technique with which to determine investor expectations. That's what the financial analyst is determining, investor expectations.

We urge you to select a number close

to, if not identical, with Staff's recommendation of 9.5 percent. We suggest to you that that is supported in -- by corroborating evidence that Mr. Murray has marshaled in his testimony. I refer to the evidence of expectations of MOSERS, a local large institutional investor, and also the financial equity analyst predictions which have been provided in corrected schedules 20-1 through 20-7 attached to Mr. Murray's rebuttal testimony. I will remind you that the average of those 30 predictions is 8.24 percent.

With respect to capital structure, Staff is taking a different course today than it has taken in the past with this company because of information that has come to Staff's attention about the financing practices of Southern Union Company. Staff no longer believes, no longer believes that the actual consolidated capital structure of Southern Union is the appropriate ratemaking capital structure. Staff believes that a hypothetical capital structure would be more appropriate.

A hypothetical capital structure is simply prepared by taking the average of each component from the proxy group, so it is the average of the proxy group, and it reflects an average value.

With respect to short-term debt, Staff has the corrected figure of 1 percent which is quite a bit lower than the figures used either by Mr. Hanley or by Mr. Lawton. And I would urge you to consider the way that Staff derived that number and the evidence that supports it.

I think the evidence is unrefuted that most of the proxy companies issue commercial paper and raise short-term money in that manner, short-term less than six months to maturity, usually about a month, and that they are doing so at quite low cost. Thank you very much for your attention. You'll now hear from Mr. Murray.

JUDGE PRIDGIN: Mr. Thompson, thank you. Commissioner Davis?

COMMISSIONER DAVIS: Mr. Thompson, can we go back and can you explain your -- your "lined up like bowling pins" analogy again?

MR. THOMPSON: Simply -- simply 9.5, 10, 10.5. That's kind of regular --

COMMISSIONER DAVIS: And you -- and you said that -- that that doesn't rarely happen at this Commission, correct? Is that -- is that my recollection?

MR. THOMPSON: I did say that.

COMMISSIONER DAVIS: Okay. Mr. Thompson, where were you in 2004?

MR. THOMPSON: Probably right here.

COMMISSIONER DAVIS: And to the best of your recollection, were you -- were you the regulatory law judge in the MGE case or was that Judge Woodruff?

MR. THOMPSON: That was Judge Woodruff.

COMMISSIONER DAVIS: That was -- that was Judge Woodruff.

MR. THOMPSON: Yes, sir.

COMMISSIONER DAVIS: Do you recall what the -- what the ROE recommendations were in that case?

MR. THOMPSON: No, sir.

COMMISSIONER DAVIS: Would it surprise you to know that the ROE recommendations in that case lined up exactly like bowling pins as well?

MR. THOMPSON: I am surprised.

COMMISSIONER DAVIS: Hmm. You're shocked?

MR. THOMPSON: I wouldn't characterize it as quite shocked, sir --

COMMISSIONER DAVIS: Okay.

MR. THOMPSON: -- but I am certainly

surprised.

COMMISSIONER DAVIS: You're surprised?

MR. THOMPSON: Yes, sir.

COMMISSIONER DAVIS: So correct me if I'm wrong, Mr. Thompson, but the company files its case, correct?

MR. THOMPSON: Yes, sir.

COMMISSIONER DAVIS: And then Staff, Office of Public Counsel and anybody else files their direct later on, correct?

MR. THOMPSON: Yes, sir.

COMMISSIONER DAVIS: And so in at least two of the last three MGE rate cases, we had the numbers lining up exactly like bowling pins, correct?

MR. THOMPSON: Well, we know about this one, and you -- you've described the 2004 case.

COMMISSIONER DAVIS: Well, assuming that to be true, then that would be the case then?

MR. THOMPSON: That's correct.

COMMISSIONER DAVIS: Is that magical?

MR. THOMPSON: I don't think so.

COMMISSIONER DAVIS: Okay. Thank you, Mr. Thompson.

MR. THOMPSON: Thank you, Commissioner.

JUDGE PRIDGIN: Before I swear in

Mr. Murray, I'll just note that it's roughly 11:15 and my hope is to break for lunch somewhere in a natural break around noon. I'll try not to stray more than a half hour before or after noon. So depending on the line of questioning, we may break for lunch before Mr. Murray is finished testifying or -- or after, I'm not really sure. But anyway, that's my plan. Anything further from counsel before Mr. Murray is sworn?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Mr. Murray, if you'll raise your right hand to be sworn, please.

(The witness was sworn.)

JUDGE PRIDGIN: Thank you very much, sir. Please have a seat. Mr. Thompson, anything before he's tendered for cross?

DIRECT EXAMINATION BY MR. THOMPSON:

Q. Please state your name.

A. My name is David Murray.

Q. And how are you employed, sir?

A. Acting utility regulatory manager in the financial analysis department.

Q. Of what agency?

A. The Missouri Public Service Commission.

Q. And did you prepare or cause to be

prepared a portion of what is marked as the Staff cost of service report, Exhibits 39 and 40, 39 is MP and 40 is HC?

A. Yes, the rate of return portion, that's correct.

Q. And also Exhibit 57, David Murray rebuttal testimony?

A. Yes.

Q. And Exhibit 58, David Murray surrebuttal testimony?

A. Yes.

Q. And do you happen to have any corrections to any of those pieces of testimony?

A. In -- in the -- on the cost of service report in the appendices.

Q. Yes, sir.

A. On appendix one, page 14, it came to my attention that a couple of the cases for the Utilicorp at that time, Utilicorp Company in 2001 that I had -- that I had -- have a typo on the ER and the EC case. I'll just count down the number of rows on that page. One, two, three, four, five, six, seven. On the seventh row, it should read -- instead of "EC-2002-265," it should read "ER-2001-672."

The next row which should be -- instead

of "ER-2001-265," it should be "EC-2002-265." And that's the extent of my changes and corrections.

Q. Okay. And no change to either of the other two exhibits?

A. No.

Q. Okay. And if I were to ask you those same questions now, would your answers be the same?

A. Yes.

Q. And are they true to the best of your knowledge, information and belief?

A. Yes.

MR. THOMPSON: I will offer Exhibit 57 and Exhibit 58. I don't know what the practice is with respect to the cost of service report, Judge, whether you want me to offer his portion of that now or -- I can certainly do that.

JUDGE PRIDGIN: I don't necessarily have a preference, but it might be a little cleaner if the cost of service report is offered all at once whenever -- I guess whenever Staff is finished with its case.

MR. THOMPSON: Very well. I'll pass that on to Staff's other counsel. Well, Exhibits 57 and 58, then.

JUDGE PRIDGIN: All right. 57 and 58

are offered. Any objections?

(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, 57 and 58 are admitted.

(EXHIBIT NOS. 57 AND 58 WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. THOMPSON: I tender the witness for cross. Thank you, your Honor.

JUDGE PRIDGIN: Mr. Thompson, thank you. Let me see which counsel wish cross. Mr. Poston, will you have cross?

MR. POSTON: I have no questions. Thank you.

JUDGE PRIDGIN: Mr. Swearengen, you'll have cross?

MR. SWEARENGEN: Yes, I do, your Honor.

JUDGE PRIDGIN: Any other counsel have cross?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Mr. Swearengen?

MR. SWEARENGEN: Thank you. Could I have an exhibit marked as the -- it's the document that I handed out earlier this morning during my opening remarks that sets out the positions of the parties.

JUDGE PRIDGIN: Yes, sir. That will be 98.

(EXHIBIT NO. 98 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

MR. SWEARENGEN: And if it's okay, I'll just ask my few questions from back here.

JUDGE PRIDGIN: Yes, sir, you may.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Mr. Murray, good morning.

A. Good morning.

Q. How are you doing?

A. Pretty good. How are you doing?

Q. Fine. I think I just handed you what has been marked as Exhibit 97?

A. Yes.

THE COURT REPORTER: 98.

JUDGE PRIDGIN: I believe that's 98, Mr. Swearengen.

BY MR. SWEARENGEN:

Q. 98, I apologize. And I will represent to you that -- that this purports to set out the positions of the Staff, the company and the Public Counsel in this case with regard to capital structure and -- and the related cost rates.

Would you take a look at the -- where the Staff's recommended capital structure and cost rates is set out in the middle of that document and tell me if -- if you believe that that accurately reflects the Staff's recommended capital structure and the related cost rates?

A. Yes, that's accurate.

Q. Okay. Thank you. And does it also accurately reflect your understanding of the position of Missouri Gas Energy on these matters?

A. Yes, it does.

Q. And if I asked you does it accurately represent your understanding of the Public Counsel's position on these matters, would you agree?

A. Not necessarily. Not necessarily on that.

Q. Okay. What -- what part of that -- the document doesn't accurately reflect the Public Counsel's recommended -- recommended capital structure and cost rates?

A. With the revenue requirement reduction recommended of 1.8 million, or approximately --

Q. Okay.

A. -- the recommended ROE would be approximately 9.5. Actually, this -- I think it's

actually 9.53 percent.
Q. Now, is -- is -- is it your testimony here today that the Public Counsel has put in testimony directly by a surrebuttal that would support that number that you just gave?
A. Not that specific number. Approximately 9.5 percent. They have submitted testimony that supports that.
Q. Okay. And is it your position that it's the Public Counsel's position that that's the appropriate return on equity as opposed to 10 percent that shows in this -- this exhibit?
A. That's the effect of ROE that's being recommended as far as what would be reflected in the cash flow.
Q. Okay. So it's your position, then, that what the Public Counsel has said about 10 percent ROE is not accurate?
A. That's the number, that's accurate.
Q. Okay.
A. That's his number.
Q. And -- and that's the number that shows up on the -- on this Exhibit 98?
A. Yes.
Q. Okay. Let me ask you, is -- is it your

understanding that Missouri Gas Energy is an operating division of Southern Union Company?

A. Yes.

Q. And would you agree that Southern Union Company is a corporation?

A. Yes.

Q. And do you know where it's incorporated?

A. In -- I think they're in Houston now, Texas. I -- I believe they relocated. They were in Pennsylvania.

Q. Do you think they're -- they were a Pennsylvania corporation but now they're a Texas corporation, is that your testimony?

A. If I recall correctly.

Q. Do you know whether or not Southern Union Company shares are traded on the -- publicly traded on the New York Stock Exchange?

A. Yes, they are.

Q. Would you agree that Missouri Gas Energy does not issue its own capital?

A. Yes.

Q. And would you agree that this Commission regulates what we know as the gas distribution operations in Missouri Gas Energy?

A. Yes.

Q. As far as you know, does this Commission regulate any of the other business operations of Southern Union Company?

A. No.

Q. And what are those other business operations, do you know?

A. They've acquired Panhandle Eastern Pipeline. I don't know all the activities that occurred -- occurred under Panhandle Eastern Pipeline since they acquired that entity, but I know that there's a trunk line, natural gas, Florida Gas Transmission.

The recent -- I guess -- I guess it was occurring during the last 2006 case they acquired the Sid Richardson energy properties which are the gathering and processing operations which that -- that, I believe, is under the SUGS. When I say SUGS, Southern Union Gas -- Southern Union Services -- I can't remember the -- I remember the acronym, but it's under SUGS. So that's the extent of what Southern Union has.

Q. So if I said that those -- those other businesses included generally transporting gas, gathering gas and storing gas, processing gas in addition to the distribution of gas that MGE carries on, would you agree that that's a fair general description of the business of Southern Union Company?

A. Yes.

Q. Okay. Is it your understanding that Southern Union Company issues debt?

A. Yes.

Q. And what is the most recent amended cost of debt of Southern Union Company, do you know?

A. I believe it's reflected in -- in the other parties' testimonies. It was in the low 6 percent range, 6.1, 6.2. Now, that's with total -- that's -- that's all debt. When I say Southern Union -- and maybe we should back up and clarify. When you say "Southern Union debt," are you referring to just operating company level debt?

Q. I'm asking you, Southern Union Company, what is your understanding of Southern Union Company? You think it's a corporation that at one time was incorporated in Pennsylvania and now is incorporated in Texas. If I ask you about Southern Union debt, what do you know about that?

A. Southern Union operating company level debt is about 7.7 percent. When you include the people debt which was excluded -- excluded in the last couple of rate cases in front of this Commission and the trunk line debt which was also at the people level, it brings it down to about 6, a little over 6 percent.

Q. Now, what level are you talking about, the people level?

A. Panhandle Eastern Pipeline.

Q. And what's that?

A. That's the acquisition in maybe 2004.

Q. What is Panhandle Eastern Pipeline?

A. It's the transmission -- or excuse me, the transportation. It's the pipeline subsidiary of Southern Union.

Q. It's a subsidiary?

A. Yes.

Q. And what does that mean?

A. It's a subsidiary corporation, it's a wholly owned corporation of Southern Union.

Q. So Panhandle is not Southern Union Company, right?

A. That's correct.

Q. Okay. And it has its own debt, Panhandle?

A. Panhandle issues its own debt, that's correct.

Q. Looking at Exhibit 98 and turning your attention to the Public Counsel's recommended capital structure, do you know whether or not that capital structure reflects the debt of the wholly owned subsidiary, Panhandle?
A. It does.
Q. So would you agree with me that the Public Counsel's proposed capital structure includes something other than just Southern Union capital?
A. Yes.
Q. Okay. Now, I think your counsel said, and I've read your testimony, and I think it reflects -- it is reflected on Exhibit 98, for purposes of setting rates for Missouri Gas Energy in this case, the Staff is recommending the use of a hypothetical capital structure; is that correct?
A. Yes.
Q. And that's based on -- the percentages are based on your analysis of a group of proxy companies that you selected; is that true?
A. Yes.
Q. And are there -- were there seven gas companies in that proxy group; is that right?
A. That's correct.
Q. And in your view, those seven companies

are comparable to Missouri Gas Energy?
A. It's a -- it is a good starting point, yes, it's a proxy. It -- it approximates the -- the -- as best as we can with all practical circumstances we have with holding companies, a natural gas distribution cost of equity.
Q. Now, looking at Exhibit 98, am I correct in understanding that the capital structure that is shown there would be the -- the average capital structure of your proxy group?
A. Yes, for the most recent fiscal year. No, excuse me. This was update -- I updated my information as of the most recent quarterly 10Q filing of each company, yes.
Q. And with -- with regard to the cost components of the capital structure that you're proposing, for example, the 5.92 percent long-term debt, is that based on your proxy group's average embedded cost of long-term debt?
A. Yes.
Q. And to estimate the -- the cost of common equity that is shown there as 9 and a half percent, am I correct in understanding that you performed an analysis of your seven -- the same seven proxy companies?

A. Yes.
Q. And you ultimately came up with a 9.5 percent as the -- the midpoint of your range; is that right?
A. That's the midpoint of the lower half of my range.
Q. Midpoint of the lower half of your range, okay. And then you -- the next step would be you apply that 9.5 percent to the average common equity ratio of 51.06 percent; is that true?
A. Yes.
Q. Now, with regard to your proposed cost of short-term debt which shows at 1 percent on -- on Exhibit 98, that's not based on the average cost of all seven of your proxy companies; is that true?
A. Yes.
Q. Instead, it's based on the simple average of the weighted average cost of short-term debt of the two A-rated companies in your proxy group; is that right?
A. Yes.
Q. Do you have the Staff report in front of you that, I think, contains your direct evidence on this topic?
A. Yes, I do.

Q. If you could turn to page 36, please.
A. Yes.
Q. Looking -- looking at page 36, lines 7 to 9, am I correct that the -- that you state the Staff's estimate of the proxy group's cost of common equity is in the range of 9.25 percent to 10.25 percent?
A. Yes.
Q. And the high end of that, the 10.25 percent, is just 25 basis points below the company's recommendation in this case which is 10 and a half percent; is that true?
A. Yes.
Q. And I -- and I use the word "just" because 25 basis points is not that great of a difference when compared to past cases, would you agree with that?
A. Yes, I agree.
Q. But then you go on to say in that same page of the report that you disregard that range and instead are using the range of 9 and a quarter to 9.75?
A. Yes, I didn't -- well, excuse me. Let me back up. I did not disregard the range.
Q. Okay. What -- what did you do?

A. I -- I was -- I'm still within the range, but I just chose the lower half because of my observations on the investment community's -- community's commentary on nonregulated activities of these comparable companies which can comprise almost 30 percent of the -- of the net income at times, and then also understanding their views on -- on the risk reduction benefits of a -- of a decoupled rate design.

