BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's	)	
Tariffs to Implement a General Rate	)	Case No. GR-2004-0209
Increase for Natural Gas Service	)	

MEMORANDUM OF LAW OF MISSOURI GAS ENERGY, A DIVISION OF SOUTHERN UNION COMPANY, IN SUPPORT OF ITS MOTION TO EXCLUDE CERTAIN TESTIMONY AND OPINIONS OF DAVID MURRAY

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Comes now Missouri Gas Energy, a division of Southern Union Company ("MGE"), by counsel, and submits this memorandum of law in support of its motion to exclude from the above-referenced proceeding the direct testimony and opinions of Mr. David Murray ("Murray") regarding a calculated rate of return for MGE as inadmissible pursuant to Section 490.065, Revised Statutes of Missouri ("RSMo.").

Preliminary Statement

In this natural gas rate proceeding, Murray, a member of the Staff ("Staff") of the Missouri Public Service Commission (the "Commission"), has submitted written direct testimony ("Murray Direct"), with accompanying schedules ("Murray Schedules"), on behalf of the Staff to support his "opinion" that the Commission should find that a "fair and reasonable" rate of return for MGE is between 6.68 and 6.94 percent of the value of its rate base.

Murray's "opinions" are only admissible in this proceeding if he is an expert in utility finance and his testimony comports with Missouri's rules regarding expert testimony. Nonetheless, it is unclear whether Murray is even being offered by the Staff as an "expert." His responses to recent deposition questions – and his counsel's repeated assertions of attorney-client privilege during that deposition – suggest that Murray is being offered by the Staff as a fact witness. However, lay opinions are generally excluded from evidence under Missouri law, and Murray's testimony clearly does not fit into the narrow exceptions to that law.

Further, even if the Staff intends to offer Murray as an expert, his testimony must still be excluded. First, Murray does not have the education or expertise to engage in the necessary qualitative analyses of his data and methodologies. Indeed, his approach to calculating a rate of return for MGE is simply mechanistic and demonstrates a lack of understanding regarding the basic purpose of his models or the application of any independent judgment. Section 490.065 RSMo. requires that an expert witness have "scientific, technical or other specialized

knowledge" that "will assist the trier of fact." MGE respectfully submits that Murray fails to meet this requirement.

Second, even if Murray were assumed to be an expert in utility finance, his opinions are based on unreliable data and unreasonable applications of utility finance techniques. In *State Board of Registration for the Healing Arts v. McDonagh*, 123 S.W.3d 146 (Mo. Sup. Ct. 2003), the Missouri Supreme Court recognized that expert testimony in administrative proceedings like this one is subject to § 490.065 RSMo. and that such testimony should be excluded where, like here, that testimony is based on unreliable facts, data or methodologies.

Murray's calculations are replete with distorted data, unreasonable assumptions and misapplied methodologies. Although Murray purports to use standard techniques for calculating the various components of his rate of return – including a discounted cash flow ("DCF") analysis – Murray's application of these techniques is mechanistic, arbitrary, wholly at odds with accepted practices and apparently driven by the result-oriented desire to keep MGE's rate of return as low as possible. As just one salient example, Murray – in an attempt to predict future investor expectations for MGE – purports to analyze trends in historic natural gas utility growth rates, yet refuses to consider the most recent historic data from 2003. Not surprisingly, when the omitted and readily available 2003 data is considered – as any objective utility financial analyst or investor would do – MGE's calculated rate of return increases.

This Commission has repeatedly recognized the importance of ensuring that Missouri utilities like MGE are allowed a fair and reasonable rate of return. Murray's rate of return calculations are not only arbitrary and unreliable, they are anathema to that goal. Under the requirements of § 490.065 RSMo., his testimony and opinions should be excluded.

ARGUMENT

I. Relevant Standards

Section 490.065 RSMo. provides in pertinent part that:

> 1. In any civil action, if scientific, technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise.
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> . . .
>
> 3. The facts or data in a particular case upon which an expert bases an opinion or inference may be those perceived by or made known to him at or before the hearing and must be of a type reasonably relied upon by experts in the field in forming opinions or inferences upon the subject and must be otherwise reasonably reliable.

In *McDonagh*, *supra,* the Missouri Supreme Court held that (a) Section 490.065 RSMo. applies in proceedings like this one and (b) the United States Supreme Court's landmark decision in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), is useful in interpreting Section 490.065.1, which Section is virtually identical to the version of Fed. R. Evid. 702 that *Daubert* analyzed. 123 S.W.2d at 153-155.

In *Daubert*, the Supreme Court held that a trial court is obliged to ensure "that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand," 509 U.S. at 597, and is based on "more than subjective belief or unsupported speculation," *id.* at 590. Accordingly, the trial court (and this Commission) must conduct a "preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology properly can be applied to the facts in issue." *Id.* at 592-593. The mere fact that an expert "utilized a method of analysis typical within his field," does not render his testimony immune from challenge where he does not consider "all independent variables that could affect the conclusion." *Blue Dane Simmental Corp. v. American Simmental*

Ass'n, 178 F.3d 1035, 1040-1041 (8th Cir. 1999). *See also Children's Broadcasting Corp. v. The Walt Disney Co.*, 245 F.3d 1008, 1018 (8th Cir. 2001) (expert's DCF model and testimony should have been excluded where critical variable had not been considered); *Frymire-Brinati v. KPMG Peat Marwick,* 2 F.3d 183, 192 (7th Circuit 1993) (expert DCF testimony should have been excluded where based on unreliable valuations).

