Exhibit No.:	
Issues:	*Rate of Return and Capital Structure*
Witness:	*Zephania Marevangepo*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*GR-2014-0007*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DEPARTMENT

REBUTTAL TESTIMONY

OF

ZEPHANIA MAREVANGEPO

MISSOURI GAS ENERGY DIVISION
OF LACLEDE GAS COMPANY

CASE NO. GR-2014-0007

Jefferson City, Missouri
March 2014

** **Denotes Highly Confidential Information** ** **NP**

TABLE OF CONTENTS

OF THE REBUTTAL TESTIMONY OF

ZEPHANIA MAREVANGEPO

MISSOURI GAS ENERGY

CASE NO. GR-2014-0007

EXECUTIVE SUMMARY 1

MS. AHERN'S TESTIMONY 3

CAPITOL STRUCTURE 3
EMBEDDED COST OF DEBT.. 4
COST OF EQUITY 7
MR. GORMAN'S TESTIMONY... 14

REBUTTAL TESTIMONY

OF

ZEPHANIA MAREVANGEPO

MISSOURI GAS ENERGY

CASE NO. GR-2014-0007

Q. Please state your name.

A. My name is Zephania Marevangepo.

Q. Are you the same Zephania Marevangepo who prepared the Rate of Return Section of the Staff's Revenue Requirement Cost of Service Report that was filed in this case?

A. Yes, I presented direct testimony in the Missouri Public Service Commission Staff's (Staff) Cost of Service Report filed on January 29, 2014.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to parts of the direct testimony of Missouri Gas Energy's (MGE) cost of equity expert witness (Pauline M. Ahern/ Ms. Ahern) and Office of the Public Counsel's (Public Counsel or OPC) cost of equity expert witness (Michael Gorman/ Mr. Gorman).

<u>EXECUTIVE SUMMARY</u>

Q. Would you please summarize the specific rate of return positions sponsored by Ms. Ahern, Mr. Gorman and Staff in this case?

A. Ms. Ahern recommended an overall rate of return of 8.80 percent based on a recommended 10.25 percent return on equity (ROE), 4.35 percent embedded cost of debt, and consolidated capital structure comprising 53.60 percent equity and 46.40 percent long-term debt. Ms. Ahern's consolidated capital structure was based on Laclede Group's (parent company of Laclede Gas Company (Laclede Gas), which includes both the Laclede Gas Division and the MGE Division) *pro forma* consolidated capital structure as at July 31, 2013.

Mr. Gorman, filing on behalf of Public Counsel, recommended an overall rate of return of 6.60 percent based on a recommended 9.35 percent return on equity, embedded cost of debt of 4.35 percent and Laclede Gas Company's (regulated subsidiary of Laclede Group, which includes the Laclede Gas Division and MGE Division) capital structure comprising 45.02 percent equity and 54.98 percent long-term debt as at September 30, 2013.

Staff recommended an overall cost of capital range of 5.65 percent to 6.18 percent based on an estimated cost of equity range of 7.90 percent to 8.90 percent, embedded debt cost of 3.12 percent (cost of debt to acquire the MGE assets) and Laclede Group's consolidated capital structure comprising 53.08 percent equity and 46.92 percent long-term debt as of September 30, 2013.

Q. What major issues will you address in your rebuttal testimony?

A. Staff's major difference with both the Company's and OPC's position on rate of return pertains to the appropriate cost of debt to use for purposes of the appropriate allowed rate of return to apply to MGE's rate base. Mr. Gorman simply adopted the Company's embedded cost of debt recommendation, which as Staff will address in its rebuttal testimony, includes debt that was included in Laclede Gas' last rate case. Until MGE's and Laclede Gas' revenue requirements can be determined simultaneously, MGE's debt costs should be based on only the incremental amount of debt used to fund the MGE acquisition.

Staff will also discuss the difference in the capital structure recommendations. Staff's direct position is somewhat aligned with MGE in that Staff recommends the use of Laclede Group's consolidated capital structure without an adjustment for goodwill relating to the MGE acquisition. Mr. Gorman proposes using Laclede Gas' capital structure after the equity amount is reduced by the amount of goodwill relating to the MGE acquisition.

Staff also believes Ms. Ahern's cost of equity estimates are beyond the zone of reasonableness when compared to Laclede's own financial advisors that it hired to evaluate a fair price to pay for MGE's assets. Staff's cost of equity estimate actually falls in between the two financial advisors' cost of equity estimates. Although Staff continues to believe there is sufficient expert evidence to support the reasonableness of its cost of equity estimates, Staff also recognizes the Commission's preference to consider allowed ROEs in other states when deliberating on a fair and reasonable ROE for Missouri's utilities. As a result, Staff's Cost of Service Report provided this information to the Commission to assist it in assessing a fair and reasonable ROE for MGE as it compares to the Commission's recently awarded ROEs for Ameren Missouri (Ameren) and Kansas City Power & Light Company (KCPL) and KCP&L Greater Missouri Operations (GMO).