Q. So that was a judgment thing you made based on that information?

A. Yes.

Q. Okay. Now, do you have your surrebuttal testimony there in front of you?

A. Yes.

Q. And if you could look on page 7, I believe.

A. Yes.

Q. On page 7 of your surrebuttal testimony, you refer to a March 9, 2009 Goldman Sachs report; is that true?

A. Yes.

Q. And that report assumes a 10 to a 10 and a half percent allowed ROE; is that right?

A. Yes.

Q. But then down on lines 26 and 27, you say you disregard that Goldman Sachs report and the 10 and -- the 10 and a half percent range contained in that report because it does not conform to your own DCF analysis; is that true?

A. I don't -- I don't believe I disregarded it.

Q. Well, your -- the statement I'm looking at begins on line 26 of page 7, and you say, "Staff's estimated cost of equity based on its DCF analysis does not confirm this to be the case."

A. Yes, I was -- I was explaining some context on estimated cost of equity.

Q. So let me ask you first of all, you're making a judgment at that point?

A. I'm sorry. Please rephrase or clarify a "judgment" by what...

Q. Well, do you believe that the -- let me ask you this question: Do you believe that the statement in the March 9, 2009 Goldman Sachs report assuming a 10 to 10 and a half percent long-term allowed ROE is accurate and correct and should be relied upon?

A. It is accurate and correct as based -- that's their analysis, yes, that's correct.

Q. And should it be relied upon?
A. That's -- relied upon for what? I'm sorry. I --
Q. For any purpose.
A. For any purpose, sure, yes.
Q. Okay. And what purpose would you rely on it for?
A. To understand the context of what allowed returns have been and -- and, you know, what may influence them to -- to become -- go lower.
Q. And should this Commission rely on it for purposes of setting rates in this case?
A. It's a consideration, yes.
Q. Okay. Let me ask you just a couple of questions about your short-term debt cost. Would you agree that there's a pretty significant difference between your position on that and the positions of the other two parties in this case, the company and the Public Counsel?
A. Yes.
Q. Would it be fair to say that with regard to your seven proxy companies that the precise short-term debt costs for each of those companies is not available?
A. No.

Q. It is available?
A. Yes.
Q. Would you --
A. Not for all of them, but it is available for -- for -- for several of them.
Q. And -- and which ones is it available for?
A. I'd -- I'd have to go back and look at the -- the 10Q's, but I do know that there's probably at least a couple other that it was available for as of the second quarter 10Q. The reason why I selected the two A-rated companies was because that was the average credit rating, the proxy group. And if you're going to try to, you know, assume a -- the, you know, same risk, if you will, for -- for proxy group for MGE as -- as -- as reflected in an A credit rating, I felt it was most appropriate to rely on those two companies.

But by and large, all the companies I've looked at, even the ones that may have a triple B credit rating, the average cost of short-term debt -- weighted average cost of short-term debt reflected in their 10Q's was -- they were all below 1 percent.
Q. Let me ask you: Is your recommendation based on what could be called a spot cost rate?

A. No.
Q. What is a spot cost rate?
A. Spot would be right as of like today if we looked at the Wall Street Journal and looked at the commercial paper rate.
Q. Would you agree that a short-term debt rate -- a short-term cost debt rate, at least for ratemaking purposes, should be indicative of a representative future period of time when the new rates resulting from, for example, this proceeding will be in effect?
A. Yes.
Q. And would you agree that historical short-term borrowings may not be indicative of this future?
A. Yes.
MR. SWEARENGEN: That's all I have. Thank you.
JUDGE PRIDGIN: Mr. Swearengen, thank you.
MR. SWEARENGEN: I would offer Exhibit 98.
JUDGE PRIDGIN: 98 has been offered. Any objections?
(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, 98 is admitted.

(EXHIBIT NO. 98 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

JUDGE PRIDGIN: Let's see if we have any bench questions. Commissioner Davis?

COMMISSIONER DAVIS: I'll pass and let my colleagues go first.

COMMISSIONER JARRETT: I don't have any questions.

JUDGE PRIDGIN: Commissioner Jarrett, no questions. Commissioner Kenney?

QUESTIONS BY COMMISSIONER KENNEY:

Q. I have one question of the calculation of short-term debt. Thanks for your time.

A. Good morning, Commissioner.

Q. Good morning. The -- and I'm looking at the Staff's cost of service report. It was Piedmont Natural Gas and New Jersey Resources Company that you looked at to compute the short-term debt cost; is that right?

A. Yes. Let me just make sure the -- let me look at the credit ratings and I'll tell you exactly for sure. That's correct.

Q. And that's a historical look to arrive

at that 1 percent, right?
A. This year, yes.
Q. And Mr. Swearengen was just intimating that a more accurate way to do it would be to look forward and look at a future -- forward-looking short-term borrowing, and you agreed with him that that would be a correct way to do it?
A. Well, to -- to the extent somebody could predict the future?
Q. Well, I guess my question is why did you choose one method versus -- versus the other?
A. Well, the reason why I chose the cost of short-term debt that is reflected and being incurred by companies including Laclede Gas in -- in the State of Missouri at, you know, levels below 1 percent is because these companies do have access to commercial paper. That is the -- the reality of the capital markets at this point in time.
How long are -- are short-term rates going to stay as low as they are? You know, that probably depends on when the Feds start to reverse its course on -- on providing liquidity. The -- you know, I've seen some projections that say that could go into, you know, 2010. How much will they tighten up? You know, I -- I don't know and I don't know

when they will start doing that.

Could -- could these remain in effect for three years? They may. We are in unchartered territory, as everybody is well aware of, and these are very low costs and they are costs that I discovered are -- are also passed through in Laclede's purchased gas adjustment. Now, it's done a little differently, but -- but those are real costs that would be passed through into rates.

Q. In your best educated guess, will these rates remain in effect, again, to the extent that you can read the future, at least, the end of February of 2010?

A. Yes, I've seen -- I look back at -- I think this is in my testimony. I looked at -- back in 2002 to 2004. That was the last time that the Fed kept the -- the Fed Fund rate at about 1 percent. And that was the last time the Fed was actually concerned about deflation, and it kept, you know, the -- the -- the LIBOR rates and the commercial paper rates stayed at a low level for -- for about three years.

COMMISSIONER KENNEY: That's it. Thank you.

THE WITNESS: Thank you.

JUDGE PRIDGIN: Commissioner Kenney, thank you. Commissioner Davis?

QUESTIONS BY COMMISSIONER DAVIS:

Q. Good morning, Mr. Murray.

A. Good morning, Commissioner Davis.

Q. What's been marked, filed and offered into evidence as pages 6 through 42 of Staff's class cost of service report, that's your testimony, correct?

A. Yes.

Q. Okay. And you've also filed rebuttal and surrebuttal testimony in this case, correct?

A. Yes.

Q. And this is your impartial testimony, correct?

A. Yes.

Q. And just so we're clear -- I've got the dictionary here. Impartial means not partial or biased, unprejudiced; is that correct?

A. Yes.

Q. Are you okay with that definition?

A. I'm okay with that definition.

Q. All right. Mr. Murray, can you -- do you have your Staff's class cost of service study there with you?

A. No, I do not.
COMMISSIONER DAVIS: Can someone be generous and provide Mr. Murray with a copy?
THE WITNESS: I'm sorry. You're -- you're talking about --
MR. THOMPSON: Yes, yes.
BY COMMISSIONER DAVIS:
Q. You got your --
A. Okay. I'm sorry. Yes, I do.
Q. You've got the class cost of service study and the appendices?
A. Yes, I do. That's correct, sir.
Q. Okay. Can you turn to page 28 and 29?
A. Yes.
Q. Okay. Now, in selecting your proxy group, you started with a list of 11 utilities that was covered by Edward Jones in their natural gas industry summary, correct?
A. Yes.
Q. Would you agree with me that there are more than 11 natural gas utilities in the United States, distribution utilities?
A. I'm not sure if I agree that they're pure play natural gas utilities.
Q. Okay. But you agree that they're --

well...

A. I agree they may have -- they may have some --

Q. Okay.

A. -- natural gas utility operations, but I'm not sure that they would be pure play.

Q. Okay. But in fact, are the utilities in your proxy group pure play?

A. Pure play as we can get in the -- in the environment. Like I said --

Q. Because you said -- because you've said in your testimony --

A. Yeah.

Q. -- that your proxy group is different, that when you're going with the MGE hypothetical, it is a pure play but your proxy group is not, correct? That was your testimony, wasn't it?

A. I'm sorry. Please ask the question again.

Q. In -- in -- in your testimony, I believe it was on either rebuttal or surrebuttal, you talked about how MGE's -- the hypothetical or MGE that's standalone from Southern Union is, in fact, a pure play utility and that the utilities in your proxy group are not so much pure play and that they have other unregulated activities that make them, in fact, riskier than MGE's hypothetical, correct?

A. Than -- than -- than MGE itself, that's correct.

Q. Okay. All right. Mr. Murray, did you review Mr. Lawton's testimony?

A. Yes, I did.

Q. Do you recall what criteria he used to select his proxy group?

A. I know he looked at Value Line and looked at their natural gas, a very general classification for gas utilities. I -- I -- Value Line is very broad.

Q. Right. Wasn't a nice number set of criteria like yours on page 29, though, was it?

A. No, I -- I don't recall specifically what he -- I just know he started the Value Line gas utilities.

Q. Okay. Looking at page 29, lines -- lines 11 through 14, you see the -- the sequence of numbers there?

A. Yes, and there's a mistake.

Q. There's a mistake?

A. One, two, three, four --

Q. Now --

A. -- five, six, seven.
Q. Yeah.
A. So I made a mistake.
Q. Eight -- eight should -- eight should be seven?
A. Yeah, I'm sorry. I apologize.
Q. And was that -- was that mistake caused when you were basically -- you took your -- your testimony from the previous case and then were just updating it for this case?
A. Yes. I probably looked at some other factors because, you know, obviously --
Q. Right.
A. -- there's things like with the companies, they change and the -- and a dynamics change.
Q. So you're using -- you're not using the same set of criteria to select your proxy group in this case that you used in GR-2006-422, are you?
A. Not exactly the same, no.
Q. No. And in GR-2006-422, you didn't use the same set of proxy group or comparable group selection criteria that you used in Case No. GR-2004-209, correct?
A. I believe that's correct. I don't

remember the specifics, but I believe -- I believe that's correct.

Q. Okay. And so the proxy group selection criteria that you used in this case, the 2009 case, is also different from your -- from your 2004 selection criteria, correct?

A. Yes. And if you want me to look at some specific ones, I can tell you which ones I've changed.

Q. No, that's okay. You're okay.

A. Okay.

Q. So Mr. Murray, it's fair to say that in the last three instances where you've provided testimony with regard to cost of capital for MGE that you've never used the same set of comparable group selection criteria twice, have you?

A. In the last three MGE cases?

Q. The last three MGE rate cases where you have provided cost of capital testimony, is it fair to say that you have not used the same set of comparable group selection criteria twice?

A. The exact same, that's correct.

Q. Okay. Now, can you go back to -- can you go to schedule 9 in the appendix?

A. Yes.

Q. Okay. Now, when you compute a proxy group capital structure there, you just take the simple average of the capital structures, correct?

A. Yes.

Q. Okay. Now, would you agree with me -- well, first of all, did you -- did you compute a weighted average of the capital structures?

A. It's weighted in the context of the individual companies, but as far as the -- when you go to the last column where it says "Simple average," it's a simple average of all seven companies.

Q. Right.

A. No capitalization, no higher capitalization companies get more weight.

Q. In your analysis, correct?

A. That's correct.

Q. Okay. So if we had taken a weighted average, we would have gotten a different number, correct?

A. You would have had companies that are a little larger -- I mean, you -- the larger companies would have received more weight, that's correct.

Q. That's right. So if I had taken a weighted average and come up with a average common equity of 51 point -- I'm sorry. I'm going to have to look at my -- yeah. If I would come up with a common equity percentage of 51.88 percent, long-term debt of 38.25 percent and short-term debt of 9.8 percent on a weighted basis, you'd have no reason to dispute that, would you?

A. I would want to check your calculations, but I have no reason to dispute that.

Q. Well -- well, how about you check -- check my calculations and get back to me?

A. Okay. Thank you.

Q. Okay. Now, let's go back to your direct testimony. On page 25, you indicate that Southern Union doesn't manage its finances separately from its Panhandle subsidiary. You cited that issuance by Panhandle is proof that Southern Union doesn't manage its finances separately; is that correct?

A. Yes.

Q. Haven't we always known this to be the case?

A. No.

Q. No. Okay. You hold that thought. Did you listen to any of -- any of Mr. Hack's testimony yesterday?

A. No, unfortunately. I was gone, sir.

Q. Okay. So do you know anything about

the -- the financial accounting standard No. 106, the OPEB issue that Mr. Oligschlaeger has raised?

A. No.

Q. Okay. Okay. Now, on page 24, lines 18 and 19, you talk about Southern issuing -- Southern Union issuing $100 million of 6.089 percent secured notes on February 16th, 2008, correct?

A. Yes.

Q. And the rest of the debt issued since the last -- last rate case was issued by Panhandle, correct?

A. Yes.

Q. Now, in calculating your cost of long-term debt for your proxy group, you had a number that I believe was, what, 5.92, is that --

A. Yes.

Q. That's right? So the actual cost of that debt was only 17 basis points away from the debt of your proxy group, correct? That 100 million issued by...

A. Oh, the 6.089, but that was just one debt issue.

Q. I -- I understand.

A. I understand, yes. Yeah, that's correct.

Q. That one debt -- that one debt -- debt issue, so --
A. Yes.
Q. Okay. Now, we go -- go to the Panhandle issue. They issued 7 percent senior notes and Southern Union in turn used those proceeds to pay off some notes to retire about another $425 million in debt, correct?
A. Yes.
Q. Okay. And you would agree with me that -- that 7 percent is about 75 basis points above the -- the actual cost of debt for MGE -- or for Southern Union, correct?
A. I think it's probably more like 85, but that's pretty close, yes.
Q. Pretty close, okay. Now, line 14 of page 25, you say that this is -- this is -- this is the new information, correct?
A. Yes.
Q. Okay. And you've stated previously that MGE -- that this is a new concept that MGE has not been intermingling the funds of its subsidiary and its divisions and everything; is that correct?
A. Yes.
Q. And you go on to say, "Because

performing such an approach would require debate on which debt to include in the cost of debt and whether the cost of this debt should be adjusted to consider Southern Union's lower credit rating, Staff believes the parties and the Commission's time would be more efficiently spent debating the proper hypothetical capital structure methodology as well as determining a reasonable allowed ROE for a regulated natural gas utility"; is that correct?

A. Yes.

Q. So Mr. Murray, you're here today to tell me that a group of people, being the Staff, that's willing to file testimony in this case three feet high is afraid of a little hard work, is that what you're telling me?

A. No.

Q. Okay. Are you telling me that a person like yourself who -- who studies every nuance of detail related to ROE and capital structure doesn't want to go to the trouble of having a debate?

A. No.

Q. You're not pulling my leg, are you Mr. Murray?

A. No.

Q. That's a figure of speech. Okay. Now, you did say -- it is fair to say that in employing the actual capital structure, you would have to debate whether the cost of debt should be adjusted to consider Southern Union's low credit rating, correct?

A. Yes.

Q. And that's one of the reasons why you'd rather spend your time arguing about what a good gas utility ought to be earning, correct?

A. Yes. And let me -- if you -- can I explain one thing here? Some of this has to do with experience with Aquila over the years. As you've -- as you've probably -- as everybody is aware, the -- with Aquila, we've dealt with these debt assignments and which may be based on a spot rate as of any given point in time.

And -- and while we all have, you know, our -- our opinions on -- on maybe the proper way to -- to -- to reduce, adjust the cost of debt because of all these other activities that whether fortunately or unfortunately these companies get into, you know, we -- it is not a mechanical calculation. I think a lot of the textbooks that we've -- you know, that have been mentioned in the utility ratemaking setting, you know, anticipated mechanical calculations of debt.

And to the extent that -- to the extent that the risk profile of these entities are affected by other operations, not only is ROE going to be something that is a matter of judgment, now it's going to be the cost of debt which becomes artful and you can have a variety of adjustments to that. And -- and -- and Staff has experienced that with Aquila over the years, and in my opinion gained some wisdom from that.

Q. Okay. Now, Mr. Murray, we've established previously that you provided direct, rebuttal and surrebuttal testimony in MGE's rate case GR-2004-209, correct?

