Exhibit No. _______
Issue: Rate of Return
Witness: John C. Dunn
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Sponsoring Party: Missouri Gas Energy
Case No.: GR-2004-0209
Filing Date: June 14, 2004

BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

MISSOURI GAS ENERGY
CASE NO. GR-2004-0209

SURREBUTTAL TESTIMONY

OF

JOHN C. DUNN

ON BEHALF OF MISSOURI GAS ENERGY

June 2004

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area.	))))	GR-2004-0209

AFFIDAVIT OF JOHN C. DUNN

STATE OF Missouri)
) ss.
COUNTY OF Cole)

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

JOHN C. DUNN

Subscribed and sworn to before me this 14th day of June 2004.

Lori Rackers
Notary Public

My Commission Expires: 7/14/05

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI
LORI RACKERS
Osage County
My Commission Expires
July 14, 2005

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Q. Please state your name and business address.

A. My name is John C. Dunn. My business address is 7400 West 110th Street, Suite 750, Overland Park, KS 66210.

Q. Are you the same John C. Dunn who filed direct testimony and rebuttal testimony in this case before the Missouri Public Service Commission ("Commission") on behalf of Missouri Gas Energy ("MGE"), a division of Southern Union Company ("Southern Union")?

A. Yes I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of this testimony is to respond to the rate of return rebuttal testimony of Mr. David Murray, a witness for the Commission Staff ("Staff"), the rate of return rebuttal testimony of Mr. Travis Allen, a witness for the Office of the Public Counsel ("Public Counsel") and the statistical rebuttal testimony of Ms. Barbara Meisenheimer also a witness for the Public Counsel.

ORGANIZATION OF SURREBUTTAL

Q. How is your surrebuttal testimony organized?

A. The surrebuttal testimony is organized into two main sections. Each deals with a point by point response to the individual rebuttal testimonies of the Staff and Public Counsel witnesses.

More specifically, in connection with Staff witness Murray's rebuttal testimony I will comment on the following matters:

- The cost of debt.
- The proper capital structure.

- The comparable companies.
- The determination of return on equity.
- The issue of floatation cost.
- The issue of a risk adjustment.
- The matter of including dividend growth in the discounted cash flow ("DCF") calculation.
- The issue of financial risk.
- The consideration of other Commission decisions in determining the appropriateness of the rate of return recommendation.

In connection with the Public Counsel witness Allen's rebuttal testimony, I will discuss the following areas:

- The proper capital structure.
- The comparable companies.
- The use of the retention rate calculation.
- The use of the dividend per share growth rate in the growth rate calculations.
- The recommendation of a hypothetical capital structure.
- The matter of floatation cost.
- Risk adjustments.

With respect to the Public Counsel witness Meisenheimer's rebuttal testimony, I will comment on the single issue which is discussed in that testimony, i.e. the statistical risk analysis which I included in my direct testimony.

Q. It appears that there is some commonality in the areas of discussion between the Staff and Public Counsel rate of return issues. Will your comments cover both rebuttal testimonies?

A. In the areas of capital structure, the comparative company selections, the issue of floatation cost and the inclusion of dividend growth in the DCF growth rate calculations, my surrebuttal testimony will apply to both the Staff and the Public Counsel rebuttal testimonies. The other issues will be discussed separately.

RESPONSE TO STAFF REBUTTAL TESTIMONY

Cost of Debt

Q. What is the issue with respect to the cost of debt?

A. Staff witness Murray, at page 3 of his rebuttal, states that he relies on the imbedded cost of long term debt for Southern Union on a consolidated basis which was provided to him by MGE in Response to Data Request No. 0102. He goes on to criticize my cost of debt and the fact that I did not include short term debt in the capital structure (p. 3, lns 20-23).

Q. How would you characterize the approach of Staff witness Murray to the calculation of the imbedded cost of long term debt?

A. It is not correct.

Q. Why not?

A. The Staff witness has calculated a cost of long term debt based on all of the Southern Union debt outstanding on a consolidated basis, including the debt of Panhandle Eastern Pipeline Company ("Panhandle Eastern"). This approach is wrong for at least two reasons.

Q. What is the first reason?

A. The Staff has repeatedly indicated in previous proceedings that when a company has a subsidiary which issues its own debt, that subsidiary is subject to a stand-alone analysis. In this case Panhandle Eastern is a subsidiary of Southern Union. Panhandle Eastern has its own long term debt outstanding, which is separately rated by the ratings agencies and which was issued by Panhandle Eastern based on its own financial structure without recourse to Southern Union. In fact, all of the Panhandle Eastern long term debt used by witness Murray in his calculation and shown on his as shown on Schedule 10 was issued well before Panhandle Eastern was acquired by Southern Union.

Q. What is the second reason?

A. The Staff witnesses' approach of including the Panhandle Eastern debt violates the Commission's order in Case No. GM-2003-0238 which requires that MGE be "insulated" from Panhandle Eastern.

Q. Does the Staff witness imply that Standard & Poor's is not aware of the Commission Order in Case No. GM-2003-0238?

A. Yes. In his discussion of capital structure, Mr. Murray quotes a portion of a Standard & Poor's ("S&P") Credit Rating Research Report on Southern Union. Mr. Murray concludes from this report that S&P does not recognize the fact that MGE's natural gas distribution properties have been effectively "insulated" from Panhandle Eastern. (p. 12, lns 6-27).

Q. Do you agree with his interpretation of this report?

A. No. S&P apparently was unaware of the stipulation when opining that Southern Union would use available cash to support debt service for either entity. I say this because in a subsequent S&P research report dated April 6, 2004, S&P changed the rating methodology, although not the credit ratings of Southern Union and Panhandle Eastern. Importantly, S&P dropped the statement that Southern Union management would use available cash to support debt service for either entity.

Q. Do you believe that the change in methodology is recognition by S&P that its June 11, 2003 research report was in error?

A. Yes, I do.

Q. Why?

A. A change of that magnitude by S&P is an important event. Many companies have a rating methodology which does not change for years. Here, there was an abrupt change and it was significant.