MS. AHERN'S TESTIMONY

Q. Please highlight and explain the major areas of Staff's recommendation that differ from Ms. Ahern's recommendation?

A. Capital structure, embedded cost of debt and cost of equity are the differences between MGE's witness and Staff.

CAPITOL STRUCTURE

Q. Would you please explain the capital structure issue?

A. Both Staff and Ms. Ahern recommended Laclede Group's consolidated capital structure. However, due to the timing of her testimony, Ms. Ahern's capital structure of 53.60 percent equity and 46.40 percent long-term debt was based on data as of July 31, 2013. Staff's capital structure recommendation of 53.08 percent equity and 46.92 percent long-term debt is more updated due to the fact that Staff had access to updated information – as of September 30, 2013.

EMBEDDED COST OF DEBT

Q. Would you please explain the embedded cost of debt issue?

A. Ms. Ahern's 4.35 percent consolidated embedded cost debt recommendation is a weighted average cost that includes debt costs that were considered for purposes of determining customer rates in Laclede Gas's most recent rate case (Case GR-2013-0171).

The revenue requirements developed by Staff and Laclede Gas for Laclede Gas's last rate case were based on Laclede Gas' embedded cost of debt of 5.60 percent, not the current 4.35 percent cost of debt simply because the completion and approval of the Laclede Gas rate case preceded the completion of the MGE acquisition transaction. Consequently, the recently approved rates contemplated the debt that was already on Laclede Gas' books prior to the issuance of the debt to acquire MGE. Since Laclede Gas' revenue requirement was determined based on pre-acquisition of MGE, both Laclede Gas and MGE rates have yet to be determined based on a weighted cost of debt that captures the post-MGE acquisition debt.

If the Commission allows MGE's rates to be set based on debt that was already considered in Laclede Gas' last rate case, this would result in MGE collecting more than is needed to service the debt issued for both systems. It would only be appropriate to apply the consolidated cost of debt to both systems at a time when rates for both divisions can be set simultaneously, i.e., in the next rate case.

Q. Would you please explain how the timing of these two events would affect the Laclede Gas Division and MGE Division customers if a 4.35 percent embedded cost of debt is approved in this case?

A. Unfortunately, <u>Laclede Gas Division's customer rates</u> were already set based on an approach that did not capture the lower MGE acquisition debt cost. While the parties to Laclede Gas' last rate case agreed to base the rate of return charged for the Infrastructure System Replacement Surcharge ("ISRS") on an embedded debt cost that included the post-MGE acquisition low debt-cost, Laclede Gas Division's general base rates were not set to consider the resulting lower debt-cost savings. Such savings cannot be directly considered for the Laclede Gas Division until the next rate case. The agreed upon post-MGE acquisition rate of return for Laclede Gas' ISRS is 7.1855 percent (see Laclede Gas Company's response to comments of Staff and OPC to late-filed exhibit 1 and request for approval of late-filed exhibit filed on January 10, 2014 in Case No. GR-2013-0171).

Consequently, if a 4.35 percent embedded cost of debt is approved in this case, <u>MGE customer rates</u> will be set based on a combination of Laclede Gas Division's debt costs (already captured in Laclede Gas Division's last rate case) and the low-cost acquisition debt (not captured in Laclede Gas Division's last rate case). Because Laclede Gas' rates already contemplate the debt that was on Laclede's books before the acquisition, the only debt costs that need to be serviced by the MGE Division are those issued to complete the MGE acquisition. When both divisions file a rate case simultaneously, it will then be appropriate and fair to apply the consolidated embedded cost of debt to both divisions because this will allow for recovery of aggregate revenues sufficient to service the consolidated debt.

Q. When did Laclede Gas issue long-term debt?

A. Laclede Gas issued long-term debt on August 13, 2013 to finance the MGE acquisition by Laclede Gas from Southern Union Company (Southern Union) on September 1, 2013. The embedded cost of this long-term debt is 3.12 percent (see Schedule ZM-8 attached to Staff's Cost of Service Report appendices).

Q. When will both Laclede Gas and MGE rates be considered at the same time?

A. The Stipulation in the MGE acquisition case, Case No. GM-2013-0254, stated that for the first general rate case filing made by Laclede Gas subsequent to October 1, 2015, Laclede Gas shall include both its Laclede and MGE Division service territories.