A. Yes.

Q. Okay. I'm going to read to you a quote from page 22 of your direct testimony for those of you who are paying attention.

MR. THOMPSON: Direct testimony in this case?

COMMISSIONER DAVIS: Direct testimony -- no, no. This is from the 2004-209 case, Mr. Thompson.

MR. THOMPSON: Thank you, sir.

BY COMMISSIONER DAVIS:

Q. Before we get there, Mr. Murray, do you write your own questions in -- in -- in this testimony, direct, rebuttal and surrebuttal, do you write your own questions?

A. Yes. Some of those questions may have been carried on from other testimonies, you know, but -- but -- but I agree to them before I --

Q. Okay.

A. -- accept them.

Q. All right. Why didn't -- here's the question: "Why didn't you utilize the preceding capital structure for purposes of your recommended rate of return in this case?

"A, Answer: Southern Union's divisions receive capital from the corporate treasury, and this corporate treasury can have various mixes of capital in it at any given point in time with debt proceeds from various debt issuances. Therefore, it is appropriate to utilize Southern Union's consolidated capital structure, if it is reasonable, because it is verifiable and represents how Southern Union's divisions are capitalized.

"Additionally, Southern Union's credit rating is a function of its consolidated capital structure, not on the hypothetical of what Southern Union might be if one tried to exclude the Panhandle operations. S&P does not evaluate the creditworthiness of Southern Union's natural gas distribution operations on a standalone basis because they are not subsidiaries that issue their own debt.

"Therefore, no objective analysis has been performed that would indicate if a 15.42 percent common equity ratio for natural gas distribution operations would be appropriate for a triple B-rated natural gas distribution company. If Southern Union's natural gas distribution operations were spun off into their own subsidiary and this subsidiary were ringfenced from the rest of Southern Union's operations, then it may be possible to analyze the capital structure of Southern Union's natural gas distribution operations and determine if credit rating agencies believe the capital structure is adequate for an investment grade credit rating." That was your testimony then, correct?

A. Yes. Was that surrebuttal or rebuttal, I'm not --

Q. No. That was direct. We'll get to rebuttal here in just --

A. Okay.

Q. -- we'll get to rebuttal here in just a minute.

A. Thank you.

Q. Okay. Now we're going to go to your rebuttal testimony. Okay. Do you recall your rebuttal testimony in GR-2004-209, page 11, when you were speaking to this Commission regarding the appropriateness of using Southern Union's actual capital structure?

You noted that in the two previous Aquila rate cases, Cases No. ER-2004-34 and ER-2001-672, you said, "If MPS were a subsidiary of Utilicorp and it issued its own debt capital, then the MPS capital structure would be a reliable capital structure because MPS would have its own capital structure."

A. Yes, sir.

Q. Okay. Mr. Murray, is MGE a subsidiary or division of Southern Union?

A. A division.

Q. Okay. Okay. Let's go to your surrebuttal testimony in that case. Page 36, starting with line 1. "Are there any sources that you are familiar with that give some guidance as to when one might recommend the consolidated capital structure?

"Answer: Yes. In David C. Parcell's

book, The Cost of Capital: A Practitioner's Guide, the following guidance is given to help determine if a consolidated capital structure is appropriate or if a subsidiary capital structure is appropriate.

"'Subsidiary versus consolidated capital structure. Many utilities are subsidiaries of other companies which can be holding companies, other utilities or diversified companies. When a utility is a subsidiary of another firm, the question frequently arises as to whether the proper ratemaking capital structure is represented by the utility or its parents.

"'Among the considerations which help determine whether the utility versus parent capital structure is appropriate are, one, whether subsidiary utilities obtain all of its capital from its parents or issues its own debt and preferred stock; two, whether parent guarantees any of the securities issued by the subsidiary; three, whether a subsidiary's capital structure is independent of its parents, i.e., existence of double leverage, absence of proper relationship between risk and leverage of utility and nonutility subsidiaries; four, whether parent or consolidated enterprises diversified into nonutility operations.'

"Question: Isn't the above reference addressing whether to use a subsidiary capital structure or a consolidated capital structure rather than a capital structure for a division such as MGE?

"Answer: Yes. However, I believe this provides even stronger support for the use of the consolidated capital structure because divisions, unlike subsidiaries, aren't even separate legal entities that issue their own capital. This supports why Staff has applied the consolidated capital structure when recommending a rate of return for the divisions of the operating companies as Staff has done for Aquila's Missouri operating divisions in the past." Do you recall those statements?

A. Yes.

Q. Okay. Mr. Murray, since Southern Union acquired MGE in 2003, has MGE issued any of its own debt?

A. Southern Union acquired MGE in 2003 or is it 1995?

Q. I don't know. Well, has MGE issued any of its own debt since Southern Union acquired it?

A. No.

Q. Okay. And Mr. Murray, you've testified here in this case that MGE's comparable companies would have most likely issued debt in the period since MGE's last rate case, didn't you?

A. Yes.

Q. Okay. Just a second, Mr. Murray. Okay. This is from your rebuttal testimony, Case No. GR-2004-209, page 11, line 20. "Question: What capital structure currently supports Southern Union's investment grade credit rating? Which is the credit rating that is associated with the cost of Southern Union's debt that is charged to MGE ratepayers?

"Answer: Southern Union's on a consolidated basis including Panhandle.

"Question: What capital structure will support Southern Union's credit rating in the future?

"Answer: Southern Union's on a consolidated basis. Therefore, this is the appropriate capital structure to use in this case for ratemaking purposes."

Okay. Now let's go to line -- we're going to go to page 16 of your rebuttal testimony, lines 12 through 20. "Question: Did you make any adjustments to your cost of debt to take into consideration the fact that your comparable group of natural gas utility companies had an average credit rating of an A versus Southern Union's triple B credit rating?

"Answer: No, because I recommended Southern Union's actual consolidated capital structure as of the end of the update period. Because Southern Union is still rated investment grade, this capital structure is appropriate for ratemaking purposes. If I had used a capital structure that was less leveraged than Southern Union's capital structure, then I would have had to consider making a downward adjustment to my recommended embedded cost of long-term debt."

Mr. Murray, is Southern Union still investment grade today?

A. Yes, they are.

Q. Okay. Now, here's a question, page 16, your rebuttal testimony in the 2004 case, lines 21 through 23. "Did you make any adjustments to your cost of common equity recommendation to take into consideration that your proxy group had a better credit rating than Southern Union?

"Answer: Yes, I made an upward adjustment of 32 basis points to my cost of common equity recommendation for MGE to take into consideration the risk differential between the risks that are associated with Southern Union and its more leveraged capital structure versus the comparable group that I use." Do you recall that statement?

A. Yes.

Q. Okay. Now we're going to go to page 21, line 19. There's another statement from you, Mr. Murray. "Actually, it is because Southern Union has a triple B credit rating that I decided to make an adjustment to my proxy group cost of common equity because the average credit rating of my comparable group was A. The difference in credit ratings indicates that investors will expect a higher rate of return because of the increased risks associated with Southern Union." Is that a correct statement, Mr. Murray?

A. Yes.

Q. So when using the actual capital structure in the 2004 MGE rate case, you recommended an upward adjustment of 32 basis points to your cost of common equity to account for the differences between your proxy group and the actual capital structure of SUG, correct?

A. Due to the credit rating differences. I want to specify --

Q. Uh-huh, okay.

A. -- yes, yes, but I did recommend an

upward adjustment due -- due to the credit rating differences, yes.
Q. Right.
A. Which --
Q. And that was the -- and that was the difference between A-rated utility bonds and triple B-rated utility bonds, correct?
A. Yes. And that -- and that -- because at the time, Southern Union was still predominantly a -- a natural gas distribution/transportation company.
Q. Okay.
A. So I think -- I think it's attributed a lot to the financial risk because they do have a different capital structure. There's no doubt that Southern Union has always had a more leveraged capital structure than natural gas distribution utilities.
Q. All right. Thank you, Mr. Murray. Mr. Murray, do you know what the spread is between A-rated utility bonds and triple B-rated utility bonds today?
A. It -- it was higher, it's coming down. I don't know what it is right -- as of right now. I think at times it -- it was brutal. It was quite high at the end of '08, extremely high. I think I --

actually, I mentioned that in my testimony, if I recall correctly.

Q. Right. Does the Public Service Commission have a subscription to Value Line?

A. Yes, we do.

Q. And you rely on Value Line Investment Services in preparing your testimony, do you not?

A. Yes. And actually, I did look at this just recently. These are spot yields, and -- and as we've talked about, you want to be careful with spot yields. But as of 10/21/09, according to Value Line, the spot yield as -- was 6.16 for -- for triple B and 5.53 for single A.

Q. Okay.

A. So you're talking about 60 -- you know, over 60 basis points.

Q. And -- and -- and what was it a year ago?

A. You had --

Q. Doesn't Value Line, if you get the paper, get you -- you get three columns? You get one for current, one for --

A. Three months ago, a year ago, you're right. A year ago it was, wow, only five basis points. That was spot yield, mind you. I mean, so

who knows what's going on with the markets --
Q. All right.
A. -- at that point in time?
Q. All right.
A. But you know, three months ago -- let me -- I'll give you some information that I think you're trying to get at here -- is three months ago, 6.97 versus 5.81.
Q. Uh-huh.
A. So over 100 basis points. So yeah, it's -- it's been volatile.
Q. Okay. So let's just say that the -- is it fair to say that based on that spot -- spot check from Value Line, the current difference is about 60 basis points?
A. Yes.
Q. Okay. Now, Mr. Murray, do you have a copy of the true-up reconciliation filed by the -- by the Staff?
A. No.
COMMISSIONER DAVIS: Mr. Oligschlaeger, can you -- can you help Mr. Murray out here?
MR. OLIGSCHLAEGER: We can get one real quick.
COMMISSIONER DAVIS: You can get one? I

have my copy, but I don't have any others.

BY COMMISSIONER DAVIS:

Q. Okay. Looking at, I guess this would be page -- page 3, it would be the actual revenue requirement reconciliation, line 6. The -- the revenue requirement value of return on equity is listed as approximately $5,034,947, correct?

A. Yes.

Q. Okay. And the difference in terms of basis points in the revised reconciliation is the difference between Mr. Hanley's 10.5 and your 9.5 percent return on equity, correct? It would be 100 basis points, correct?

A. Yes.

Q. Okay. So if we divide 5 million by 100, we can determine that roughly every basis point is worth approximately $50,000, correct?

A. Yes.

Q. Okay. So if every basis point is worth $50,000 and if we assume that today the difference between A-rated utility bonds and triple B-rated utility bonds is 60 basis points, and we applied that to the same logic you used in the 2004 MGE rate case, MGE would be entitled to a $3 million adjustment for a difference in the comparable group size if we were

using MGE's actual capital structure, correct?
A. Yes, but there would be some offset on the capital structure, I believe, so...
Q. Yes, yes.
A. Yeah. So -- but yes, I mean, that's --
Q. Right.
A. -- the value of the ROE --
Q. So it would be -- that would be $3 million gross -- no -- yeah, gross before you -- and then you'd have to net out the change in the capital structure, correct?
A. Yes, because that would apply to --
Q. Yeah.
A. -- I'll accept OPC's equity ratio of 39 percent, I believe it is, somewhere around there.
Q. All right. All right. Can we go back to schedule 10 in the Staff cost of service appendix? Okay. And do you -- do you have a revised schedule 10 in either your rebuttal or surrebuttal testimony?
A. No. It's -- I didn't make any changes.
Q. Okay. All right. Well, Mr. Murray, the first company you have listed there is AGO Resources, Incorporated, correct?
A. Yes.

Q. And so what you do is you divide the interest expense in column 3 by the amount of outstanding debt to get the -- the average or the state of -- stated cost of long-term debt in column 4, correct?
A. Yes.
Q. Okay.
A. Those -- yes, that's correct.
Q. Okay. Now, Mr. Murray, do you have a calculator?
A. Actually, I think I do, yes.
Q. Okay. Let's go down and look at the totals. If we divide 403,672 by 6,675,515, what number do you get?
A. That's 6.05 percent. That's a weighted average.
Q. That's a weighted average, okay. But that's different than the 5.82 percent that you have on your page, correct?
A. That's a simple average, that's correct.
Q. Okay. Then you allow ten basis points for issuance costs, do you not?
A. Yes.
Q. Okay. So if we added ten basis points to the weighted average, we'd get 6.15 percent, would

we not?

A. Yes.

Q. Okay. And am I correct in recalling that Mr. Hanley testified that Southern Union's actual average cost of long-term debt is a percentage with something like 6.258 percent; is that correct?

A. That's approximate. It's in the low 6 percent range.

Q. Okay. And would you agree with me that 6.15 percent is closer to 6.25 percent than it is to your 5.92 percent?

A. Yeah, I think it's ten basis points versus -- versus 23; is that right?

Q. Uh-huh. Now, let's go back and look at column 4 here, the stated cost of long-term debt. You've got seven utilities in your proxy group, so you've got seven averages. What is the median of that group?

A. It's the middlemost, so it would be No. 4. So 5, if you want to rank them here, 1, 2, 3. Sorry.

Q. That's all right.

A. 6.07 percent.

Q. 6.07 percent. And if we added ten basis points for issuance cost, it would be 6.17 percent,

would it not?
A. Sure, yes.
Q. Okay. All right. Now let's move on to your CAPM analysis. Your direct testimony indicates that you believe that the constant growth DCF model is the model to be used when calculating a utility's cost of common equity, correct?
A. Yes.
Q. Now, you -- you did calculate the CAPM analysis and then you disregarded it -- discarded it because it yielded, quote, unreasonably low results, correct?
A. Yes. It didn't influence my final recommendation. I -- I -- I always take insight from it, I don't just disregard it. But as far as my ultimate recommendation, yes, you are correct.
Q. Okay. In your CAPM analysis, you use two risk premiums, the arithmetic and the geometric, and then you average those two results together, correct?
A. Let me take a look at the specific schedule. I didn't average the two results, I just showed the two results.
Q. Okay. You just showed the two results.
A. Uh-huh.

Q. In the past have you averaged them?
A. I don't think I have.
Q. Okay.
A. You might know.
Q. Page 38 of your direct testimony, lines 14 and 15, and also on schedule 16 of the appendix, you indicate that the long-term arithmetic average of historical return differences from 1926 to 2008 was 5.6 percent, correct?
A. 1926 to 2008, 5.6 percent, that's correct.
Q. Okay. And that's the number that you used for the arithmetic average in your calculations, correct?
A. Yes.
COMMISSIONER DAVIS: Judge, I believe -- have we already had this admitted into evidence? I believe we have, haven't we?
JUDGE PRIDGIN: Let me look. One page.
COMMISSIONER DAVIS: Hmm?
JUDGE PRIDGIN: Only one page.
COMMISSIONER DAVIS: Only -- only one page, okay.
BY COMMISSIONER DAVIS:
Q. Well, Mr. Murray, I'm going to hand you

this book. Let see, it's already been marked. Now, can you -- can you show me in that book where you get the number 5.6 percent?

A. It might take a little bit because in our department we use the classic yearbook. You guys apparently have a different version of the Ibbotson book. It might take me a little while to find if the -- where the same information is at in this book.

Q. That's okay. Judge Pridgin doesn't look hungry yet.

A. Yes, it's on page 23. That's the same information that's in our book, but just in a different format.

Q. Okay. Now, Mr. Murray, is it fair to say that you go to -- go to table 21, or I guess it's 21 in the Ibbotson book. Apparently there's...

A. It's a different version.

Q. There's -- apparently there's different versions, but in your citations to the Ibbotson book, you don't say it's the classic version, do you?

A. 2009 yearbook, it's not the -- that's just specifically called the Valuation Yearbook.

Q. Uh-huh.

A. The 2009 yearbook, no, I don't specifically say the classic yearbook. I think that's how -- they -- they are expanding more and more and -- and -- and charging more and more for some of these publications. And -- but the very, you know, first publication that they -- really became widely available was the classic yearbook. It's a burgundy book.

Q. Okay. So you subtract the -- the arithmetic mean for the large company stock total returns of 11.7. You take -- that's your top number. And then you subtract it -- subtract it. Is it the long-term corporate bonds or the long-term government bonds?

A. Government bonds.

Q. Okay. Long-term government bonds, total returns, that's 5. -- 5.7 percent, correct?

A. Or was it 6. -- because it should be 5.6, 11.7 minus 6.1, right? Or did I miss something there?

Q. Right. And you're using -- you're using a 5.6 number for your arithmetic risk premium calculation saying it represents the difference of stocks over bonds from 2006 to 2008. And I'm still trying to figure out how you get -- okay. Here we go. Total returns -- okay. So you're -- you're subtracting total return?