Q. What is the proper cost of MGE's long term debt for purposes of this case?

A. It is 7.434% at April 30, 2004, the true up date for the capital structure.

Q. Is there a difference between the Staff and MGE in the cost of preferred stock?

A. No. There is only a rounding difference in the costs. Mr. Murray calculates his cost of preferred stock on <u>Schedule 11</u> to his direct testimony. The source of that calculation is MGE's response to Data Request 0102. The correct number is 7.758%.

<u>Capital Structure</u>

Q. What is the issue concerning capital structure that Staff witness Murray addresses in his rebuttal testimony?

A. In his rebuttal, Staff witness Murray criticizes my use of the Southern Union capital structure exclusive of Panhandle Eastern at June 30, 2003. Mr. Murray proposed in his direct testimony the consolidated capital structure, including the Panhandle Eastern long term debt, and he continues on pages 7 and 8 of his rebuttal testimony to make a series of calculations using an erroneous capital structure which was first introduced in his direct testimony. Mr. Murray then reiterates in his rebuttal his support for the consolidated capital structure. This significant error by the Staff witness is discussed in the rebuttal testimony of MGE witness Gillen.

Q. In discussing the capital structure issue in his rebuttal, Staff witness Murray states that it has always been the Staff position that when a company (such as MGE) is a division of a "parent" company (such as Southern Union) and relies on the "parent" for its capital needs the Staff "has consistently recommended the consolidated capital structure of the parent company," for ratemaking purposes. (rebuttal, p. 10, lns 5-6) Is this a correct statement?

A. No.

Q. Please explain.

A. In Docket No. RP99-485-000, a rate proceeding before the Federal Energy Regulatory Commission ("FERC") involving KPC (the former Kansas Pipeline Company) the Commission presented the testimony of Mr. Ron Bible, the Commission's Manager of the Financial Analysis Department. The examiner's report in that case summarizes the Commission's position and states that the

> "MoPSC asserts that in setting the rate of return allowance for a regulated pipeline, the Commission has a preference for using the actual capital structure of the pipeline, so long as the pipeline can demonstrate that it is an independent financial entity. To demonstrate the requisite financial independence, the pipeline must show: (1) without a guarantee from its parent it issues its own debt; and (2) it has its own bond rating." (Footnotes omitted)

Q. How does the Commission's position in the KPC case apply in this case?

A. The Panhandle Eastern subsidiary is an independent financial entity according to the definition advocated by Mr. Bible for the Commission. Therefore, in this case the independent financial entity, Panhandle Eastern, should be removed from the Southern Union consolidated capital structure because it will be regulated separately on its own capital structure by FERC. Consequently, the Southern Union standalone capital structure, without Panhandle Eastern, should be the capital structure used for determining the rate of return for MGE in this case.

Q. Mr. Dunn, what evidence do you have that Southern Union and Panhandle Eastern are separately rated?

A. The research report of S&P dated April 6, 2004, (Surrebuttal Schedule JCD-1) clearly identifies both Southern Union and Panhandle Eastern each with their own S&P ratings.

Q. Has Moody's separately rated both Southern Union and Panhandle Eastern?

A. Yes. In its analysis dated February, 2004, (Surrebuttal Schedule JCD-2) Panhandle Eastern is separately discussed by Moody's. It is clear from that document that Panhandle Eastern has a rating separate from Southern Union.

Q. Mr. Dunn, please summarize how the position on financial independence advocated by Mr. Bible on behalf of the Commission in the FERC proceeding involving KPC mandates the use of the Southern Union standalone capital structure in this case without Panhandle Eastern?

A. The position advocated by Mr. Bible on behalf of the Commission in the KPC case is that a financially independent company should be regulated using its own capital structure, and Panhandle Eastern meets this definition of financial independence. This can only mean that divisions of Southern Union such as MGE should be regulated using the remainder of the consolidated capital structure, exclusive of the capital structure of Panhandle Eastern, as long as the remaining divisions form a homogenous group and are financed as a group.

Q. What impact does this have on the capital structures and calculations that appear on pages 6 through 9 of Mr. Murray's rebuttal testimony?

A. It demonstrates that Mr. Murray's capital structure calculations are incorrect and should not be accorded any weight. The capital structure that should be used in calculating rate of return is the capital structure for Southern Union, exclusive of Panhandle Eastern.

Q. In connection with the discussion of the capital structure and the Staff's effort to justify the use of the consolidated capital structure with a low common equity ratio, Staff witness Murray describes the refinancing of the Southern Union TOPrS with a new issue or series of preferred stock. This discussion begins at page 13, line 7 of Mr. Murray's rebuttal and continues on to page 14. Do you have a response?

A. Yes. Mr. Murray implies that proceeds from the October preferred issuance were used to fund the acquisition of Panhandle Eastern. This is not true because it would have constituted a violation of the Stipulation and Agreement approved by the Commission in Case No. GM-2003-0238 precluding the flow of cash from Southern Union to Panhandle Eastern, absent Commission approval, and otherwise insulating MGE from Panhandle Eastern.

Q. Mr. Dunn, have you made an affirmative calculation of rate of return including a proforma capital structure and actual costs of debt and preferred?

A. Yes.

Q. What is the date of that capital structure used in that calculation?

A. The date of the capital structure is April 30, 2004. This date is the true-up date for this rate proceeding. MGE and the Staff have agreed to true-up the capital structure as of that date.