Q. What approach does Staff believe would be fair and reasonable to customers of both divisions and the Company?

A. An approach that will seek to accomplish the following:

(1) acknowledge the fact that the Laclede Gas Division rates were not based on an approach that allowed specific consideration for the sharing of the benefits of the low-cost acquisition debt cost;

(2) allow Laclede Gas to recover the actual cost of the MGE acquisition debt until the rates for the Laclede Gas Division and MGE Division are considered simultaneously; and

(3) ensure that the benefits of the low-cost acquisition debt are fully shared - *through both Laclede Gas Division and MGE Division customer rates* - by applying a consolidated embedded cost of debt at the time when the two divisions file their next rate case(s). At that point, applying the embedded cost of debt for the two divisions to the

consolidated rate bases would not cause an over recovery of rates needed to service the debt, but at the same time allow both divisions to share the benefit of the lower-cost acquisition debt.

COST OF EQUITY

Q. Would you please explain the cost of equity issue?

A. Ms. Ahern's 10.25 percent cost of equity is an average of four (4) principal methods: (1) - Discounted Cash Flow Model (DCF), (2)- Risk Premium Model (RPM), (3)- Capital Asset Pricing Model (CAPM) and (4)- Market Models Applied to Comparable Risk, Non-Price Regulated Companies.

Ms. Ahern seems to imply that her use of several methods to estimate the cost of equity makes her results more accurate and reliable. Staff has evidence from Laclede Group's own financial advisors' that not only refute the reliability of Ms. Ahern's cost of equity estimate of 10.25 percent for a regulated local gas distribution company, but even indicate that Mr. Gorman's cost of equity estimates is at the high end of the financial advisors' estimates. Such estimates do not reflect the reality of the capital markets, in which regulated utility stocks are considered to be a close alternative to a bond investment. Considering the continued low cost of debt, it is simply irrational to conclude the cost of equity for a regulated natural gas distribution company that has very little volatility in its earnings is anywhere near 10.25 percent.

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Q. Should the Commission allow a 9.7 percent ROE used by the company witness (Glenn W. Buck/ Mr. Buck) to compute a rate of return consistent with the conditions of the MGE acquisition case (GM-2013-0254)?

A. No. Mr. Buck indicates on page 5 of his direct testimony that he used a 9.7 percent for simplicity's sake and because it was recently used for Laclede Gas Division's ISRS rates.

Because the 9.7 percent ROE applied to Laclede Group's equity ratio still resulted in a pre-tax return for MGE that was higher than it was authorized in its last rate case under Southern Union's ownership, Mr. Buck actually had to adjust the actual capital structure until its pre-tax return on rate base request was equivalent to that authorized in MGE's most recent rate case (GR-2009-0355). Such an approach is consistent with the language in the Stipulation in the MGE acquisition case, agreed to by all parties and approved by the Commission in Case No. GM-2013-0254.

Most importantly, the language to cap the return on rate base was only included in the acquisition stipulation agreement to ensure there was a ceiling on the potential allowed ROR in this rate case. Although Staff believes there is sufficient evidence to conclude the cost of equity is at least in the range of approximately 8 to 9 percent, the Commission has sufficient

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information from both the New England Gas allowed ROE and the recent spread between the allowed ROEs for gas and electric rate cases to at least authorize an ROE **<u>no higher than 9.50 percent</u>**.

Q. If Mr. Buck had adjusted the ROE rather than the common equity ratio in order to comply with the stipulation and agreement in Case No. GM-2013-0254, what ROE would he have had to recommend?

A. 9.43 percent.

Q. Why do all of Ms. Ahern's costs of equity estimates, other than the DCF estimates, cause what you believe to be an unreasonably high overall cost of equity recommendation?

A. The other three cost of equity estimates, furnished on Ms. Ahern's Schedule PMA-4, produce cost of equity estimates that are unreasonably high and inconsistent with those that were suggested by the Company's financial advisors for purposes of acquiring the MGE assets. Ms. Ahern's estimates are also inconsistent with the average of the allowed ROEs as reported by the Regulatory Research Associates (RRA).

Q. Would you please state the specific input or driver that inflates Ms. Ahern's other three cost of equity estimates?

A. The market equity risk premium.

Q. Would you please explain Staff's specific issues with Ms. Ahern's equity risk premium calculation methodology?

A. Ms. Ahern relied on the Predictive Risk Premium Model (PRPM) to compute the equity risk premium input for the other three (3) cost of equity estimates. First, Staff would like to note that this is the first Missouri rate case in which the PRPM has been introduced. To Staff's knowledge, it is not commonly used in the practice of cost of equity estimation in utility ratemaking in other jurisdictions. Staff also is not aware of any equity analysts that use the PRPM in the analysis of utility stocks for purposes of advising investors. Therefore, considering the fact that the PRPM, as used by Ms. Ahern, produces market risk premium estimates are much higher than those used by the investment experts Laclede hired to estimate a fair price to pay for the MGE assets. Simply put, Staff is not aware of any examples in which the PRPM, as used by Ms. Ahern, is used in practice. From a regulatory perspective, most commissions, if not all, use cost of equity models more commonly used in the investment practice, such as the DCF and CAPM, because they are widely accepted and actually used in the practice of equity valuation.