A. You were right, and I -- and I apologize. You were right.

Q. Okay. So it's 11.7 minus 6.1, that's 5.6?

A. Yes.

Q. Now, is that the number that Ibbotson recommends that you use for making that calculation?

A. Ibbotson -- no, no.

Q. No, it's not?

A. No.

Q. As a matter of fact, they just recommend that you use the income portion, correct?

A. That -- that's correct.

Q. That's correct. So the actual historical equity risk premium that Ibbotson uses is 6 and a half percent, correct, first time period?

A. I think it would be something higher. I -- I don't recall because -- I don't even recall that that income return is in -- in the classic book. It's in this New Valuation edition.

Q. Uh-huh.

A. But it would be higher because the income is going to be just a smaller portion of total return.

Q. Okay. And -- and then obviously you

have the -- the same problem with your historical equity risk premium that you calculate on a -- on a geometric basis as well, that Ibbotson says the -- because Ibbotson only uses the income, they calculate the value as 5.7 and you calculate the value as 3.9?

A. I would say that's their opinion. I don't know if I would characterize it as a problem, but yes, that's correct.

Q. So you rely on their -- you rely on their data to make your calculations, but you don't rely on their methodology, is that a fair statement?

A. Yes.

Q. Okay. All right. So let's take a step back and look at your CAPM analysis one more time. So your direct testimony, you cited that the risk-free rate was a 30-year treasury bond, the yield for July was approximately 4.4 percent. Then in your surrebuttal you note that it was 4.37 percent in August and 4.9 percent in September, correct?

A. Yes.

Q. Okay. So if we were just going to average those numbers together, those last three months --

A. It would be lower.

Q. -- it would be approximately 4.3

percent, is that --
A. I'll accept that.
Q. -- is that fair?
A. That's fair.
Q. Okay. Well, I mean, you do -- you do that -- you do that analysis when you -- when you're doing your DCF analysis --
A. Three -- three months?
Q. Uh-huh, in your average?
A. Yes. There's -- there's some logic there, yes, without a doubt.
Q. I'm not disputing that there's some logic there. Okay. So in schedule 16 you take the Value Line beta for each of the seven companies in your proxy group?
A. Yes.
Q. Okay. Now, each individual beta has a weighted average, but again, you don't take the weighted average of -- of the betas based on company size, do you?
A. No. Simple average.
Q. Just a simple average. Okay. Now -- and your average for your proxy group was -- was .65, correct?
A. .66.

Q. .66, okay. So if we multiplied that number by the number that Ibbotson uses in the 2009 valuation yearbook that I have here, you would get .66 times 6.5 percent, so we'd roughly get 4.29 percent, correct?

A. That's exactly correct.

Q. Okay. So if we add that number to the 4.3 percent for the risk-free rate, that would get us roughly 8.59 percent?

A. That's correct.

Q. Okay. Now, if we're following the -- the Ibbotson formula, they suggest a size premium, do they not?

A. Yes, they have a very generic --

Q. A very -- a very generic -- as a matter of fact, Mr. -- Mr. Hanley noted it in his testimony?

A. Yes, and I'm not aware that this is done in practice by investors, but -- but yes, that -- that -- that is what Ibbotson has.

Q. Right. And Ibbotson puts it in their book, correct?

A. Yes, but I'm aware of other equity analysts that disregard it because -- because they're a monopoly.

Q. Right. But Mr. Hanley is an equity

analyst too, isn't he?
A. He doesn't make investment decisions. He's the rate of return witness.
Q. Okay. But it's possible that equity analysts do rely on it since it's in the book?
A. I haven't seen anything. I've seen to the contrary.
Q. Okay. Okay. But let's just assume that we are going to follow -- follow the book. The average market cap of your proxy group is less than 1.85 billion, correct?
A. That's -- that sounds about right, yes.
Q. So if we were going to use what the book says for a size premium, we'd either use the generic 1.7 percent adder for the low cap decile group or we'd go one step further and make a 1.62 percent adjustment because the average utility in that proxy group would actually fall into the seventh decile, wouldn't it?
A. I -- I can't -- I haven't looked at the details of this.
Q. You can't -- okay. So if we did follow Ibbotson's book and we made a size adjustment corresponding to the size of your -- your proxy group, you'd have no reason to -- to dispute that it

would be a 1.62 percent adder, correct?
A. I can't -- I have not looked at the specifics of these numbers.
Q. Okay. Okay. But if we added 1.6 percent --
A. And -- and can I offer something up? If there's concern about size, there's actually smaller companies in a comparable group. If -- you know, if you want to go directly to the market data, you can go to those smaller companies --
Q. Uh-huh.
A. -- instead of relying on -- I mean, I know there's a lot of theory. You know that -- what -- with the rate of return.
Q. Right.
A. And so, you know, I think there are other methodologies. Ibbotson has its --
Q. Right.
A. -- you know, has its reasons. But yeah, that is --
Q. Right.
A. -- that's -- that's a generic approach for small-size risk premium.
Q. Okay. All right. So if we did -- we did just follow the book, we'd add that in there and

then that would get us to approximately 10.2 percent. If you add 1.6 to the -- to the 8.59, that would roughly yield 10.19 percent, correct?
A. I'll -- I'll accept those numbers. Like I said, I have not looked at the details.
Q. Okay. Now, if we were going to perform a company-specific CAPM for -- for SUG, you know, obviously they've got a much different beta --
A. Uh-huh.
Q. -- don't they?
A. Yes.
Q. Do you know what their Value Line beta is?
A. It's higher than one. I don't recall the --
Q. All right. So we could use maybe 1.05, would that be a good -- do you think that would be a good estimate?
A. For -- for an explanation, that's fine.
Q. Okay. So obviously on a company-specific basis, if we just followed the -- the arithmetic numbers, multiplied 1.05 times 6.5 percent, you know, that gets us to roughly 6.8, you know, add that to your -- to your risk-free rate of 4.3 percent, that would be 11.1 percent, correct?

A. Yes.
Q. Okay.
A. Let me -- and I'll have to -- I know we've been going along with this process and I'm thinking because -- because of the -- the income return --
Q. Uh-huh.
A. -- the aspect of that -- that logic of the CAPM, you know --
Q. You've got a copy of Dr. Moran's book, don't you?
A. Yes, I do.
Q. And he -- and he says use income return.
A. Was that -- was that in the most recent book or did he it say in the -- in the '94 book as well?
Q. I know he -- I believe --
A. Did he change?
Q. I don't -- I don't know. Does he say it in the most recent book?
A. I'll have to look. I mean, I don't recall.
Q. But you can get back to us on that?
A. Sure.
Q. Okay. Okay. All right. Now, you use

both the arithmetic and the geometric mean in your testimony, correct?

A. Yes.

Q. And that's despite the fact that you insist that the geometric mean is more reliable?

A. Yes. And especially in certain markets it's more reliable.

Q. Okay.

A. And certain types of investments it's more reliable.

Q. All right. And so you've got the -- got the Ibbotson book, but you don't rely on the data the way Ibbotson recommends, do you?

A. The methodology is the way they recommend. I would say that's accurate.

Q. Okay. Okay. Mr. Murray, do you think some definitive guidance in the area of whether we should use the arithmetic for the geometric mean would be helpful? Do you think some definitive guidance would be helpful?

A. I think it would be helpful, but we do have to keep in mind the -- the -- what -- where the markets are at. I -- I think that to the extent that arithmetic is considered -- maybe given more weight would depend on maybe some of the current volatility in the market to the extent that investors, you know, are opening up their statements saying, oh, my God, what's going on? I mean, so the ups and downs of the market are starting to impact them.

But if you -- if you remember, there's many academics and investors that have said, hey, invest for the long run. That's what you need to keep in mind when you're looking at the risk of what your ending net value is going to be in your investment. Don't -- don't -- don't pay attention to the year-to-year or quarter-to-quarter.

But you -- if you go on arithmetic averages, you -- you can average it daily. The arithmetic averages in Ibbotson are -- are yearly. Who says that -- that investors look at it yearly? They may look at it every seven years or what have you.

So it's -- it's important to really understand, you know, what type of investors you're talking about. If you're investing for the long run, then the geometric average, the -- you know -- well, for instance, the MOSERS expected returns, the risk premium that they are expecting are -- are -- are requiring is based on their long run -- long run market return expectations which is not an arithmetic average.

Q. Are you done?

A. Yes.

Q. All right. Mr. Murray, I'm going to go to your rebuttal testimony in Case No. GR-2006-422 that was the previous MGE rate case, page 23, line 2. "As I mentioned in my direct testimony, the CFA program is internationally recognized and considered by many employers and investors as the, quote, definitive standard for measuring competence and integrity in the field of portfolio management and investment analysis.

"Many individuals that are pursuing their CFA designation may either work in the investment field or intend to work in the investment field. If these individuals employ a risk premium estimate as used in these textbooks, their valuation analysis will be based in part on historical geometric average risk premiums."

A. That's correct.

Q. Do you recall making that statement?

A. Yes, I do.

Q. Now, Mr. Murray, you are a candidate for the CFA designation, are you not?

A. I'm a level three candidate, that's

correct.

Q. You are a level three. So you've already passed the first two tests, correct?

A. Yes.

Q. Okay. So are you familiar with the CFA program curriculum?

A. Yes. Not as -- not as well as I'd like to be, but yes, as far as level three. But hopefully that will change this next year.

Q. Okay. And would you agree with me that the publications put out by the -- by the CFA program are authoritative sources in the investment field?

A. Yes.

Q. Mr. Murray, I'm going to read to you from the CFA program curriculum. This is -- this is volume one. This is the 2009 edition. You may -- you may have an older version.

A. Actually, they just gave out textbooks back then. They didn't even bound [sic] them for us.

Q. Right. This is page 306, "Using Geometric and Arithmetic Means. With the concept of descriptive statistics in hand, we will see why the geometric mean is appropriate for making investment statements about past performance. We will also explore why the arithmetic mean is appropriate for making investment statements in a forward-looking context." Do you agree with that statement?

A. Well, I -- that's a statement there, but there's also other statements in the CFA curriculum that say that geometrics should be used. And I have not reviewed that. That's probably material that may not have been in there whenever I took level one. I'd have to verify --

Q. Okay.

A. -- that to be the case, and I don't know who the author is of that.

Q. So let's go further here. This is the next-to-last paragraph on the page. "In addition to reporting historical performance, financial analysts need to calculate expected equity risk premiums in a forward-looking context. For this purpose, the arithmetic mean is appropriate." Do you agree or disagree?

A. It depends on the situation.

Q. Okay.

A. And I am curious about the change in the curriculum because I -- I provide citations in my testimony that indicate that the geometric mean should be used, and that's, you know, from some other sort of -- Reilly, Brown, maybe Demoterin [phonetic spelling], a couple others. So CFA is obviously, you know, changing some of their curriculum if that's something that is in there.

Q. All right. Now, you recall in your -- in your rebuttal testimony that page 19, line 16, the question is asked, "Should Mr. Hanley's B -- DCF be adjusted for MGE's small size?" Do you recall asking yourself that question?

A. Yes, I do.

Q. Okay. Then on page 19, lines 21 through 22 and page 20, lines 1 through 10, you cite an article by Dr. Annie Wong, associate professor at Western Connecticut State University that was published in the Journal of Midwest Finance Association, volume 22. And you stated on lines 1 and 2 of page 20 that, "The article refutes the need for an adjustment based on the smaller size of public utilities," correct?

A. Yes.

Q. Okay. Mr. Murray, I mean, you talked about citations. I mean, do you -- do you consider the way you cited that article a proper citation?

A. I cited the source and the volume, I did not cite the dates, so maybe I should have cited the date. So I apologize for not putting that in there.

Q. Do you -- do you recall when the article was published?

A. In the '90s.

Q. Okay. 1993, does that sound right?

A. That sounds about right.

Q. Okay. Do you have a copy of the article?

A. Yes, I do.

Q. Okay. So you'd know what it looks like, then?

A. Yes.

(EXHIBIT NO. 99 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

BY COMMISSIONER DAVIS:

Q. Mr. -- excuse me -- Mr. Murray, is that the complete article?

A. Yes.

Q. Okay. Could you please turn to the -- the last page of text, and could you read the entire conclusion which includes but is not limited to the -- the excerpt that you use in your rebuttal testimony?

A. You mean the entire section 6, "Concluding Remarks"?

Q. Uh-huh.

A. Okay. "The fact that the two samples show different, though weak, results indicates that utility and industrial stocks do not share the same characteristics. First, given firm size, utilities' stocks are consistently less risky than industrial stocks. Second, industrial betas tend to decrease with firm size, but utility betas do not.

"These findings may be attributed to the fact that all public utilities operate in an environment with regional monopolistic power and regulated financial structure. As a result, the business and financial risk are very similar among utilities regardless of their sizes. Therefore, utility betas would not necessarily be expected to be related to firm size.

"The objective of this study is determined if the size effects exist in the utility industry. After controlling for equity values, there's some weak evidence that firm size is a missing -- missing factor from the CAPM for the industrial but not for utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the finding suggests there's no need to adjust for the firm's size in utility rate regulations."

Q. Okay. Can you -- can you hand that back, please? So Mr. Murray, in including this quote in your rebuttal testimony, is it fair to say that you left out the -- the first sentence that says -- the first sentence of the Concluding Remarks that says, "The fact that the two samples showed different, though weak, results indicates that utility and industrial stocks do not share the same characteristics"?

A. Yes.

Q. Okay. And you also left out the -- I guess it would be the last sentence that says, "after controlling for equity values, there's some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for the utility stocks."

A. Yes.

Q. Okay. Is that the work of an impartial witness?

A. It's evidence -- evidence that refutes a generic study. I -- I mean, what are -- it's weak evidence or -- or -- or evidence that calls that into question whatsoever is -- is something that I think is -- is important to -- to provide and response to a very generic small size utility -- or not -- a small size risk premium adjustment that's based on companies that are in the competitive market.

I just wanted the Commission to be aware that there have been things looked at when -- when you're looking at a specific competitive market. The Ibbotson book is very generic as far as cost of capital.

And -- and also, you know, I'd like to point out once again that I've reviewed actual investment analysts that -- that do not make a small size risk premium adjustment because they're monopolies, and so it's done in practice. And these are the investors.

Q. Okay. And basically your argument is that based on this article, a size premium is inappropriate for -- for a public regulated utility, correct?

A. Yes.

Q. Does this article really demonstrate that or is a more accurate way to phrase it that it demonstrates that in the model used by Mrs. Wong, she could not find any evidence of a size differential for utilities?

A. In the model used, I -- I agree with that statement.

Q. Okay. Have you ever reviewed the -- the literature regarding this article to see if anyone has attempted to verify Ms. Wong's results in the last 16 years since its publication?

A. I don't recall anything offhand, no.

Q. So you're not aware of any testimony or articles refuting Mrs. Wong's conclusions?

A. The testimony in this case from Mr. Hanley, of course, but other than that, I don't -- I don't recall anything specific.

Q. Do you know Thomas Zepp?

A. Thomas Zepp. The name doesn't ring a bell.

Q. Okay. Okay. So you're not aware that he wrote an article entitled "Utility Stocks and the Size Effect Revisited," published in The Quarterly Review of Economics and Finance in 2003, you're not aware of that study, are you?

A. No.

Q. Okay. Wong relies -- I'm -- I'm going to -- I'm going read to you a statement. "Wong relies on Berry and Brown, 1984, and Brauer to suggest the small firm effect may be explained by differences in information available to investors of small and large firms.

"She states that the requirements of file reports and information generated during regulatory proceedings indicate the same amount of information is available for large and small utilities. And thus, if the differential information hypothesis explains the small firm effect, then the uniformity of the information available among utility firms would suggest the size effect should not be observed in the utility industry." Do you agree with that statement?

A. Yes.

Q. Okay. "But contrary to the facts she assumes, there are differences in information available for large and small utilities, more parties participate in proceedings for large utilities and thus generate more information." Do you agree with that statement?

A. Yes.

Q. Okay. "Also in some jurisdictions, smaller utilities are not required to file all of the information that is required of larger firms." Is that a fair statement?

A. Yes.

Q. "Thus, if the small firm effect is explained by differential information contrary to

Wong's hypothesis, differences in available information suggest there is a small firm effect in the utility industry. Wong did not discuss other potential explanations of the small firm effect for utilities." Do you agree with that statement?