Q. What is the cost of long term debt which will be used in that capital structure?

A. The cost of debt included in the capital structure is 7.434%.

Q. What is the cost of preferred stock?

A. The cost of preferred stock included in the capital structure is 7.758%.

Q. What is the total capital structure?

A. The total capital structure is $2,002,287,943. That capital structure is composed of the following elements:

TABLE 1
Pro Forma Capital Structure
Southern Union Company Only
April 30, 2004

	Amount	Ratio
Long Term Debt	$ 948,833,985	47.39%
Preferred Equity	230,000,000	11.49
Common Equity	823,453,958	41.13
TOTAL	$2,002,287,943	100.00%

Q. The capital structure has no short-term debt included. Is there a short-term debt balance at April 30, 2004?

A. Southern Union has no short-term debt balance on April 30, 2004. All of its short term debt has been repaid.

Q. What adjustments have been made to this capital structure?

A. There have been three adjustments. The purpose of which was to eliminate any effect of the Panhandle Eastern acquisition from the resulting capital structure. The first adjustment is to eliminate $48.9 Million of common equity which is related to the Panhandle Eastern purchase. This is the value of three million shares of Southern Union stock that were included in the transaction. The second adjustment is to eliminate $91 Million in equity related to retained earnings of Panhandle Eastern since the acquisition. The third adjustment eliminates the hybrid security. The last adjustment recognizes that the balance of the purchase price, approximately $145 million, was raised through the issuance of common equity and equity units; approximately $84.5 million in equity and $60.5 million in debt (the 5.75% equity units).

Q. In your opinion does this capital structure eliminate all amounts related to the acquisition of Panhandle Eastern?

A. Yes. This capital structure eliminates all Panhandle Eastern related capital and complies with Generally Accepted Accounting Principles ("GAAP").

Q. What is the rate of return associated with this capital structure using the cost of debt and preferred stock that you previously stated?

A. The overall rate of return, using the cost of debt and preferred previously stated and a return on equity of 12%, is 9.35%. That calculation is as follows:

TABLE 2

Rate of Return
Southern Union Company Only
April 30, 2004

	Ratio	Cost	Weighted Cost
Long Term Debt	47.39%	7.434%	3.52%
Preferred Equity	11.49	7.758	.89
Common Equity	41.13	12.000	4.94
TOTAL	100.00%	----	9.35%

Q. Do your comments with respect to capital structure apply equally to the Staff and Public Counsel rebuttal testimonies?

A. Only to a certain extent. Public Counsel advocated the consolidated capital structure in its direct testimony, but it did not use the Panhandle Eastern debt to attempt to reduce the cost of debt for MGE. The use of the consolidated capital structure was wrong, but the calculation of the cost of debt was correct. In the rebuttal testimony, the Public Counsel recommended the use of a hypothetical capital structure. (p. 14, lns 13-20) I agree that the use of a hypothetical capital structure is appropriate, but I disagree with the ultimate selection of the hypothetical capital structure. I will discuss that later in this testimony.

Q. Have you reviewed the deposition of Dr. Roger A. Morin which was taken in this case by the Staff and Public Counsel on June 10, 2004?

A. Yes. I attach a copy of the transcript of Dr. Morin's deposition as Surrebuttal Schedule JCD-3.

Q. Did Dr. Morin comment on the use of a hypothetical capital structure in his deposition?

A. Yes, he indicated that the use of a hypothetical was very appropriate, in fact probably the best approach in this case because of the low equity ratio of the consolidated capital structure advocated by the Staff in this case. (Morin deposition, p. 97 and following)

Comparable Companies

Q. Does the Staff witness indicate that he has concerns with respect to the proxy companies that you use for your return on equity analysis?

A. Yes. Beginning at page 18 of Mr. Murray's rebuttal testimony, there is some discussion concerning the selection and the resulting group of companies that I use to establish a benchmark or baseline return on equity.

Q. What is the essence of the criticism?

A. The primary criticism is that some of the companies in my comparative group are not in the Edward Jones natural gas distribution group at December 30, 2003 and therefore are not the least diversified group of gas distribution companies available.

Q. Do you believe this is a reasonable criticism?

A. No. Furthermore, I don't believe that it has any meaning.

Q. Please explain.

A. As I explained in my direct testimony, in a rate of return analysis, it is impossible to develop a group which is precisely comparable to any subject company. Consequently it is essential that a benchmark return be developed for a proxy group of companies and that the risk differential between the proxy group and the subject company then be quantified using statistical and qualitative tools so that appropriate adjustment for risk/comparability differences can be made.

Q. Did you perform such an analysis, i.e. determine a benchmark return and then calculate adjustments using statistical and qualitative tools?

A. Yes, I did.

Q. Did either the Staff or the Public Counsel witnesses follow this approach?

A. No.

Q. Did Dr. Morin comment on the selection of comparable companies in his deposition?

A. Yes.

Q. And what was said?

A. He indicated that in the past he tried to select companies that were as comparable as possible in making a comparative group. However, he went on to say that with the changes in the utility industry, he now selected as broad a group as possible and did his analysis followed by an appropriate risk adjustment. (Surrebuttal Schedule JCD-3, pages 52 & 53)

Q. Is this the methodology you used?

A. It is.

Q. Since the Staff witness did not make a qualitative analysis or quantitative analysis of the risk differences between its proxy group and MGE, is it possible that there are substantial differences between MGE and the Staff proxy group?

A. Yes. There are very substantial differences between the proxy companies used by Staff and by MGE. As a matter of fact, the Staff's proxy group just isn't comparable to MGE.

Q. Please give us an example.

A. One of the companies in the Staff proxy group is AGL Resources, the parent company of Atlanta Gas Light. AGL Resources does not own the natural gas in its system in the traditional distribution sense. AGL Resources simply sells transportation services to its customers.

Q. What impact does this difference with AGL have on a comparative analysis?

A. It has a major impact on risk. The weather exposure for natural gas cost and the exposure to disallowances of natural gas costs incurred by the company is eliminated for Atlanta Gas Light, while it is substantial for MGE. As a result MGE has much greater risk.

Q. Are there other differences?

A. Yes. The depreciation rates for MGE are lower than for the Staff comparative group. This means that MGE's investors will recapture their capital investment over a longer period of time than will the investors in the companies that comprise the Staff proxy group. This means that, all other things equal, the return of investment in MGE is at greater risk, simply because the investment is exposed to higher levels and greater numbers of unexpected events over a longer period of time.