Q. What other concerns does Staff have with Ms. Ahern's PRPM?

A. Staff does not believe it is acceptable to recommend to the Commission cost of equity estimates based on a model that can't be verified. Ms. Ahern's direct testimony, page 25, 15-47, clearly states the following:

> Using a generalized form of ARCH, known as GARCH, each gas distribution company's projected equity risk premium was determined using Eviews© statistical software.

Given the limited ability to review and verify the soundness of the equity risk premiums based on the GARCH coefficient displayed on Ms. Ahern's Direct Testimony Schedule PMA-6 p2, Staff send the following data request to the Company:

> Please provide Staff with the means to have remote access to the statistical software used to develop the GARCH coefficient and the market's projected equity risk premium. **(Data Request 0168)**

The Company provided the following response:

> We have no way to allow Staff remote access to the Eviews. However, Staff should be able to do the PRPM analysis using any statistical software such as Eviews or SASS.

Due to the fact that Ms. Ahern cannot produce work papers to support the accurateness and reliability of the PRPM, any cost of equity estimates produced using this method should be summarily dismissed.

Q. Regardless of the lack of work papers, are the equity risk premiums produced by Ms. Ahern's application of the GARCH coefficient consistent with those used in practice for purposes of determining the value of local gas distribution companies?

A. No.

Q. What does Staff believe is the primary responsibility of a cost of equity expert witness?

A. Staff believes the primary responsibility of any cost of equity expert witness is to try to emulate the decision-making process of investors and incorporate the information gathered (cost of equity inputs) into methods that are widely used in practice when determining a fair price to pay for utility stocks. The methods and the application of such methods should be consistent with those used in practice by investors, investment analysts and valuation experts.

Q. What was the major implication of using an equity risk premium input based on the PRPM?

A. It resulted in inflated cost of equity estimates.

Q. In reference to the cost of equity estimates on schedule PMA-1, page 2 of 2, of Ms. Ahern's direct testimony, what would be Ms. Ahern's ultimate cost of equity estimate if you exclude the following: (1) a variation of the risk premium model that exclusively relied on the PRPM and (2) a market equity risk premium input that was computed based on the PRPM and applied to several costs of equity computations that resulted in the 10.25 percent cost of equity recommendation?

A. The results would be as follows:

1. Discounted Cash Flow (DCF) result will remain 8.66 percent,

2. Risk Premium Model (RPM) result (excluding the PRPM results) would be 10.15 percent,

3. Capital Asset Pricing Model (CAPM) result (excluding the PRPM equity risk premium) would be 9.28 percent,

4. Market Models Applied to Comparable Risk, non-regulated companies (excluding the PRPM equity risk premium) would be 10.04 percent.

After taking an average of all of the above results, **Ms. Ahern's cost of equity estimate would be 9.53 percent.**

Q. Is a 9.53 percent return on common equity reasonable?

A. While a 9.53 percent return on common equity recommendation is approximately 63 basis points over the higher end (8.90 percent) of Staff's recommendation, Staff notes that such a return on equity is in line with the approximately 9.68 percent equally weighted average of the gas utilities' allowed ROE for the 2013 calendar year. This data is reported by the Regulatory Research Associates (RRA) and was presented in Staff's Cost of Service Report on page 32, lines 14-18.

MR. GORMAN'S TESTIMONY

Q. Would you please explain the differences that Staff has with Mr. Gorman that are separate from what has already been discussed above?

A. Yes. Staff understands that Mr. Gorman did not recommend a consolidated capital structure as Staff did. Instead, he recommended Laclede Gas' capital structure and adjusted the equity component for goodwill. The goodwill adjustment resulted in a recommended capital structure comprising 45.02 percent equity and 54.98 percent long-term debt.

Q. What is Staff's response to Mr. Gorman's logic for his adjustment?

A. Staff understands and acknowledges the reasoning behind Mr. Gorman's capital structure recommendation. Staff believes Mr. Gorman's approach is acceptable based on its own merits.

Q. Does this conclude your rebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy, Inc.'s Filing of Revised Tariffs to Increase its Annual Revenues for Natural Gas	)))	Case No. GR-2014-0007

AFFIDAVIT OF ZEPHANIA MAREVANGEPO

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Zephania Marevangepo, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 14 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Zephania Marevangepo

Subscribed and sworn to before me this 4th day of March, 2014.

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

D Suzie Mankin
Notary Public