A. I can't answer that.

Q. Okay. You think -- are you familiar with the concept thin trading bias?

A. Please -- I mean, it's something fairly general. I don't -- something -- thin trading bias, are you talking about the risk premium or --

Q. I'm talking about the fact that because a small utility is so small, many of its investors may, in fact, be -- be local owners and not institutional investors because there's not enough of the stock for the institutional investors to buy; therefore, the stock is not traded actively; therefore, it has a low beta. Are you familiar --

A. I'm not aware of the beta aspect, and I do -- I do know about the liquidity premium. I mean, obviously, you know --

Q. Because the beta is a measure of the correlation with the -- with the -- the average stock market, correct?

A. Covariance of the market is divided

by --

Q. Yeah.

A. -- the variance of the market.

Q. Okay. All right. Well, you're not -- okay. Did you analyze Wong's imperial -- empirical results?

A. I analyzed the article that you provided to me. As far as any follow-up, I have not reviewed that.

Q. Do you agree with Zepp's conclusion that her empirical results are not strong enough to include that beta risks of utilities are unrelated to size?

A. I don't have an opinion on that right now.

Q. Okay. Do you recall what -- what approach Wong used to estimate how well firm size and beta explained future returns in her -- in her periods of time that she used?

A. For cost, she did some -- she did a regression analysis, I mean, a fairly standard statistical analysis.

Q. All right. Okay. So you have no idea to know whether Zepp's conclusion is -- well, first of all, Zepp's conclusion is that the result is speaking -- in his analysis he reached a result that was statistically significant at the 90 percent level. In terms of the issue being addressed by Wong, the 99 basis could be the result of differences in beta risk, the small firm effect or some combination of the two?

A. I -- like I said, I -- I have not had a chance to look at that.

Q. Haven't had a chance, okay. Let me ask you one more question here. His conclusion. "Wong's concluding remarks should be reexamined and placed in perspective. She noted -- noted that industrial betas tend to decrease with increases in firm size, but the same relationship is not found in every period for the utilities." Would you -- would you agree that the -- she did not find the same relationship in every period for the utilities?

A. I don't -- I don't recall her specific finding. I do recall -- I mean, I'll just talk about some general knowledge here. I do recall Jeremy Siegel looking at some of the small size impacts and what have you, so the -- you know, the period of time selected is -- is -- it's very important.

Q. Right.

A. And I -- and I -- I think I recall 1970s to 1980s that Jeremy Siegel had questioned whether or not there was a small size effect even in -- in -- in the competitive market. So I mean, just like with anything else in rate of return, there's lots of differing opinions, I understand that.

Q. Right. So if she had used longer time intervals, she might have reached a totally different result; is that -- is that fair?

A. I'd have to look at the data. I -- I...

Q. Okay. Mr. Murray, going back to your rebuttal testimony, page 20, line 17 through 24, you ask yourself has Staff reviewed information in other rate cases that provide support that the size adjustment is not made in practice by investors; is -- is that correct?

A. Yes.

Q. And you cited a Duff & Phelps study to support your position?

A. Yes.

Q. And you were the witness who proffered that testimony, were you not?

A. Yes, I was.

Q. Mr. Murray, are you an accountant?

A. No, I am not.

Q. Okay. And the study conducted by Duff &

Phelps was, in fact, an asset impairment test performed to ensure compliance with one of the -- the FS -- FAS standards, correct?

A. Yeah, asset and fair -- fair value type of analysis, yes.

Q. Yeah. What is asset impairment testing?

A. It's to determine whether or not the value of an asset has -- has decreased to a point where you need to write that down and you have to use discount rates to determine what you think the fair value is in order to determine what is the appropriate write-down.

Q. Okay. So what Duff & Phelps was actually testing for was to determine if the recoverable amount of an asset was less than the amount being carried on the books?

A. Yes.

Q. And if that occurs, then the asset is impaired and the asset's carrying amount has to be reduced to the recoverable amount, correct?

A. Yes.

Q. Okay. Now, you agree that the asset impairment test that Duff & Phelps conducted was for the period of January 2003 through December 2005?

A. I don't recall specific dates, but

there -- there is some things in -- in -- in that case where -- it was confidential information, so I want to be careful. Now, I'm -- I'm just providing this as --

Q. Right.

A. -- as -- so as far as the specific dates, it had to do with the period of time when they were evaluating American Water assets before they -- RWE was -- was spinning them off.

Q. Okay.

A. Or partially spinning them off, excuse me.

Q. Do you know if the test was a prospective or a retrospective test?

A. Well, if you determine the value of an asset, it would really need to be prospective because, you know, that's the value as of -- that you'd be carrying on the books. But -- but as you pointed out, I'm not an accountant --

Q. Right.

A. -- and so if there's specific accounting rules that --

Q. So if they used -- they used historical data, you wouldn't -- you wouldn't know, then, correct?

A. No.
Q. Okay. All right. And talk about -- you -- was the asset impairment test, was that performed for ratemaking purposes, do you think?
A. Not that I'm aware of.
Q. Okay. And you would agree that in ratemaking, you know, we look at the -- the current and expected capital market conditions, correct?
A. Yes.
Q. Do you think that the market conditions in 2003, 2004, 2005 accurately reflect current investor expectations?
A. Well, I -- the -- the debate on a small size effect has occurred over many years, and that doesn't change regardless of what the capital markets are. I told you that as far as geometric versus arithmetic, I think you need to reevaluate that based on the capital market situation. But the small size effect, I mean, I don't know how long Ibbotson's been providing their data, but they've been advocating it for quite some time.
Q. Mr. Murray, did you answer my question?
A. Please repeat the question.
Q. Do you think that the market conditions in the 2003, 2004, 2005 time frame accurately reflect

current investor expectations?

A. They've changed.

Q. Okay. Thank you. Do you recall if Duff & Phelps used Value Line betas?

A. No, I don't recall.

Q. Okay. If they used an unadjusted beta from Barra, do you think that would make a difference on their outcome?

A. On the overall outcome, yes.

Q. Okay.

A. They're usually lower, I believe.

Q. Uh-huh. Do recall how Duff & Phelps calculated their equity risk premium?

A. I can't remember if they did an implied risk premium or -- I don't recall.

Q. Okay. Page 4 of your rebuttal testimony in this case, and you've referenced it, Mr. Thompson has referenced it, you reference -- you reference a March 9, 2009 Goldman Sachs report and another one on August 31st, 2009; is that -- is that correct?

A. I'm sorry. What page was that?

Q. Well, let's just go to your surrebuttal testimony, page 7.

A. Okay.

Q. Lines 10 through 21.

A. Okay. Yes, I'm there.
Q. You've got a -- you've got a specific citation to a Goldman Sachs, report, correct?
A. Yes, I do.
Q. Okay. Now, are you on the Goldman Sachs distribution list?
A. No, I am not.
Q. Do you get it through Research Regulatory Associates?
A. No.
Q. How do you receive it?
A. Actually, IBES, Institutional Brokerage Estimate System. They -- up until spring of this year, they were producing a IBES utility report that provided a lot of the raw numbers, you know, statistical data, means, medians, consensus, you know, three years -- three months ago, six months ago, what have -- what have you.
They discontinued that, and I told them, I said, "We paid for your service, so I expect to receive these IBES growth rates, you know, continuing forward because the Commission paid for this." And they said, "Hey, you know what we can do for you, we'll open up Knowledge Reuters which has information not just on IBES growth rates, but a variety of other

things, and you can look at it and see how useful you think this information is going to be, but we will not charge you any more than what you pay for the IBES growth rates which you will get in addition to this." So I thought it was a really good deal.

And -- and I -- I think it provided very good information, and I'd love to get some feedback from the Commission as to if you think this type of information is helpful in testing reasonableness of cost to equity recommendations because it -- it's available but it comes at a cost just like any of the other data that we have, whether it's a yearbook or what have you. But these are equity analysts.

But anyway, my point to that is, is that that's how I came across, you know, being able to get access to this Knowledge Reuters database which is available to Central Bank. I don't know about MOSERS, because they -- you know, they manage -- they work with the fund managers. I'm sure those fund managers have access to it.

But anyway, so that's -- that's how I gained access to that -- to that Knowledge Reuters. It was a negotiation.

Q.   Okay. Did you get permission from Goldman Sachs before reproducing a quote and using it

in your testimony?
A. No.
Q. Are you aware that Goldman Sachs has a policy that requires consent before you distribute their materials?
A. I didn't consider this a distribution, so -- but -- but no, I -- if they have that policy -- I think everybody probably has that policy, all these citations we have, but...
Q. Okay. Going back to your -- your direct testimony, your class cost of service report, lines 1 through 6 on page 36. Considering the -- I'm going to read this statement to you. "Considering the Commission's position regarding the quarterly compounding of dividends expressed in its Report and Order in the most recent Union Electric rate case, Case No. ER-2008-318, it is important to note that this dividend yield has not been adjusted for quarterly compound.
"Staff is attempting to estimate investors' expectations and because the Value Line quoted dividend yield does not reflect quarterly pound -- compounding. Staff is not convinced that investors analyze the expected dividend yield on a quarterly compounded basis." That's your statement,

correct?
A. Yes.
Q. Where -- when you say that "Staff is not convinced," you're applying the word "convinced" in the -- the normal and ordinary sense of the word, correct?
A. Yes.
Q. Okay. Mr. Murray, do you know what the -- you were -- were you listening in yesterday when -- when I asked the attorneys here present what the burden of proof is in this case?
A. I'm sorry. Once again, I was unable to.
Q. Okay. Do -- does Southern Union pay out its dividends annually or quarterly?
A. I believe they pay quarterly.
Q. Do the utilities in your proxy group pay dividends annually or quarterly?
A. I believe they pay quarterly.
Q. Okay. And when you use the geometric mean, use of the geometric mean implies a long-term buy and hold and growth strategy, does it not?
A. Yes.
Q. Okay. But you don't make a DCF -- quarterly DCF adjustment or even a semiannual DCF adjustment like Mr. Hanley did, do you?

A. No. I just take expected dividends for the next year, yes.

Q. Mr. Murray, in your future testimony when you cite articles, when you cite reports, do you think you could be so kind as to just go ahead and include a complete copy of the report with your -- with your testimony?

A. I would love to do that, and actually, if there is an opinion right now that I can do that -- I mean, because you asked about the copyright issue with Goldman Sachs. I would love to just provide all these reports. I think there was some dispute as to whether or not that was acceptable. So -- but I would -- I would -- I would like to do that.

Q. Do you think it would be possible for -- if you could get to Mr. Thompson and at least make it publicly available to any party and Commissioners who actually want to study that information?

A. Well, yeah. And if I can just get a little feedback here. It's my understanding that -- that if it's filed confidential in -- in -- in the context of a rate case, you would not have any copyright issues.

And I -- I guess -- you know, I'm not an attorney. I want to provide all the support that I use for my testimony. And regardless of what the article is, regardless of who the reporter is or, you know, the equity research analyst, just let me know if I can do so and I will do it.

Q. All right. Mr. Murray, this is your last question. Do you think it's possible for a person of reasonable intelligence with knowledge of all the pertinent facts in this case to question your impartiality?

A. Yes.

COMMISSIONER DAVIS: Thank you, Mr. Murray. No further questions.

JUDGE PRIDGIN: All right, Commissioner Davis. Thank you. This looks to be the natural break for lunch. It's about ten after 1:00 according to the clock at the back of the room. Let's reconvene at 2:15 or so. Is there anything further from counsel before we break for lunch?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Hearing nothing, we will go off the record. We will reconvene at 2:15.

(THE LUNCH RECESS WAS TAKEN.)

JUDGE PRIDGIN: Good afternoon. We're

back on the record. I believe when we left off, Mr. Murray was on the stand, and it will be time for recross from counsel. Mr. Murray, I'll remind you you're still under oath. Is there anything from counsel before we go on to recross-examination?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Hearing nothing, Mr. Poston, any recross?

MR. POSTON: I do not, thank you.

JUDGE PRIDGIN: Mr. Swearengen?

MR. SWEARENGEN: No, sir, thank you.

JUDGE PRIDGIN: Redirect, Mr. Thompson?

MR. THOMPSON: Thank you.

REDIRECT EXAMINATION BY MR. THOMPSON:

Q. Mr. Murray, do you have any influence at all on any of those other analysts that you cited?

A. No, I -- no, I do not.

Q. And with respect to the questions that Commissioner Davis asked you, is there anything in your testimony you want to change?

A. No, I do not.

Q. And finally, you are an impartial witness; is that correct?

A. In my opinion, yes, I am.

MR. THOMPSON: Thank you. No further

questions.

JUDGE PRIDGIN: Mr. Thompson, thank you. There's nothing further?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Mr. Murray, thank you very much. You can step down. And anything before Mr. Lawton takes the stand? Mr. Poston, do you have an opening statement?

MR. POSTON: Just a brief one, yes.

JUDGE PRIDGIN: Yes, sir. When you're ready, sir.

MR. POSTON: Thank you. Good afternoon. In the Commission's 2004, 2006 MGE rate cases, the Commission ordered Southern Union to use its own capital structure rather than a hypothetical capital structure. In 2004 the Commission concluded that when a business analyst such as Moody's or Standard & Poor's examines Southern Union to assess its creditworthiness, it looks to Southern Union's capital structure to make its determination.

In 2006 the Commission again stated that the capital structure of Southern Union is the result of its management decisions and it must live with those decisions. We support those findings and again urge the Commission to require Southern Union to use its capital structure and not a nonexistent hypothetical capital structure.

And contrary to Mr. Swearengen's assertions during his opening, the reasons we support this are not simply because it's how it was done before. If you read Mr. Lawton's testimony, you'll see why the Commission's prior decisions were right. Being consistent with these earlier decisions is -- is important because employing the proposed hypothetical capital structure will allow Southern Union to recover revenues in excess of costs.

Southern Union made the decisions to employ a substantially higher percentage of lower cost debt, and to employ a hypothetical capital structure would allow it to earn an equity return on certain capital that was financed by debt.

OPC -- OPC witness Mr. Lawton testified that given the company's rate base investment employing a hypothetical capital structure would allow Southern Union to recover 4.8 million in phantom equity return. We assert that to allow this is not just and reasonable.

Mr. Lawton also testified in support of a return on equity between 9.5 and 10.5 percent, and 10 percent being Mr. Lawton's midrange. If the

Commission chooses to adopt a straight fixed variable rate design, our evidence will show the Commission needs to recognize the reduction in business risk inherent in a rate design that virtually guarantees Southern Union will recover its margin of revenues.

This risk reduction can be recognized through 1.8 million reduction in cost of service which we are recommending or a 50 basis point reduction to ROE, both of which are supported by Mr. Lawton's testimony. Of course, if the Commission adopts OPC's proposed rate design and loss margin revenue recovery mechanism, an adjustment is not necessary. As I said, our witness is Mr. Daniel Lawton and I'd like to call him to the stand at this time.

JUDGE PRIDGIN: Mr. Poston, thank you. Mr. Lawton, if you'll come forward to be sworn, please, sir.

(The witness was sworn.)

JUDGE PRIDGIN: Thank you very much, sir. Please have a seat. Mr. Poston, any questions for him?

MR. POSTON: Thank you.

DIRECT EXAMINATION BY MR. POSTON:

Q. Can you please state your name.

A. Yes. My name is Daniel J. Lawton, L-a-w-t-o-n.

Q. And by who are you -- by whom are you employed and in what capacity?

A. I am self-employed. I'm an attorney with Lawton Law Firm, and my business address is 701 Brazos, Suite 500, Austin, Texas.

Q. Are you the same Daniel Lawton who prepared and caused to be filed direct, rebuttal and surrebuttal testimony that has been marked as Exhibit 69, 70 and 71 respectively?

A. Yes, I am.

Q. Do you have any changes to your testimony?

A. None that I'm aware of.

Q. If I were to ask you the same questions in your testimony today, would your answers be substantially the same?

A. Yes, they would.

MR. POSTON: Your Honor, I offer Exhibits 69, 70 and 71 into the record and tender Mr. Lawton for cross-examination.

JUDGE PRIDGIN: 69, 70 and 71 are offered. Any objections?

(NO RESPONSE.)

JUDGE PRIDGIN: Hearing none, 69, 70, 71 are admitted.

(EXHIBIT NOS. 69, 70 AND 71 WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

JUDGE PRIDGIN: See if we have any cross-examination. I don't see any other counsel on the record. Mr. Thompson, any questions?

MR. THOMPSON: I have no questions for this witness. Thank you.