Q. Are there any other differences?

A. Yes. Several of the companies in the Staff proxy group (AGL Resources, New Jersey Resources, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries and WGL Holdings, Inc.) have weather normalization or moderation clauses of one type or another. This is also true for a number of companies the Public Counsel proxy group (AGL Resources, South Jersey Industries, Northwest Natural Gas and WGL Holdings, Inc.) as well as for several companies in the MGE proxy group (AGL Resources, Atmos Energy, Laclede Gas, NUI Corp., New Jersey Resources, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries and WGL Holdings, Inc.). MGE does not have such a clause. MGE has requested one in this proceeding, but the Staff and Public Counsel have opposed that request. Consequently, MGE has greater risk exposure due to the impact of weather on its revenue streams. Furthermore, in comparison to Atlanta Gas Light, the risk for MGE is magnified because Atlanta Gas Light has no costs associated with any weather related commodity costs. AGL Resources, Nicor and Peoples Energy also have in place environmental recovery surcharges/riders related to manufactured gas plant costs that mitigate risk related to the recovery of MGP-related costs.

Q. Did the Staff witness make any analysis of the companies which he included in his proxy group?

A. Incredibly he did not. MGE's Data Request No. 0163 to Staff witness Murray on 5/11/04 requested that Mr. Murray describe his evaluation of his comparable companies including a specific evaluation of:

a. the equity ratio of each of the companies;

b. the sales mix of each of the companies;

c. the ownership of pipelines by each of the companies as it compares to Southern Union and MGE;

d. the sale or propane by each of the companies as it compares to Southern Union and MGE;

e. the number of customers of each of the companies as it compares to Southern Union and MGE;

f. whether or not the companies are legally established as a holding company;

g. whether or not each of the companies engage in exploration;

h. whether or not the companies generate electricity;

i. whether or not he companies own natural gas storage.

Mr. Murray did not evaluate any of these important factors except for the sales mix of each of the companies. Attached as Surrebuttal Schedule JCD-4 is a copy of his response.

Q. One of the concerns expressed by the Staff in its rebuttal testimony is that you included in your proxy group a Missouri company, Laclede Gas Company. How do you respond?

A. It is not a valid concern.

Q. Please explain.

A. Many years ago, when the Commission made its determination of the required return on equity using book data only, it was appropriate that it not consider companies under its jurisdiction in reaching conclusions about other companies under its jurisdiction. Clearly there was a problem of circularity if the Commission used its own prior decisions to make current decisions.

Today, however, things are entirely different. The Staff and other witnesses before the Commission on the issue of rate of return have used the DCF methodology. The DCF model breaks the chain that makes circularity or feedback a problem in the decision making process.

Q. How does it do that?

A. The Commission makes a decision. That decision may impact the book returns on equity and the book earnings of the company. However, it is the multitude of shareholders and institutions acting independent of the Commission and independently from each other which causes stock prices to move up and down and dividend yields to be established. It is these shareholder determined dividend yields that become a crucial part of the DCF calculation and dominate the DCF cost of common equity. Thus even though the Commission made a decision that impacts book returns, it has limited impact on the DCF return and those DCF returns therefore do not have the potential for introducing material circularity or feedback into the decision making process if they are an appropriate part of a comparative group. It is simply incorrect to exclude Missouri companies from the process just because they are Missouri regulated.

Determination of Return on Equity

Q. What does the Staff witness say in his rebuttal testimony concerning your determination of the required return on equity for MGE?

A. Beginning at page 23 of his rebuttal testimony, Mr. Murray presents his position on calculating the return on equity. An important part of that position is that no floatation costs should be taken into consideration in calculating the DCF cost of equity, in spite of the fact that floatation cost is a required and a well-accepted part of the DCF formula. The Staff witness also asserts that MGE cannot be classified as a small company and consequently does not experience greater risk as a result of its size; that I did not calculate a growth rate by averaging a series of numbers as the Staff did, but rather used judgment in determining the appropriate growth; that I should have used a geometric mean rather than an arithmetic mean in calculating historical growth rates in my year-to-year growth rate calculation; and that it is impossible to make an adjustment for financial risk because it is impossible to hold everything else equal or constant in a proxy group (p. 39, lns 1-9)

Q. How do you respond?

A. These are not valid criticisms and some of the assertions, such as the inability to make a financial risk adjustment, are incorrect.

Floatation Cost

Q. Staff suggests that the stipulation approved by the Commission in connection with the acquisition of Panhandle Eastern prohibits an adjustment for floatation expense. Do you agree with that assertion?

A. No. Staff uses the stipulation or ignores it as suits its purpose. Staff ignores it, for example, by including the lower cost of debt of Panhandle Eastern when calculating the cost of debt of Southern Union. Staff then takes advantage of the stipulation to argue that a conventional, ordinary and reasonable adjustment to the DCF for floatation expense is prohibited.

Q. What is the floatation adjustment?

A. The floatation cost adjustment is explained in the direct testimony but it is simply an adjustment to reflect the fact that expenses are incurred in connection with the sale of new common stock and that the only way in which the shareholder can be reimbursed for those expenses is if they are accounted for in the rate proceeding. It also accommodates pre-offering pressure.

Q. Does Southern Union anticipate a sale of common stock?

A. Yes.

Q. Is there any affirmative evidence of that fact?

A. Yes. The Massachusetts Commission received a presentation by Southern Union in connection with the sale of that common stock and has approved the sale by an order. I have attached that order as Surrebuttal Schedule JCD-5.

Q. Will MGE benefit from the issuance of new common stock?

A. Yes, it will. There will be additional equity capital available to MGE to add to the facilities which are used and useful in supplying natural gas distribution service to its Missouri customers; there will be an improvement in the equity ratio of Southern Union; there will be a maintenance of investment grade ratings for Southern Union's bonds and the capital structure will be more balanced. All of these factors will benefit the customers of MGE.

Q. Will any of these funds be used for the direct benefit of Panhandle Eastern?

A. No. None of these funds related to the proceeds of the sale of equity securities will be distributed to Panhandle Eastern. It will not be a beneficiary of the equity offering.

Q. Is an adjustment for floatation costs an ordinary part of the DCF model?

A. It is.

Q. Did Dr. Morin comment on the lack of a floatation adjustment in the Staff DCF calculation?

A. Yes he did. On pages 13 and 14 of the transcript of his deposition he indicates that the floatation cost adjustment is omitted from the Staff DCF calculation and that it results in an understatement of the cost of equity of 30 basis points to Surrebuttal Schedule JCD-3. On page 40 of his deposition he describes the Murray DCF as lacking "the real world refinements like floatation costs" and concludes at page 26 of his deposition that this is one of the errors which causes him to conclude that Mr. Murray is not an expert in the field of rate of return. (id.)

Growth Rate Calculation

Q. Staff witness Murray is critical of the fact that you did not have a specific calculation to determine your growth rate for the DCF. How do you respond?

A. It is not a valid criticism.

Q. Please explain.

A. The Staff witness has employed a very mechanical approach to the determination of the cost of equity using the DCF model. In my opinion, rather than following this rigid "mechanical" approach, it is much more appropriate to examine the data and apply judgment to that data to determine the appropriate return on equity using the DCF model. Specifically, a component of the DCF calculation is the growth rate and the appropriate way to determine the growth rate is to examine the historic growth rates and available projected growth rates, and based upon that array of data to reach a conclusion about a reasonable growth rate for the future of a typical natural gas distribution company. Reaching that conclusion is a matter of judgment; it is not just a matter of mechanically running raw data through a series of calculations.

Q. Does Dr. Morin agree that the process is one of judgment and not simply calculation?

A. Yes. During his deposition, he indicated that he reviews all of the information that he can develop and then reaches a "global judgment" on the issue of rate of return. It is not a calculation. (Surrebuttal Schedule JCD-3, page 103)

Q. Are there any other pitfalls associated with the use of the mechanical approach such as that used by the Staff witness?

A. Yes. After layering average on top of average, Staff witness Murray has included historical growth in dividends per share in his calculation several times. As has been abundantly demonstrated in testimony in this proceeding and by the data included in the Staff and Public Counsel testimonies and schedules, the dividend policy of natural gas distribution companies has changed. Many of the companies in the Staff group, for example, have not raised their dividends for many years at a time. As a result, the growth in dividends per share is abnormally low and no longer relevant investors' forward looking growth expectations. Unfortunately, Mr. Murray's mechanical approach excludes the application of judgment, and ultimately produces an end result radically at odds with reality simply because these anomalous numbers are averaged into the calculation when they should be excluded.

Q. Does Dr. Morin agree that the current dividend growth rates are not relevant and using them leads to incorrect answers?

A. Yes he does. In fact, he is clear that the use of historic dividend growth is totally in error. (Surrebuttal Schedule JCD-3, pages 29-31)

Q. Why does Mr. Murray use a mechanical approach without the exercise of judgment?

A. Based on his testimony and his deposition which was taken in this case I believe it is because he lacks the expertise to determine the reliability of the methodology and data that he uses. Consequently, he simply goes through a "mechanistic" approach without the exercise of judgment that one would expect from an expert. I am not alone in my view that Mr. Murray is not an expert. I have reviewed the testimony of Dr. Roger A. Morin, as well as his deposition which was taken in this case by the Staff and Public Counsel on June 10, 2004, and he concurs. I attach a copy of the transcript of Mr. Murray's deposition as Surrebuttal Schedule JCD-6. As indicated, Dr. Morin's deposition is Surrebuttal Schedule JCD-3.

Q. Does this criticism with respect to including historic dividend per share growth in the calculation apply to the Public Counsel witness?

A. Yes it does.

Risk Adjustment

Q. The Staff witness is critical of your discussions with respect to the risks associated with a small company as compared to a larger company. He says that the company being regulated is Southern Union and that Southern Union is a large company.

A. Southern Union is a large company. However, MGE, the division of Southern Union which is regulated by the Commission and whose rates are under consideration in this proceeding, is a small company as compared to the companies in the proxy group.

Q. Mr. Dunn, did you make a specific adjustment to the return on equity for the size effect?

A. No, I did not.

Financial Risk Adjustment

Q. Staff witness Murray failed to make an adjustment for financial risk and, on page 39 of his rebuttal testimony, indicated that such an adjustment is impossible since it requires everything else be held equal in order to make a comparison. Do you agree?

A. I do not. The matter is much less complex than implied by Mr. Murray. In fact, it is entirely appropriate, reasonable and in fact essential to make a financial risk adjustment when a company has a significantly different equity ratio than the proxy group such as the equity ratio attributed to MGE by the Staff witness.

Q. Why is the matter less complex then suggested by Mr. Murray?

A. There are only two types of risk which genuinely concern the shareholder. The first of these is "business risk" and the second "financial risk." Financial risk is an observable matter. If a company has a lower equity ratio than its peer group, it has greater financial risk. The business risk may be higher or lower than the business risk of the comparable group of companies, and that can be dealt with separately. The fact of the matter, however, is that financial risk differences are absolute and can be considered independently of business risk differences. Consequently, it is inappropriate to say the matter is too complicated when in fact it is really simply and direct. Part of Mr. Murray's problem with this is that it appears he does not understand the meaning of the term "financial risk," a point that I will address later. This again demonstrates that he is not a cost of capital expert.

Q. Is a financial risk adjustment required?

A. Yes. If the Staff persist in using the low equity capital structure, it is essential that the Staff make an adjustment for the increased risk caused by the low equity ratio. In the alternative, a hypothetical capital structure could be used.

Q. Did Dr. Morin comment on this issue in his deposition?

A. Yes. During his deposition, Dr. Morin clearly indicated that either there is an adjustment for the low equity ratio or a hypothetical capital structure should be used. (Surrebuttal Schedule JCD-3, pages 108 & 109)

Consideration of Other Decisions

Q. On page 39 of his rebuttal testimony, Staff witness Murray is critical of your consideration of the results of other jurisdictions and the returns authorized by other jurisdictions in various rate proceedings involving natural gas distribution companies. Do you believe this is an appropriate criticism?