JUDGE PRIDGIN: Thank you. Mr. Swearengen?

MR. SWEARENGEN: Yes, your Honor, I have a few. Thank you.

JUDGE PRIDGIN: When you're ready, sir.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Good afternoon, Mr. Lawton.

A. Good afternoon, Mr. Swearengen. How are you?

Q. Fine. Glad to see you here in Jefferson City.

A. Well, thank you, I appreciate it. It's nice.

Q. We need the economic stimulus.

A. I'll do all I can.

Q. We'll try to keep you here for a couple of days. Let me ask you, the -- the purpose of your testimony, I think, is simply to propose a capital structure and a cost of capital that the Commission's utilized in this case for purposes of setting MGE's rates. Is that a fair statement basically about what your -- your testimony covers?

A. Most everything. You left out the part on --

Q. I'm going to get to that.

A. Okay.

Q. You also are proposing a revenue adjustment, as I understand it, in the event the Commission allows Missouri Gas Energy to -- to continue to utilize a straight fixed variable rate design; is that true?

A. Not quite correct.

Q. Okay. Go -- correct me, then.

A. It's to continue to use the straight fixed variable as well as expand the straight fixed variable what was previously approved.

Q. Okay. Thank you. And I -- and I think -- I understand based on the pleadings in the case that -- and your counsel has said, an alternative to that revenue adjustment would be a

50 basis point downward adjustment to ROE in the event the straight fixed variable rate design continues. Is that your -- I didn't really see that in your testimony, but I understand your counsel is saying that's your position.

A. I -- in your question, I -- I don't relate that to what counsel said if you're talking about what he said a few moments ago in his opening statement, right?

Q. Right.

A. Your question -- could you repeat your question a little louder, sir?

Q. Well, what I'm trying to find out is, I understand you've got a $1.8 million revenue reduction proposed if the company is allowed to continue to have the straight fixed variable rate design and has that extended to some new customer classes? I think you just said that.

A. That is absolutely correct.

Q. Okay. Are you also proposing that as an alternative to that $1.8 million revenue reduction, a 50 basis point reduction to ROE?

A. Yeah, that's -- that's in the testimony. The evidence is in the record. If the Commission elects not to use a revenue requirement reduction, then a 50 basis point reduction ROE is an economic equivalent.

Q. Okay. All right. Thank you. I think you said in addition to your other qualifications that you have listed in your testimony, you mentioned that you're a licensed attorney; is that right?

A. Yes.

Q. In -- in what -- what jurisdictions are you licensed?

A. That would be Texas, not here.

Q. Okay. And I think I understand your testimony that for purposes of setting rates, you believe the Commission could -- should continue to do what it's done in the past, and that is use the Southern Union corporate capital structure, is that true?

A. Yes, that's what I proposed.

Q. What is your understanding of the relationship between Missouri Gas Energy on the one hand, the gas distribution company, and Southern Union Company on the other hand?

A. Missouri Gas Energy is a division of the Southern Union Gas Company -- or Southern Union Company.

Q. Okay. And Southern Union Company is a corporation, would that be your understanding?

A. Yes, it's incorporated in the state of Delaware.

Q. If I said Southern -- Missouri Gas Energy does not issue its own capital, you would agree with that, right?

A. Yes, it's totally reliant upon its corporate parent, Southern Union for all capital infusions.

Q. Is Southern Union to your knowledge involved in any other business other than the gas distribution business through Missouri Gas Energy?

A. Yes.

Q. And what are those businesses?

A. Those would be primarily gas transport, gas storage, some gas processing associated with its gathering operations.

Q. Would you agree that a relatively small percentage of Southern Union's business is involved in the distribution of natural gas?

A. If you -- "relatively small" is a relative term, so if we look at it in terms of revenues, the answer would be yes, it's under 20 percent. If you look at it in terms of assets, again, the answer would be yes. So we could measure it a number of ways. Those two measures are metrics, I think, to answer your question.

Q. Okay. Thank you. Would you agree that Southern Union Company is not known as a local gas distribution company?

A. Not anymore.

Q. Okay. It was at one time?

A. At one time it had a lot more gas distribution or LDC operations.

Q. Would you agree that these other businesses that Southern Union Company is in, other than the local gas distribution business, have different business risks than the business risk of a local gas distribution company?

A. Different business risks?

Q. Yes.

A. Yes.

Q. Now, you're familiar with the capital structures that the company has proposed in this case and the Staff has proposed in this case, a fair statement?

A. Yes, and I've read your one-sheet handout which I think is evidence in the record that reflects those differences.

Q. Fine. And --

A. And I don't know what the number is so we can refer to it.

Q. The number of the exhibit?

A. Yes, sir.

Q. I've always had a hard time keeping track of that myself.

JUDGE PRIDGIN: I'll double-check. I believe it's 98.

THE WITNESS: I'm going to write it down on there.

JUDGE PRIDGIN: Correct, 98.

BY MR. SWEARENGEN:

Q. And have I accurately stated -- I had a little difficulty with the Staff witness on this about what your position is, and I understand you've got a revenue adjustment or another ROE adjustment there in the wings, but have I accurately stated on here what the Public Counsel's position is on the capital structure and the various cost rates?

A. Yes, sir, you have.

Q. Okay. Thank you. In looking at that exhibit, you would agree with me that both the Staff and the company are proposing a hypothetical capital structure?

A. Yes, sir, they are -- you are.

Q. And if I used the word fictitious capital structure, would you agree with that or do you prefer a hypothetical?
A. Hypothetical, fiction, you -- you can use whatever adjective you like and I'll -- I think I could go along with either one.
Q. Now, you recall I took your deposition in this case down in Austin, Texas back on the 6th of October of this year?
A. I do recall that day.
Q. Just as an aside, let me ask you this: Would you agree that as a general proposition, investors are influenced by historical events?
A. Investors are -- if you say not solely historical events, then I would say yes.
Q. Okay. Do you think investors are also influenced by future expectations?
A. Yes, and sometimes future expectations are based upon historical events.
Q. Going back to the deposition down in Texas, do you recall that during that deposition I asked you whether or not you were aware that other commissions and other regulatory bodies for ratemaking purposes from time to time have utilized hypothetical capital structures rather than the

utility's actual capital structure? Do you remember me asking you that question?

A. I do remember you asking that question.

Q. And your answer was that they have, do you recall that?

A. My answer was not only that they have, that I have as well.

Q. Okay. And I think you went on to say that the use of a hypothetical capital structure for ratemaking purposes -- and your words as I recall from the deposition were "is done frequently"?

A. Is -- that -- that is correct.

Q. Okay. And you also said in that deposition that the circumstances that would lead a regulatory body to using a hypothetical capital structure typically would result in the fact that the subject company had a low equity ratio. Do you remember that?

A. Yes, and I think added some additional words around that which could result from extraordinary events, whether it be prudence issues or so forth.

Q. Now, the capital structure, the common -- the common equity ratio that you are recommending in your capital structure is 38.66

percent; is that right?
A. That's -- that's the stated capitalization or equity level of the company, that is correct. It's on Exhibit 98.
Q. And MGE's proposal as shown on that exhibit is 48 percent?
A. Yes, sir, it is.
Q. Okay. And the Staff's is 51, right?
A. That is correct.
Q. Do you have your direct testimony with you?
A. I have it with me, yes, sir.
Q. Good. If you could please turn to page 49.
A. I am there. What line?
Q. Well, you're ahead of me. Beginning on line 8 there's a question, "How does the company's proposed primary capital structure which includes a 48 percent equity ratio compare with the capital structure ratios of the comparable risk companies?"
A. I see that.
Q. Okay. And your answer is, "The company's proposed capital structure compares quite favorably to the equity ratios in the natural gas utility industry," correct?

A. Yes.
Q. When you say "natural gas utility industry," what do you mean?
A. That, that I described earlier regarding the comparable group. It's the industry identified by -- by Value Line as being pretty much LDC operations or gas distribution operations.
Q. Okay. In the nature of Missouri Gas Energy, is that a fair statement?
A. Yes.
Q. Now, your cost of equity recommendation, the midpoint is 10 percent?
A. That is correct.
Q. And that's based on -- on the results of your study of a proxy group of 12 companies, I believe?
A. That is correct.
Q. Okay. And -- and I think you would say that those companies are similar to Missouri Gas Energy, the companies in your proxy group?
A. Yes.
Q. But the capital structure that you're proposing which is the corporate capital structure of Southern Union Company is not based on the capital structures of those proxy companies, correct?

A. That's absolutely correct, and that's explained at lines 17 to 20 on page 49 that you referenced earlier.

Q. But you do apply, do you not, the cost of equity recommendation which is derived from your proxy group of gas companies, you apply that to the capital structure of Southern Union Company; is that correct?

A. That -- that is correct because that's Southern Union's actual capital structure, and again, page 49, line 17 to 21 explain it.

Q. Does your Southern Union corporate capital structure include Panhandle debt?

A. Yes, it does, and the Southern Union capital structure that I'm employing is the one employed by the company itself and as its alternative recommendation.

Q. And what is Panhandle, do you know?

A. Panhandle is an operation that was purchased -- its pipeline operation, purchased, I think in 2004 for, I think about $1.8 billion by Southern Union.

Q. If I represented to you that if you backed that Panhandle debt out of the Southern Union corporate capital structure, then Southern

Union would have an equity ratio of about 48 percent, would you accept that?

A. Well, I -- I can certainly check that, but I would never do such a thing because then you would have a hypothetical capital structure which for good reason I'm not employing.

Q. Are you familiar with Mr. Hanley's testimony where he, in fact, demonstrates that?

A. He may demonstrate it, I don't recall.

Q. Okay. Turning back to your deposition, do you recall that I asked you that when compared to your proxy groups, Southern Union is more thinly capitalized from an equity standpoint than the companies in your proxy group, and you answered yes to that question, do you remember that?

A. Yes, and just as I answered yes to the prior questions on the same line.

Q. So would you agree with me that Southern Union Company is not really representative of how a gas distribution company is financed?

A. It's certainly not representative of how the -- of the capitalization of the use of capital that we have in our comparable group. I would say that.

Q. And generally speaking, is -- is the

difference that it had that Southern Union has less equity and more debt?

A. Well -- well, both go hand in hand.

Q. Right.

A. And so they're very highly leveraged for the way they operate their -- their business, and so the high leverage means less equity.

Q. Debt leverage equals financial risk; is that -- is that right? Is that what financial risk is?

A. Not exactly. Debt leverage is more -- more debt from one company to the next, but what you want to look at is why is that financial risk. It's the interest obligation you have on that debt. But in this case, that goes away, so the financial risk has been eliminated through the decoupling mechanism proposed by the company.

Q. Would you say that the greater amount of debt in the capital structure of a particular company the greater financial risk that company would have?

A. Generally so, but you can't look at it blindly without the decoupling and the impacts on how the revenues are being collected and guaranteed to the company.

Q. Would you agree with me, and I think you said in your deposition, that as a general proposition, if you have more risk, you need a higher return in order to attract capital?

A. Absolutely. In general terms, that's what we'd be talking about.

Q. And once again, as a -- as a general proposition with regard to cost of capital for ratemaking, if you have a utility with a thin equity component in its capital structure, you testified earlier that regulatory bodies have used hypothetical capital structures to deal with that situation; is that true?

A. That's absolutely true, and typically you don't see it done when the -- the -- the subject company is a division of the corporate entity. It's more done when it's a legal -- separate legal entity, a subsidiary.

Q. I asked you also, I think, at your deposition another way for a regulatory body to deal with and to recognize the risk of a thinly -- a thinly capitalized company from an equity standpoint would be in a rate case to make an upward adjustment to the return on equity. Do you recall agreeing with me on that at your deposition?

A. Well, that's certainly another way of doing it, either A, you increase the equity ratio changing the capital structure, or B, you can make a -- an equivalent adjustment by adjusting the return on equity, neither of which are necessary in this case.

Q. Your ROE recommendation, I think you said, is based on a range of 9 and a half to 10 and a half percent, correct?

A. That is correct, sir.

Q. And during your deposition, I think you said that it was your opinion that the 9.5 percent which is the low end of your range would be a reasonable rate of return in this case, at least in your opinion?

A. Yes, I -- I think I said to you in the deposition so we have it correct, is that 9 and a half to 10 and a half we typically estimate ranges, reasonable ranges. Every number from the bottom to the top is a reasonable estimate --

Q. Okay.

A. -- and -- and could be picked.

Q. So the -- likewise, in the 10 and a half percent which is the high end of your range would fit your definition of something reasonable for MGE in this case?

A. It is within the reasonable results of the study, and I picked -- there's no reason -- once you've picked a reasonable range, you then determine is there a reason to go from one end or the other, the high end or the low end. In this case there was none, so I chose the midpoint.

Q. And that 10 percent ROE recommendation is for Missouri Gas Energy, it's not for Southern Union Company; is that true?

A. That's absolutely correct.

Q. But it's to be applied to the Southern Union capital structure, I think you said that?

A. It's to be applied to the actual capital structure which happens to be the Southern Union capital structure. That is how MGE is financed. To do otherwise would be to provide capital that -- or -- or higher rates than -- than reasonable.

Q. In connection with your preparation for this case, did you do a -- or make a cost of capital calculation for Southern Union Company?

A. No, I didn't. And I think we discussed that at the depo as well.

Q. Now, in addition to your capital structure and cost of capital recommendation, you also have this other recommendation that we talked about, the revenue reduction for the straight fixed variable rate design or an alternative would be a 50 basis point reduction to the ROE for the rate design; is that correct?

A. That is correct, they're economic equivalents.

Q. And I think in your direct testimony you referred to it as risk shifting associated with decoupling --

A. That is correct.

Q. -- do you recall that? And by "decoupling," you're talking about the straight fixed variable rate design, is that --

A. Yes. By decoupling, what I'm -- what I -- what I'm talking about is charging customers, in this case residential and commercial, one price every month, no volume charges, guaranteeing your revenue stream.

Q. Schedule DJL-3, that probably --

A. Are you looking at the direct, sir?

Q. Yes. I think that's attached to your direct testimony, DJL-3, page 1 of 1.

A. Yes, I am there.

Q. The heading is "Analysis of Straight Fixed Variable and Minimum Bill Charges." Is that

the same document I'm -- I'm looking at?
A. I'm looking at one that's not numbered. Let me get one that's numbered. Give me a moment. DJL-3, I'm there, yes, sir.
Q. Okay. And the document I'm looking at says, "Missouri Gas Energy Rate Case," it's got the case number. Starts out, it says -- the heading says "Analysis of Straight Fixed Variable and Minimum Bill Charges." Does that -- are we looking at the same document?
A. That is what -- what I am looking at.
Q. Okay. Good. And then you have the heading "Company-Requested Capital Structure and Cost Rates"; is that correct?
A. Yes, sir.
Q. And -- and what is shown there in -- in that information that's underneath there?
A. Are you asking what is shown there?
Q. Yeah, what is that?
A. That -- I believe that's the company's requested capitalization level adjusted in the last column for federal income taxes or a gross-up factor which is necessary in rate setting.
Q. Okay. And then the next heading says "Capital Structure Adjusted For Reduced Risk."

A. Yes, sir.
Q. And what is that, now?
A. Well, it's the same company-requested capital structure except the debt and equity is adjusted. I think I adjusted it 2 and a half percent, increased the debt level 2 and a half percent, reduced the equity level 2 and a half percent to calculate what a 2 and a half percent shift in debt-to -- in equity-to-debt low leverage would do to estimate the impact of decoupling.
Q. Okay. So you -- your approach to -- to dealing with this straight fixed variable rate design is to increase the company's long-term debt from 41.06 to 43.56; is that right?
A. To estimate the impact of decoupling, yes, sir.
Q. And by the same token, then, you're lowering the common equity ratio from 48 percent to 45 and a half percent, right?
A. That -- that would be what the estimate would entail, yes, sir.
Q. Okay. And that adjustment would be designed to reflect a reduction in business risk that would result from the straight fixed variable rate design?

A. Most risk. I don't know that I capture it all, but typically in evaluating utilities, rating agencies will allow more leverage for less risky companies, and so I employed a 2 and a half percent shifting of more leverage, trying to reflect the perception that a rating agency would have on a standalone estimate.

Q. Now, when you raise the long-term debt from 41.06 to 43.56, are you not, in fact, increasing the financial risk of the company?

A. Generally, yes, and we were talking in general terms throughout this examination. But I said, remember, you've got to keep into consideration decoupling and the revenues that have guaranteed to flow, and therefore you don't have an increase in financial risk.