A. No. As a matter of fact, I believe that the criticism applies to the Staff witness for not using such information.

Q. Why?

A. The Staff witness, in discussing his failure to use information concerning other companies and other Commission decisions, says that he has done a thorough and complete job of his analysis and that he calculated the right answer.

Q. Why, then, does he refuse to confirm the reasonableness of his result?

A. If Staff analysis truly produces the "right answer,", there should be no reason why the Staff witness is reluctant to compare his "right" answer with the decisions made by other commissions based on recommendations from other analysts who also believe that they are making valid studies of the cost of equity.

Q. What would Mr. Murray discover if he compared the end result of his work with the decisions of other commissions?

A. He would discover that his views are radically out of step with the rest of the regulatory world. Mr. Murray is recommending in this proceeding a return on equity in the range of 8.52% to 9.52%. The return on equity authorized by other commissions for 2003 and the first quarter of 2004 is 11% to 11.1%. Such a significant difference, given the fact that the decisions of other commissions involve numerous commissioners and experts, suggests that Mr. Murray's estimate is so far below the range of reasonableness that it cannot be helpful to this Commission in reaching a decision. For that reason alone, his recommendation should be afforded no weight.

Q. Mr. Dunn, have the Staff rate of return recommendations to the Commission always fallen significantly below the decisions made by other commissions around the country?

A. No sir, they have not.

Q. Have you prepared a comparison of Staff recommendations and nationwide commission decisions over an extended period?

A. Yes I have. Surrebuttal Schedule JCD-7 is an analysis for the period 1993 through 2004 of natural gas decisions by commissions around the country compared to Staff recommendations. Also included on the schedule are the recommendations of the Public Counsel during the same period. This schedule contains data reported by Regulatory Research Associates ("RRA") on natural gas distribution return on equity decisions and all of the Staff and Public Counsel return on equity recommendations on natural gas distribution companies for the period.

Q. Do financial analysts making rate of return determinations typically rely on information such as that reported by RRA?

A. Yes.

Q. Is the information reported by RRA considered reliable?

A. Yes.

Q. What does the data show?

A. The data shows that for the period 1993 through about 1997, the Staff made recommendations which were comparable to the decisions made by regulatory commissions around the country. The average regulatory commission decision for that period, 1993 through 1997, was 11.32%. The average Staff recommendation for 5 cases during that period was 11.13%. Starting in about 1998, however, the Staff went off in a different direction.

Q. What is the comparison for the period 1998 through 2004?

A. During that six year span, the average nation-wide regulatory decision for natural gas distribution companies was 11.07%. However, the Staff, during that same period, for a total of ten cases, had an average recommendation of only 9.71%.

Even more striking is the difference between the Staff recommendations to the Commission and the average commission decisions nation-wide for the period 2001 through 2004.

Q. What does that comparison reveal?

A. The average nation-wide regulatory commission decision for return on equity for natural gas distribution companies for the period 2001 through 2004 is 11.02%. The average recommendation of the Staff to the Commission for six cases for that same four-year period is 9.34%. Clearly, there is a substantial difference and that difference is striking with the Staff recommending 9.25% return on equity in three cases and 9.22 and 9.02% return on equity in two others.

Q. What is the detail which supports these averages?

A. The specific decisions as reported by RRA and the recommendations of the Staff in natural gas rate cases for the period 2001 to 2004 is as follows:

Year	RRA Regulatory Decisions	Staff Recommendations
2001	10.95%	9.25%/10.05%
2002	11.03%	9.25%
2003	10.99%	9.25%
2004	11.10%	9.22%/9.02%

Q. How would you characterize these Staff recommendations?

A. They are clearly outside of the mainstream of return on equity decisions by commissions around the country. They do not in any way reflect the true cost of equity during this period. There is no way the Staff recommendations can be reconciled with the decisions made by commissions nation-wide.

Q. Did Dr. Morin comment on the level of the Staff recommendation?

A. Yes. He indicated on page 105 of his deposition that if the result of the Staff analysis was in the range of 9.01 to 9.34 using two different methods, that the results of both would be wrong. (Surrebuttal Schedule JCD-3)

Q. Does Dr. Morin use or review the results of other commissions in making his analyses?

A. Yes. On pages 32 and 33 of his deposition Dr. Morin refers to the RRA report on the decision of other commissions and concludes that the data indicates that the Staff result is too low. In fact, he says that the data speaks for itself. (Surrebuttal Schedule JCD-3)

Q. What else does Mr. Murray's criticism on pages 39 and 40 of his rebuttal testimony tell you about the Staff's overall approach to its cost of capital recommendations in rate cases?

A. The Staff's approach, in failing to consider what is going on in the rest of the world is clearly outside the mainstream. In this regard, Mr. Murray's testimony in the recently concluded Aquila, Inc. electric rate case, Case No. ER-2004-0034, is instructive. I attached as Surrebuttal Schedule JCD-8, pages 1610 to 1743 of the transcript in that proceeding which reveals, among other things, that:

- Mr. Murray would not agree that what the courts have said with respect to a fair return is the standard this Commission should follow. "There are other things that have to be taken into consideration." (Tr. 1618)

- According to Mr. Murray the comparable risk standard "may be one of the standards that is considered." (Tr. 1620)

- It is the policy of the Staff not to look at allowed ROE's or earned returns of other utilities to come up with cost of capital recommendations in rate cases. (Tr. 1733). Mr. Murray cannot square this Staff policy with the requirement of the *Hope* case. (Tr. 1734) and is not sure that the *Hope* case must be followed in any event. (Tr. 1618, 1619).

- Mr. Murray has never read any decisions from any other Commissions (Tr. 1732), including rate case decisions. "As far as what goes on in the specifics of cases throughout this country, I would be working 24/7 to be able to keep up with that." (Tr. 1625)

- Mr. Murray is not really familiar as to how one finds returns actually being earned by other utilities. (Tr. 1622, 1624)

- Mr. Murray has never looked at the textbook *Principles of Utility Rates* by James Bonright. (Tr. 1706)
- Mr. Murray incorrectly defines "financial risk" as "the ability of a company to meet its debt." (Tr. 1633)

- Most of his criteria for selecting comparable companies have nothing to do with risk. (Tr. 1642)

<u>Murray's "thorough and complete analysis"</u>

Q. Mr. Dunn, on page 40 of his rebuttal testimony, Staff witness Murray testified that he has based his return on equity recommendation for MGE in this case on what he calls "a thorough and complete analysis of the cost of common equity for a comparable group of companies, primarily using the DCF model…" What is your understanding of the other techniques which Mr. Murray used in his "thorough and complete analysis" to calculate a cost of equity for MGE in this case?

A. It is my understanding that he also used the risk premium model and the capital asset pricing model ("CAPM") to check the reasonableness of the results from use of his primary DCF method.

Q. How does his approach compare to your approach?

A. I also used the DCF model which has been utilized for many years by this Commission.

Q. Did you check the reasonableness of your results by using the risk premium model or the CAPM?

A. No. I did not. However, a proper performance of a CAPM and risk premium cost of equity analysis on the Staff's group of eight comparable companies would not support the return on equity result which Staff witness Murray says, in his rebuttal testimony, resulted from a "thorough and complete analysis." Furthermore, Mr. Murray did not accord the risk premium method and the CAPM approach any weight in his conclusion in spite of the fact that both of his alternate calculations produced higher indications of the cost of equity than his DCF calculation.

Q. By way of background, please summarize Mr. Murray's risk premium analysis and CAPM analysis.

A. Mr. Murray's risk premium analysis is contained on Schedule 21 to his direct testimony and is based in part on data from his Schedule 20. His result indicates a cost of equity of 10.41% which is substantially above his recommendation for MGE in this case. Even that, however, is a result which is lower than the result which is indicated by an analysis using published data. His CAPM analysis is on his Schedule 19.

Q. In response to Mr. Murray's statement at page 40 of his rebuttal testimony concerning a "thorough and complete analysis" have you performed a "thorough and complete" cost of equity analysis for Mr. Murray's comparable companies?

A. Yes.

Q. What did you do?

A. I performed a risk premium and CAPM analysis.

Q. Did you make a risk premium analysis using published data?

A. Yes I did.

Q. Please describe the results.

A. The first step in my risk premium analysis was to obtain a risk premium for equities for the period 1928 to 2003. I obtained that information from a web site at the New York University Stern School Website Page of Professor Damodaran. The data indicated a market return for the period of 11.82% and a long term treasury rate for the same period of 5.28% for a risk premium of 6.54%. I added Mr. Murray's 2004 long term yield rate of 4.93% to the risk premium amount for an indicated cost of equity of 11.47%. This is substantially different than the result obtained by Mr. Murray.

Q. Please summarize your CAPM model and the result.

A. I used the same CAPM model as used by Mr. Murray. I also used his information to the extent I could.

Q. Please explain.

A. In analyzing the long run market returns for the CAPM analysis, I noticed that the market returns were higher for shorter periods. For example, the 1928-2003 return was 11.82 % while the 1963-2003 return was 12.10% and the 1993-2003 return was 12.63%. As a result of this pattern of returns, I determined that it was appropriate to use the most recent 1993-2003 data in my calculation.

Q. What did you use as the proper beta?

A I used the Value Line betas from the March 19, 2004 issue, a more current issue than used by Mr. Murray.

Q. Did using the more current issue result in any changes?

A. It did. One of the eight betas increased from .60 to .65. All of the other betas remained the same. The result of this change was to increase the average beta of the group from .68 to .69.

Q. What was the result of your calculations?

A. I reduced the 12.63 market return for the period by the current 4.80 long term risk free, treasury rate from the Wall Street Journal June 11, 2004. The result was a return of 7.83% which I multiplied by the average beta of .69 for a premium amount of 5.40%. I then added back the 4.80% risk free rate for a total return of 10.20. This compares to the calculation made by Mr. Murray which resulted in a cost of 9.29% as shown on his Schedule 19.

RESPONSE TO PUBLIC COUNSEL REBUTTAL TESTIMONY

Rate of Return

Q. At page 7, line 25 of the rebuttal testimony Public Counsel witness Allen, Mr. Allen attempts to recalculate your return estimate using the Value Line edition of September 19, 2003, and the Public Counsel methodology of "BR+SV." How do you respond?

A. This is not appropriate.

Q. Please explain.

A. The BR+SV methodology contains a circularity so fundamental that the calculation is absolutely worthless in this context as a methodology to estimate the cost of common equity.

Q. Why is it worthless?

A. The methodology can be applied either historically or in a projected format. Regardless of which calculation is made, you must know the answer before you make the calculation.

Q. Discuss what you mean by a "historical calculation."

A. If the BR + SV applied historically, the actual historical results absolutely determine the calculation of BR+SV and those historical results, whether abnormal or not, completely determine the recommended cost of equity. If, for example, a company has bad years and those bad years are incorporated in the calculation, the result will be a low recommended return on equity for that company. On the other hand, if the company has had excellent or outstanding years, those will also be reflected in the BR+SV calculation and result will be a very high recommendation. The simple fact is the past absolutely determines the future using this methodology, and thus there is a serious problem in using this approach in a historical fashion.

Q. What about using this method in the forecasted or projected format in the manner used by the Public Counsel?

A. The problem with this approach is that the return on equity must be known for future years in order to make the calculation. This can be established from Public Counsel witness's direct testimony in this case.

Q. How is this established by examination of the Public Counsel witness's testimony in this case?

A. Mr. Allen's BR+SV calculations appear beginning at Schedule TA-6, page 2 of his direct testimony. The top half of this schedule shows a historic calculation of BR+SV, and the bottom half of the schedule is a calculation of a projected BR+SV. As can be seen from the top half of the schedule, the BR component of the calculation is a multiplication of the retention ratio times the equity return. The purpose of this exercise is to develop a cost of equity recommendation. However, in order to make that recommendation using the BR+SV approach, it is necessary to know the answer, i.e. the equity return, and the dividend payout before the calculation can be made. This can be seen less clearly from the bottom half of the page where the 2007-2009 estimated return on equity are multiplied times a retention ratio, both of which must be known in order to derive the BR component of the calculation. Simply stated, in order to use the formula, one must know the answer before one makes the calculation. This is a fundamental flaw in the methodology and one which cannot be overcome.