Q. Even though you're increasing the long-term risk?

A. Exactly.

Q. Okay.

A. For the 2 and a half percent shift -- and you'll see that in any rating agency evaluation, you'll see a lot of rating agencies will allow a -- more debt with less risk.

Q. Let me ask you about the 50 percent --

or excuse me -- the 50 basis point adjustment that you propose now as an alternative.

A. Sure.

Q. I think in your direct testimony -- on page 11 of your direct testimony, do you have that in front of you?

A. I have it now.

Q. On lines 14 to -- starting at line 14, you say, "As I noted earlier, regulatory authorities" --

A. Uh-huh.

Q. -- "authorities," plural, "have employed a 50 basis point reduction to equity return for similar decoupling proposals." And do you recall during your deposition I asked you about that and you agreed that the only jurisdiction you were aware of where this had been done is the Maryland jurisdiction, do you recall that?

A. I don't think that's quite accurate. I think I agreed that, yes, the Maryland jurisdiction had done it and I had provided you additional documentation referencing the Connecticut case that we talked about during the deposition. And a third case I provided additional documentation was a Texas proceeding where the utility, in fact, withdrew its -- its -- its proposal, and I think that case was a 75 basis point.

Q. Right. I think we went through that discussion, but in the end, you agreed that there was only one jurisdiction, the Maryland jurisdiction where the regulatory authority actually had voted to impose this -- this reduction.

A. Well, Maryland has done it twice, and once -- once when it originally did the gas utilities and then again when it did the electric utilities, you'll see this is a cite to the recent Delmarva case.

Q. Let me ask you -- hold on just a second. The second case that you're talking about, when did that occur, the second case in Maryland?

A. The second -- the second case in Maryland would be the Delmarva case. Prior to that it was a BG&E case.

Q. And what year was that?

A. BG&E, Baltimore Gas & Electric and other gas companies, I don't recall the year it was initially done. It was reversed, I think, in 2005, the -- the basis point adjustment was eliminated. And then in 2007, the Maryland Commission went and imposed the four, what they call the bill stabilization adjustment where the -- the dollars are tracked and there's a cap on how much the company can -- can capture, but it's -- it's equivalent to straight fixed variable.

Q. Well, what I'm asking you about, though, is back to my original question about the 50 basis point adjustment, and I'm looking at your deposition, page 33. And my question to you was, "So if I understand what you're saying is, the only jurisdiction you're aware of that -- that this is done is the Maryland jurisdiction?"

And your answer was, "Where the company has kept its request and they've gone through the entire process and then there is a 50 basis point reduction."

A. Yes. And there -- and I just pointed out there were two different cases or proceedings that I was referring to.

Q. But that's the only jurisdiction?

A. Yes, sir.

Q. Okay. Now, with regard to the Maryland jurisdiction and those -- those decisions, is it not true that the Maryland Commission did that because the proxy companies did not have decoupling mechanisms?

A. You have an unclear question, sir. "The Maryland Commission did that." Did what?
Q. The 50 basis points --
A. Did the -- okay. The Maryland Commission did the 50 basis points reduction because they saw less risk.
Q. And because the comparable companies that they were looking at did not have similar decoupling provisions, is that not true?
A. I don't believe that was in that fashion specifically stated in the Commission order that way.
Q. But wasn't it true that the proxy companies that were being looked at at that time did not have similar decoupling provisions?
A. I don't know that to be the case. Are we talking about the Delmarva decision that I've cited in my testimony or is there another one?
Q. Well, whatever case that you're talking about.
A. Well, the Delmarva decision, I don't know that to be the case, sir.
Q. You don't know whether that's right or not?
A. Well, I know that the specific language that it -- the 50 basis points is there because it's

not in the comparable group companies is not in the order that I read out of Delmarva --
Q. My question to you --
A. -- or provided.
Q. -- is whether or not the comparable companies had similar decoupling provisions, and the -- and the fact is that they didn't. But you don't know that?
A. I don't know that they didn't.
Q. Are you aware that in a subsequent Maryland case involving the same company that no adjustment was made because at that time the proxy companies did have such mechanisms?
A. No, that didn't happen. That question is incorrect.
Q. Okay.
A. You're talking about the Baltimore Gas & Electric case that happened sometime prior. My prior answer to your questions were about the Delmarva case that we were talking about, footnote 7 on page 11. So if you want to go to the Baltimore Gas & Electric case, yes, the Commission withdrew the -- or did not make a 50 basis point adjustment --
Q. And why is that?
A. -- in a subsequent case because other

companies were viewed as having -- proxy companies were viewed as having similar decoupling.

Q. Okay. Thank you. Do you recall at your deposition when I asked you whether or not prior to Missouri Gas Energy's last rate case before this Commission whether the company at that time had the straight fixed variable rate design in place and you said you did not know the answer to that?

A. That is correct. I did not research the -- the comparable group employed in the last case --

Q. So --

A. -- to determine whether or not they had a -- a decoupling adjustment.

Q. You did not know at the time that you were putting together your direct and rebuttal testimony in this case --

A. Right.

Q. -- whether in MGE's last rate case before this Commission, an equity reduction or a revenue reduction was imposed on the company when the Commission awarded them the straight fixed variable rate design?

A. I don't know that that's quite correct. If I understand your question, I believe I stated in my testimony that a 35 basis point adjustment for straight fixed variable was proposed by the company in the last case. I'm trying to recall if that was adopted or incorporated in the final ROE recommendation of this Commission.

Q. Well, when I asked you in your deposition whether or not at the time of this last case the company did have in place the straight fixed variable rate design, you said you didn't know. Do you recall that?

A. I said I didn't know if they had it in any form prior to the -- now we're going back two cases ago, and -- and I didn't know that, no.

Q. But now you understand that it was in the last case, the 2007 case where Missouri Gas Energy for the first time was authorized to utilize the straight fixed variable rate design?

A. In 2007, yes, I think I discussed that in my testimony.

Q. Okay.

A. So it's not new knowledge.

Q. And would you agree that since that time, Southern Union Company's bond rating has remained the same?

A. Bond rating currently is at triple B, and I -- I don't recall that there's been a minor notch or two downgrade since that time. I -- I haven't researched that on -- for every period. I just look at your current bond rating.

Q. So you think it may have been down-rated since that time?

A. Well, there may be a notch adjustment on there from B -- BB-plus to BB-straight or BB-minus, so forth.

Q. So if there was a benefit to Southern Union Company from the straight fixed variable rate design, those benefits did not result in any increase in Southern Union's bond rating, would agree with that?

A. Well, I -- I would agree with that based upon the premise we started this discussion, that MGE is such a small part of Southern Union you wouldn't expect that to occur. But to ignore it would be to impose additional risk on customers with no benefits.

Q. Well, let me ask you about that. During your deposition I asked you some questions about weather-related risk that both Missouri Gas Energy and its customers face. Do you recall those questions?

A. Yes, sir, I do.

Q. And do you remember I asked you if you agree that the weather risk or weather-related risk with respect to Missouri Gas Energy is the possibility that the weather, the actual weather during the time that the rates are in effect is either colder or warmer than the normalized weather used to set those rates, and your answer was the risk for MGE is associated with the weather being warmer, not colder, do you recall that?

A. Yes, sir.

Q. And that would still be your testimony, right?

A. Yes.

Q. And then I asked you if the weather is colder than normal, would the company's customers experience some risk, and you said no. Do you recall that?

A. Yes.

Q. And I asked you to explain that, and your explanation was that when weather is colder than normal, the customers would be paying for volumes in accordance with the legal rate set by the utility regulator. Do you recall that answer?

A. Yes.

Q. Okay. And I went on to ask you under

that traditional -- under the Public Counsel's rate design approach -- which I think we referred to as the traditional rate design approach?

A. Could you speak up a little? I'm somewhat audio-challenged here.

Q. The Public Counsel's rate design proposal, if we called it a traditional rate design proposal, would that be a fair way to describe it?

A. Yes, I -- I believe so. I haven't studied the Public Counsel's rate design approach, but it's my understanding.

Q. What is your understanding of the Public Counsel's rate design approach?

A. I believe it's not straight fixed variable, that it would be a customer charge with a volumetric charge based upon a cost allocation method and assignment method.

Q. Okay. And under that approach, would you agree that the company's residential customers had a risk of overpaying their non-gas costs if the weather is colder than normal? I asked you that question at your deposition and you said no because the customers under those circumstances would be paying the legal rate and that would eliminate risk in your opinion. Do you recall that?

A. I don't recall it exactly that way. I didn't say it would eliminate risk in my opinion. What I said as the predicate to your question is incorrect, and that is when customers, it's colder, they buy more gas, they pay whatever rate this Commission sets. That rate is established and they -- they pay that rate for every volume of gas. Those are found to be just, reasonable and legal rates by this Commission, and the customer pays -- they're not paying more or less than their cost, their fair share.

Q. So as a lawyer, then, is it your opinion that as -- as a matter of law, there's no risk with a residential customer overpaying their non-gas costs if the weather is colder than normal?

A. Well, as -- as a lawyer, I don't see the legal question, and I'm not a lawyer here so I'm not going to give you legal advice on that. As an analyst, an economist who studies these rates and -- and does this work, I'm telling you that the -- the -- my answer is that customers do not overpay their costs, they pay their exact costs. If it costs a dollar per MCF and it's colder than normal, you buy 100 more MCF, you're going to pay 100 more dollars.

Q. And -- and --

A. Otherwise, we would be looking at customer payments in cold weather saying that the company would -- should be required to give it back because customers are overpaying their costs.
Q. They're overpaying their costs --
A. Now, the company may earn more --
Q. Right.
A. -- but the customer is not overpaying their cost.
Q. Now, you understand we're talking about non-gas costs?
A. Yes, sir.
Q. And you think that under the colder-than-normal weather, customers would not overpay non-gas costs?
A. Absolutely not.
Q. Now, earlier I think you said that as a general proposition, investors are influenced by their expectations; is that correct?
A. Yes, sir.
Q. Do you have your surrebuttal testimony there?
A. I now have it. What page?
Q. Take a look at page 6 of 10.
A. I'm there.

Q. I'm looking at lines 12 and 13. Am I correct that there you explain your rationale for correcting Mr. Hanley's analysis, and the rationale is the need to remove from consideration forecasted information and estimates of investor expectations?

A. No, sir, it's -- it's -- it's the rule -- the need to remove unreasonable forecasts of investor expectations.

MR. SWEARENGEN: That's all I have. Thank you.

JUDGE PRIDGIN: Mr. Swearengen, thank you. Does anybody have any questions from the bench? Commissioner Davis?

COMMISSIONER DAVIS: I'll pass.

JUDGE PRIDGIN: Commissioner Jarrett?

COMMISSIONER JARRETT: I don't have any questions.

JUDGE PRIDGIN: Commissioner Kenney?

COMMISSIONER KENNEY: No, thank you.

JUDGE PRIDGIN: Commissioner Davis?

QUESTIONS BY COMMISSIONER DAVIS:

Q. Good afternoon, Mr. Lawton.

A. Good afternoon, Commissioner Davis.

Q. Mr. Lawton, I have to start by asking you this very simple question. What does the J. in

your middle name stand for?
A. Joseph, sir.
Q. Joseph. Okay. All right. Now, Mr. Lawton, in your direct testimony, do you -- do you indicate the criteria that you employed when you were selecting your proxy group? Is that anywhere in your direct testimony?
A. I believe I just selected -- or -- or stated that I was employing whatever Value Line included in its grouping for gas distribution companies, all 12 companies.
Q. Okay.
A. So there's no selection by us --
Q. Okay.
A. -- there -- just whatever Value Line had, what investors look at.
Q. Okay. Now, would you agree with me that by -- well, first of all, do you know what the central limit theorem is?
A. I used to know it by heart, but I probably have forgotten it over the years. If you want to remind me --
Q. Well --
A. -- I'll probably snap back to it.
Q. Let me -- do you agree with the concept

that a sampling distribution of means from any population would be normal for a large sample?

A. For a large sample, yes, randomly drawn sample.

Q. Right. Okay. Would you agree that by selecting a smaller sample size, you increase the opportunity for sample error in a proxy group?

A. Yes, and you create one other error, and that is the error that any -- any -- or the additional bias that any one error from one of your selections will impact the group. So if you have a larger group in one of your selections, you make an error or there's some bad data, then it won't impact your group as if you had five or four versus 15 or 20 items.

Q. Okay. Mr. Murray, his proxy group was seven utilities, correct?

A. Mr. Murray's was seven utilities, I believe that's correct. And -- and -- and I think Mr. Hanley's was nine and mine is 12. But we all cross over the same companies, as I recall.

Q. But you would agree that his proxy group was more than 40 percent smaller than yours, wouldn't you?

A. I haven't done the math, I'll accept

that.

Q. Okay. Now, you've testified, I believe, repeatedly in response to questions from Mr. Swearengen, that if the Commission sticks with the straight fixed variable rate design --

A. Yes, sir.

Q. -- it either needs to make an adjustment of $1.8 million approximately or 50 basis points, correct?

A. That's -- that's what I've recommended, yes, sir.

Q. Yes, okay. All right. And I heard you tell Mr. Swearengen that the two were equivalent; is that correct?

A. Yes, sir.

Q. Okay. Now, if I divide 1.8 million by 50, I get $36,000 per basis point, correct?

A. That is correct.

Q. Okay. Now, did you -- you were here in the room when I was asking Mr. Murray questions, correct?

A. Right. And you base that -- if you want the correct answer why that's happening, I can explain it.

Q. Okay. Explain.

A. Okay. You were starting off with the -- the company's hypothetical capital structure in that calculation --

Q. Uh-huh.

A. -- 604 million. You know, if you convert the 1.8 million to basis points employing the actual, the Southern Union capital structure, it comes out 9.5 percent equity return. Actually, I think it's 9.52. Staff witness earlier said 9.53.

Q. Okay.

A. So it's roughly 50 basis points, Commissioner, based on my capital structure.

Q. Okay. Your -- based on your capital structure it is -- it is $36,000 a basis point?

A. I believe that's the way it would come out. I think so.

Q. You believe? You believe?

A. I haven't calculated. I'm not here to estimate how much a basis point is worth. We can do the arithmetic if you like.

Q. I don't have to be anywhere until five o'clock so indulge me -- indulge -- indulge me.

A. My flight's tomorrow morning, sir, so... Okay. We have a rate base of approximately 604 million and we have a return -- and I'm going to use

Exhibit 98, Commissioner, and I'll use the bottom number, 7.772.

COMMISSIONER DAVIS: Okay. Judge, will we be able to show this up on the screen when he's done with it?

JUDGE PRIDGIN: I think we've got a projector that's on, I think we should be able to do that.

THE WITNESS: Actually, my rough estimate is $25,972. That's before income taxes which would be on top of that. So if you want me to redo this calculation --

BY COMMISSIONER DAVIS:

Q. So you'd have to -- you'd have to gross it up for taxes?

A. Right. You would gross up the -- the -- the equity as well as the preferred.

Q. Okay.

A. And the tax factor in this case, as I recall, is 1.6203, something to that effect.

Q. Uh-huh. That's close enough for government work at this point.

A. Well, anyway, my rough estimate here is 25,972 before taxes.

Q. Before taxes?

A. Yes, sir.
Q. Okay. All right. And so you're saying if you factor it up to taxes, then it does get you to that $36,000 basis point amount?
A. It -- it -- it should. Typically your gross-up factor is about 50 percent of your equity piece, so yeah, it should be there.
Q. Okay. All right. Mr. Lawton, is this the Ibbotson book that you use or do you use the -- the classic edition or some edition like Mr. Murray uses?
A. I too am a classic user.
Q. Okay.
A. And it's the maroon or whatever color it was. But I think the numbers are the same. I heard -- I heard your -- your -- your --
Q. Okay.
A. -- reading the book.
Q. All right. So the numbers -- the numbers are the same, correct?
A. Yes. I mean, the -- Ibbotson and Sinquefield, we all use it for the -- at least their historical data compilations.
Q. Right. And when you did your -- your DCF analysis, was it an annual, a semiannual, a

quarterly?

A. It was a semiannual in the same fashion as -- as Mr. Hanley described to you earlier. I would not use a quarterly because that would result in overstating the cost of equity to a utility even though it sounds theoretically correct.