Q. Did the Public Counsel witness make a risk adjustment in his calculation of the required return on common equity?

A. No. In fact, for some reason, Mr. Allen has suggested in his rebuttal testimony at page 22, lns 9-11 that he is now supporting the lower end of his recommended range of returns rather than the upper limit of the range of returns that he recommended in his direct testimony (p. 16, lns. 12-17).

Q. What was the point of the recommendation toward the upper limit of the Public Counsel range of returns on equity in the original testimony?

A. The Public Counsel witness indicated that he (felt) that the recommendation at the upper end of the range properly compensated MGE for the higher level of risk associated with the fact that using a consolidated capital structure resulted in a much higher level of leverage for Southern Union than for the comparable companies in his group.

Q. Do you believe that is accurate?

A. Absolutely not. An adjustment so small to compensate for such a substantial difference in the common equity ratio is simply absurd.

Q. How much difference is there in the Public Counsel recommended equity ratio for MGE and the average equity ratio of his proxy group?

A. The Public counsel proxy group equity ratio is 40.0%. The Public Counsel witness recommended equity ratio for MGE is 25.98%. This is a very substantial difference.

Q. Are there any other risk adjustments which Mr. Allen has failed to make?

A. Yes. In his rebuttal at page 19, Mr. Allen dismisses the notion of longer depreciation as a risk factor. This dismissal flies in the face of fundamental principles of finance. For example, long term bonds pay higher interest rates than short term bonds and the differential in interest rate is compensation for the fact that the funds are exposed to greater levels of risk over longer periods of time, whereas short term lendings have less exposure to such risk by virtue of the fact that the time element is shorter. The same applies to depreciation. The longer a capital investment is exposed to unknown risks, the greater the risk to the investor. The greater the risk and the higher the required return. Mr. Allen should know this, and it is absolutely improper and unreasonable that he rejects it in his surrebuttal testimony.

Q. Mr. Allen asserts, on page 21 of his rebuttal testimony, that the recently enacted infrastructure system replacement surcharge ("ISRS") legislation serves to reduce MGE's risk. How do you respond?

A. The information upon which Mr. Allen apparently relies in reaching this conclusion is insufficient to support that conclusion. As I understand it, the ISRS legislation allows companies like MGE to adjust rates periodically outside the context of a general rate proceeding to recover the cost of governmentally-mandated, non-revenue producing capital expenditures. A significant proportion of such costs for MGE relate to safety line replacement program ("SLRP") expenditures, the earnings degradation impact of which has historically been mitigated through the Commission's issuance of accounting authority orders ("AAOs"). In many ways, the ISRS process simply replaces the AAO process and, as such, should not be expected to have any material impact on risk experienced by MGE. Moreover, Mr. Allen's assertion that MGE is the only gas company that has an ISRS is wrong. Laclede Gas recently implemented an ISRS. In addition, Atmos Energy Corporation has a pipe replacement surcharge mechanism in Georgia.

Q. On page 22 of his rebuttal testimony, Pubic Counsel witness Allen asserts that a downward adjustment to return on equity is appropriate if the Commission adopts a weather mitigation rate design for MGE. How do you respond?

A. I disagree. All of the comparable company groups used by the various rate of return witnesses in this proceeding include companies that have some form of weather mitigation rate design. Therefore, investor expectations related to such rate design are already appropriately reflected in the discounted cash flow analysis and no further adjustment is needed for this item. In any event, if any adjustment is to be considered the starting point, prior to any such adjustment, must be reasonable. Comparison to equity returns being authorized by other regulatory authorities clearly establishes that the Staff and Public Counsel return on equity recommendations in the proceeding do not qualify as such a reasonable starting point.

Capital Structure

Q. The Public Counsel witness has proposed a hypothetical capital structure in his rebuttal testimony in this proceeding. Do you have any comments with respect to that capital structure?

A. Yes I do.

Q. What are they?

A. First, I should note that I believe it is appropriate to consider a hypothetical capital structure in this proceeding. Furthermore, it is not unreasonable to make a series of calculations similar to those made by the Public Counsel witness. The problem arises from Mr. Allen's selection of a hypothetical capital structure from the zone of reasonableness that he calculated.

Q. What was the zone of reasonableness established by the Public Counsel witness in his rebuttal testimony?

A. The zone of reasonableness for the hypothetical capital structure ranged from a common equity ratio of 37.6% to 58.2% (p. 13, ln. 1).

Q. After establishing that zone of reasonableness, what did Mr. Allen determine as the appropriate capital structure?

A. He selected "the very bottom of the range, 37.6%" (p. 13. ln. 12).

Q. How do you respond?

A. This is not appropriate. As a matter of fact, the analysis and calculations made by the Public Counsel witness, if they have any validity, would suggest that the mid-point of the range is the point of greatest reasonableness. In other words, the mid-point of the range is the best point for a calculation of a hypothetical capital structure.

<u>Statistical Risk Analysis</u>

Q. Public Counsel witness Meisenheimer, in her rebuttal testimony, is critical of your statistical analysis of risk. What is the nature of her criticism?

A. On page 4 of her rebuttal she states that it would be more relevant for the Commission to examine each of the individual companies in my proxy group against MGE rather than examining the average of the proxy group against MGE.

Q. Did she make such a calculation?

A. Yes.

Q. What did that calculation show?

A. According to the Public Counsel calculations, of the 15 companies in my proxy group, 10 are less risky than MGE as demonstrated by a lower standard deviation and 12 of the

15 companies are less risky as demonstrated by the calculation of the co-efficient of variation. This data, taken from Table 2 on page 8 of Ms. Meisenheimer's rebuttal testimony, supports my conclusion that MGE is significantly riskier than the proxy group.