Q. Okay. Do you have a copy of your direct testimony in front of you?

A. I do.

Q. Page, I think it's 33. Now --

A. I'm at 33, sir.

Q. You're at 33. Okay. Talking about lines 12 through 24 -- well -- and I guess going up to the top of page --

A. It would be 34.

Q. Well -- and -- and going back to the top of page 33 as well.

A. Okay.

Q. And you say, "Along with historical growth rates, the first set of growth rates is the Value Line forecasted growth rate in earnings per share." So that's your -- that's your first growth rate?

A. Yes. And pardon me, Commissioner. Can I ask where you're reading from? Maybe I have different numbers.

Q. Okay. I'm on your direct testimony, page 33 of 53 --

A. Yes, sir.

Q. -- lines -- beginning with line 14.

A. I've got different line numbers. Let me check this version of it. It might have gotten -- in the transmission, just so we can line up together. Uh-huh. I have it now. Okay, sir, go ahead.

Q. Okay. So the first number you used was the -- was the Value Line's forecasted growth rate in earnings per share?

A. That would be correct, sir.

Q. And then the second you used was the -- the Zacks forecasted growth rate in earnings?

A. Yes.

Q. And the third growth estimate is the First Call growth rates. Now, are those growth rates in earnings, in dividends, in...

A. Earnings per share.

Q. Okay.

A. Same -- same -- same growth rates.

Q. All right. All right. So in calculating your growth rate, is it -- is it fair to say that you rely more on earnings?

A. That -- that would be one way to look at it in terms of some of these forecasts, absolutely.

Q. Okay. And you reviewed Mr. Murray's testimony, did you not or did you?

A. I -- I looked at the Staff report and I think I've -- I've seen his rebuttal and surrebuttal at one point.

Q. Okay. Are you aware of any -- any scholarly authority for the practice of averaging earnings growth rates with dividend growth rates with book value growth rates?

A. Scholarly -- you're looking for some treaties that would -- I can tell you commissions that have done it --

Q. Okay.

A. -- and -- and have assigned different numerical -- for example, I believe there's been a case -- I think it was a gas case, a Questar Gas case in Utah where the Utah Commission employed, I think, a ratio of 25 percent for the dividend growth rates and 75 percent for the earnings growth rates. That case is probably four or five years old. But I know staff in Utah sometimes will present that kind of analysis.

Other places where you'll see averages

of dividends and -- and earnings, I've seen various analysts over time employ that, depending upon whether or not you've got good earnings data. The first thing you do, even though you may like earnings estimates is --

Q. Uh-huh.

A. -- is you look at what if you don't have any data, what if -- what if the -- there are no earnings estimates. You've got to look for something or -- or good data. So sometimes you have to look at dividend growth rates or book value growth rates.

So I -- I -- I've seen it out there and I've seen -- now, commissions don't specifically generally state we only look at earnings and nothing else. Typically commissioners as decision-makers try to keep that -- that option open, and they give everything the weight it deserves when they make -- when they vet the evidence and make their final decisions.

Q. But you've never -- you've never seen anyone accept that methodology of a straight one-third, one-third, one-third equal weighting?

A. No, no, no. But the closest I can come is the Utah case that I described to you earlier.

Q. Okay. And there it was a 25/75 split?

A. I think it was 25/75.
Q. Almost -- almost like an ECAPM analysis?
A. Almost.
COMMISSIONER DAVIS: Mr. Lawton, I don't have any further questions. Thank you.
THE WITNESS: Thank you for your time, appreciate it.
JUDGE PRIDGIN: Commissioner Davis, thank you. Do we have any recross, Mr. Thompson?
MR. THOMPSON: No, thank you, Judge.
JUDGE PRIDGIN: Mr. Swearengen?
MR. SWEARENGEN: Yes, I've got one or two.
RECROSS-EXAMINATION BY MR. SWEARENGEN:
Q. I'm a little confused now, Mr. Lawton.
A. I'm sorry, Mr. Swearengen. I didn't mean to confuse you, sir.
Q. Well, Commissioner Davis asked you right at the outset about your two proposals to deal with the straight fixed variable rate design, one being the $1.8 million revenue reduction, the other being the 50 basis point ROE reduction. Do you recall that?
A. That's correct.
Q. Okay. Now, do you have your direct

testimony in front of you?

A. I do.

Q. Turn to page 49, if you would, please.

A. I'm there.

Q. And reading on line 17, you say, "In terms of the alternative or actual capital structure" -- and I believe you're talking about the Southern Union capital structure; is that not correct?

A. That would be correct, sir.

Q. "-- the equity ratio of about 39 percent is below the gas industry average. While this reflects higher financial risks for MGE, business risk has been reduced, especially in light of the benefits (risk reductions) associated with decoupling."

A. Yes, sir.

Q. Okay. And that's your testimony?

A. Yes, sir.

Q. So what you're saying here is that using the Southern Union capital structure, you -- you're making an adjustment to account for the straight fixed variable rate design; is that true?

A. If you could repeat that. I want to make sure I'm clear.

Q. Let me ask -- let me ask it this way: What it appears to me is going on is, is that you are, in fact, doing that. You're using the Southern Union Company capital structure with the 39 percent equity ratio and rationalizing that by saying, "While it reflects higher financial risk, business risk has been reduced, especially in light of the benefits (risk reductions) associated with decoupling."

And then you go ahead and say another 50 basis point reduction or $1.8 million revenue reduction ought to be made on top of that. So it sounds to me like you're really double-dipping this issue.

A. Gee, I -- I -- I -- I -- even I'm not that good. I wouldn't double-dip you, sir.

Q. Okay.

A. What I'm saying is the 1.8 million is my recommendation. That does not -- that is to reduce revenue requirement. That does not belie or eliminate the fact that your financial risk associated with having more leverage goes away. Why?

The reason it goes away is because every month you will bill the customers in the MGE service area, get that money. The financial risk is associated with being able to pay that interest payment with more leverage. That risk is -- pretty much goes away.

Q. It seems to me that you're -- you're -- you're taking two bites at the apple.

A. No, sir, I wouldn't do that.

MR. SWEARENGEN: Yeah. Thank you.

THE WITNESS: You're welcome.

JUDGE PRIDGIN: Mr. Swearengen, thank you. Commissioner Davis.

QUESTIONS BY COMMISSIONER DAVIS:

Q. I'm sorry. Mr. Lawton, can I go back and ask you about one other thing?

A. Oh, sure.

Q. I think in your direct testimony you made reference to a Connecticut decision --

A. Yes, sir.

Q. -- that was a 100 basis point reduction; is that -- is that correct?

A. It's -- it's not exactly correct. I mentioned a Connecticut decision --

Q. Uh-huh.

A. -- which did not approve the decoupling and pointed out, based on some evidence, that -- that not even 100 basis points would be enough. The Commission was pointing out that the adjustment would be so draconian, nobody would buy it, the return.

Q. Draconian, that's an interesting word.

A. Yeah, I -- utility experts really use it. But that was one that --

Q. Have you -- have you ever heard -- have -- have you ever heard the word draconian used to describe the Connecticut Commission?

A. No.

Q. No?

A. No.

Q. No? Are you familiar with the -- I believe it's the United Illuminating case that was decided in Connecticut, February of this year?

A. I did read something on it.

Q. Do you want me to help refresh your recollection?

A. Try, thank you.

Q. "The 8.75 percent return on equity awarded was the lowest non-penalty ROE determination for an energy utility nationwide in more than 30 years." Does that -- does that ring a bell?

A. It may. Is it on Exhibit 98, the one -- the one the Staff put in with the --

Q. I don't -- I don't believe it is.

A. Well, it should be.

Q. Well, yeah, that's right, it would be -- it would be -- it would be in Exhibit 98.
A. Yeah, and I don't recall seeing it there, but I might have missed it.
JUDGE PRIDGIN: Just to clarify, if you're referring to the RRA information, that would be Exhibit 96.
THE WITNESS: Okay. Thank you, Judge.
JUDGE PRIDGIN: You're welcome.
BY COMMISSIONER DAVIS:
Q. Mr. Lawton, do you -- do you subscribe to SNL's RRA?
A. No. I -- I -- I get copies occasionally from -- from different folks.
Q. Okay.
A. I'm sorry. Can I have a moment, Commissioner Davis?
Q. Sure.
A. I -- I really don't see it on this list. I do see a June 30th, '09 Connecticut case where they awarded 9.31 percent, and I believe the footnote indicates it was a forward-looking rate base for 12/31/09, so I would assume they upped -- or lowered the equity for the forecast allowing the post-test year stuff, yeah.

Q. Right. Are you aware that Research Regulatory Associates ranks the various state public utility commissions?

A. A lot of people -- they -- they -- they do, and a lot of folks --

Q. Right.

A. -- rank them.

Q. Do you -- do you know what scale they use?

A. No. No, I don't.

Q. Okay. So would -- would it surprise you to know that they rank based on basically a -- I'd say a nine-point scale where they rank utilities either above average, average or below average, and then from there in each category they have three subcategories, one, two and three, with one being the best and three being the worst?

A. Okay.

Q. Do you have any idea what Connecticut's rating is?

A. Ratings from RRA's perspective?

Q. From RRA's perspective.

A. No.

Q. So would it -- would it surprise you to learn that Connecticut has the -- the lowest rating of any utility on their scale?

A. It -- it -- it -- it may. I mean, I don't know what factors go into it.

Q. Right.

A. It may be the consumers rank it the highest in the country, I don't know.

COMMISSIONER DAVIS: Okay. Judge, I don't have any further questions.

JUDGE PRIDGIN: Commissioner Davis, thank you. Further recross based on bench questions?

(NO RESPONSE.)

JUDGE PRIDGIN: No? Redirect?

MR. POSTON: Thank you.

REDIRECT EXAMINATION BY MR. POSTON:

Q. Mr. Swearengen asked you questions about backing out that pipeline debt in making your cost of capital recommendation, and you said you wouldn't do that, do you recall that?

A. That's correct, I wouldn't do that.

Q. Okay. Can you please explain why you wouldn't do that?

A. Well, the capital structure I've employed is Southern Union's actual capital structure. It's the same capital structure presented by the company in this case as an alternative. And that reflects the cost of debt and equity and preferred or financing of MGE, and to take out the Panhandle debt which the company is responsible for, it may be nonrecourse debt, but the company is ultimately responsible; that is, Southern Union Company.

And the only way I would even consider taking that out is through proper ringfencing where you make a -- something like Panhandle a bankruptcy remote entity, and that would involve a lot more work than what's been done here. So there's no basis to pull out Panhandle debt.

Q. And Mr. Swearengen also asked you questions about why you wouldn't use a hypothetical capital structure when you're looking at a division versus a separate company.

A. Yes, sir.

Q. Can you please explain why?

A. Well, a separate company, a corporate entity in and of itself has its own issues of typically its own debt and it -- and it has its own level of capitalization oftentimes influenced or funded by -- with its parent in terms of equity.

This is a division. A division has no corporate life or entity. It is -- it is part of

Southern Union, part and parcel. And all its operations and to get the gas to these customers is funded through this actual capital structure. And to do otherwise, to set rates otherwise, would give the company an opportunity to earn more than its authorized equity return.

Q. And Mr. Swearengen also asked you questions about the number of other jurisdictions that have employed a 50 basis point reduction.

A. Yes, sir.

Q. Is straight fixed variable a common rate design?

A. No. It's something that's starting to sweep the country. I'm seeing it all over the country, called different things. Some companies -- I have a litigation next week where the company just increased its customer charge and just charges a penny or two for the volume charge and has mentioned nothing about decoupling. But that's exactly what's going on, it's -- it's decoupling.

And it's happening all over the country. It's been around for a while, but it's really picking up -- picking up steam in -- among regulatory authorities around the country.

Q. That wasn't where I was going with that, but I'll move on. You said that under colder-than-normal weather, customers would not overpay costs. Can you explain that?

A. Sure. The -- the rate set by this Commission in the last case is the current rate that customers must pay.

Q. Okay.

A. Say it's a dollar. If it's colder than normal, I'd buy more than I ordinarily would because of the cold. I am paying whatever this Commission has told me I should pay is a just and reasonable rate. I'm not overpaying, I'm not underpaying, I'm paying for every volume of gas I purchase, margins.

The company when it's cold may earn more than its authorized return, that is true, but the customer does not pay more or less. It pays the legal rate which this Commission has determined what level it should be set at.

Q. I'm going to try again with that last question and go back again about straight fixed variable. Have most jurisdictions in -- in the United States looked at or been faced with a straight fixed variable proposal?

A. The answer is no. Again, it's sweeping the country in terms of a proposed rate design.

There's more and more pressure put on commissions to adopt higher fixed charges for customers. If you look at even Mr. Hanley's FJH-3, his schedule where he shows the various jurisdictions, only two, I think, gave decoupling or straight fixed variable. Most of them are weather normalization adjustments which have been around for years. So we don't have them.

Q. And could that be a reason why there isn't a large number of jurisdictions that have addressed this need to make these reductions in risk?

A. That's the only explanation.

Q. And following up on questions from Commissioner Davis, why did you use your Value Line proxy without employing a selection criteria similar to the one used by Mr. Murray?

A. Well, first of all, more is better, and I point that out, that the more companies you have to -- to analyze, so long as you can justify that they're -- they're good proxies as well. And I employed the 12 companies that a typical investor would look at when looking at Value Line. They're the same companies as Mr. Hanley.

Moreover, if -- if -- it's a nonissue because my recommendation doesn't change if you take these three companies out. It really didn't affect the results in this case. If you look at my schedule where I come up with the rate of the return for the DCF and the two-stage DCF, it really doesn't change, it's a nonissue.

Q. And my last question is Mr. Swearengen on recross alleged in regards to your testimony, I think it was direct, page 49, that you were double-dipping. Can you please explain why it's your belief you did not double-dip?

A. I -- I -- I -- other than to say I didn't double-dip, I'll try it one more time. And that is, if this Commission accepts my recommendation and lowers the revenue requirement by $1.8 million for the decoupling adjustment that I've recommended, that does not take away the fact that the company, even though it has this adjustment, has less financial risk. It doesn't eliminate or change the risk factors, and -- and -- and it will have going forward under decoupled rates less financial, less business, less risk. It's not an added-to, it's just that it never goes away, it stays less risky.

MR. POSTON: Thank you. That's all I have.

JUDGE PRIDGIN: All right, Mr. Poston,

thank you. Mr. Lawton, thank you very much, sir. You may step down.

THE WITNESS: Thank you, Commissioners and thank you, your Honor.

JUDGE PRIDGIN: Thank you. I see Mr. Lawton is the last witness for the day, and I don't see any other witnesses that are -- you know, it's 3:30, it's been a long day. I'm assuming that the parties intend to stick with the proposed schedule and that is to begin with class cost of service beginning with MGE witness Cummings in the morning; is that correct?

MR. THOMPSON: Yes, your Honor.

JUDGE PRIDGIN: All right. Is there anything else further from counsel or from the bench?

COMMISSIONER DAVIS: Judge, I -- I have no objection to dismissing Mr. Hanley now if you choose to do so.

JUDGE PRIDGIN: All right. Thank you, Mr. Hanley. You may be excused. Thank you very much.

MR. POSTON: And Mr. Lawton as well?

JUDGE PRIDGIN: Oh, yes.

COMMISSIONER DAVIS: Mr. Lawton is waving his hands back there frantically.

JUDGE PRIDGIN: Thank you, Mr. Lawton. You're excused. Anything further from counsel or from the bench before we go off the record?

(NO RESPONSE.)

JUDGE PRIDGIN: All right. Hearing nothing, we will resume at 8:30 in the morning, begin with class cost of service beginning with MGE witness Cummings. Thank you very much. We're off the record.

(WHEREUPON, the hearing of this case was recessed until October 28, 2009.)

I N D E X

COST OF CAPITAL

COMPANY'S EVIDENCE

STAFF'S EVIDENCE

OPC'S EVIDENCE

EXHIBITS INDEX

EXHIBITS INDEX (CONTINUED)

** Not yet received into evidence.

CERTIFICATE OF REPORTER

STATE OF MISSOURI)
)ss.
COUNTY OF COLE)

I, PAMELA FICK, RMR, RPR, CSR, CCR #447, within and for the State of Missouri, do hereby certify that the witness whose testimony appears in the foregoing deposition was duly sworn by me; that the testimony of said witness was taken by me to the best of my ability and thereafter reduced to typewriting under my direction; that I am neither counsel for, related to, nor employed by any of the parties to the action to which this deposition was taken, and further that I am not a relative or employee of any attorney or counsel employed by the parties thereto, nor financially or otherwise interested in the outcome of the action.

PAMELA FICK, RMR, RPR, CSR, CCR #447