The *McDonagh* decision also held that Section 490.065.3 RSMo. is a stricter standard than the similar provisions of Fed. R. Evid. 703 and *"expressly requires a showing that the facts and data [relied upon by an expert] are of a type reasonably relied on by experts in the field in forming opinions or inferences upon the subject of the expert's testimony."* 123 S.W.2d at 156 (emphasis in original). The court further held that Section 490.065.3 RSMo. requires the trial judge (and this Commission) to "independently assess" the reliability of facts and data used by an expert. *Id.*

II. Murray's Questionable Witness Status

As an initial matter, it is unclear whether the Staff is offering Murray as a fact witness or expert witness. As demonstrated below, his testimony should be excluded in any event.

During his May 4, 2004 deposition, Murray agreed that he was offering opinions on what MGE's "return on equity should be and the rate of return," and that he was testifying as "the fact witness at the Staff who's proposing to address those issues." (Deposition transcript of David Murray, dated May 4, 2004 ("Murray Dep."), at 12; Appendix A hereto.) Moreover, at various points in his deposition, Murray's counsel directed Murray not to answer questions about input he received during the preparation of his direct testimony on the ground of attorney-client privilege. (*See, e.g.,* Murray Dep. at 75-76.) Such an assertion could not possibly apply to Murray's testimony if he were being offered as an expert; under Missouri law, a party is entitled to full discovery of all information provided to a designated expert. S*ee also State v.*

Dandurand, 30 S.W.3d 831, 834-835 (Mo. 2000) (under Missouri Rule of Civil Procedure 56.01(b)(3) and (4), information provided to designated expert cannot be withheld on privilege grounds and must be disclosed: "It is appropriate, at deposition or trial, to cross-examine an expert witness as to information provided to the expert that may contradict or weaken the bases for his or her opinion regardless of whether the expert relied upon or considered the information").

If the Staff is offering Murray's testimony as a fact or lay witness, it must be excluded. The Missouri Supreme Court has held that opinions of lay witnesses are admissible only where "the fact in issue is 'open to the senses.'" *State v. Eaton,* 504 S.W.2d 12, 21 (Mo. 1973); *Beuttenmuller v. Vess Bottling Co. of St. Louis,* 447 S.W.2d 519, 526 (Mo. 1969). An opinion on a "fair" and "reasonable" rate of return for a public utility is not a matter "open to the senses." Murray should not be allowed to offer testimony only an expert can give, and then avoid the threshold admissibility considerations for all expert testimony by simply declaring himself a "fact" witness.

III. If The Staff Is Offering Murray As An Expert, His Rate Of Return Testimony Should Be Excluded

Even if the Staff is offering Murray as an expert witness, his testimony should still be excluded. The benchmark for admissible expert testimony is reliability, and (a) Murray does not have the expertise to determine the reliability of his testimony, and (b) given this lack of expertise, Murray's opinions are, not surprisingly, based on unreliable methodologies and data.

A. Murray Lacks The Expertise To Determine The Reliability Of The Methodologies Or Data He Uses

Section 490.065.1 RSMo. requires that a proffered expert witness have "scientific, technical or other specialized knowledge" gained by "knowledge, skill, experience, training, or education" that will "assist the trier of fact." Murray's mechanistic approach to his rate of return

calculations demonstrates that he lacks the "technical or specialized knowledge" of a utility finance expert, that he is not capable of determining the reliability of the data upon which he relies and that his testimony cannot possibly "assist" the Commission.

For example, in the utility finance industry, it is common to utilize a "discounted cash flow" or DCF model to calculate the future growth rate for any particular utility, and *initially* to look at, among other things, historic growth rates in the utility industry as a potential dataset for predicting a reasonable future growth rate.[1] However, historic growth rates are not absolute determinants of investor expectations, and such rates cannot be used to apply the DCF model in an arbitrary manner or in order to achieve the witness' desired result:

> The DCF method cannot be applied in a robotic, mechanistic manner. Mechanical approaches designed simply to insert numbers into an algebraic equation without regard to the reasonableness of such inputs in a regulatory setting must be avoided. For example, the determination of expected growth is judgmental, since expected growth lies buried in the minds of investors, unobservable. *Any inconsistency between historically-based growth estimates, analysts' forecasts, and sustainable growth estimates should be explainable by objective common-sense economic reasoning.*

R. Morin, REGULATORY FINANCE ("REGULATORY FINANCE"), 244 (Public Utility Reports 1994) (emphasis added). *See also id.* at 237 ("A note of caution is also necessary when dealing with historical growth rates and their use in the DCF model. Historical growth rates can be downward-biased by the impact of diversification and restructuring activities and by the impact of abnormal weather patterns in the case of energy utilities"); J. Bonbright, A. Danielson & D. Kamerschen, PRINCIPLES OF PUBLIC UTILITY RATES ("PUBLIC UTILITY RATES"), 319 (Public

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[1] A fair or reasonable rate of return for a utility is equated with its weighted average cost of capital. (Murray Direct at 20.) Accordingly, pursuant to accepted principles of utility finance, establishing a rate of return involves determining the cost of each form of a utility's capital (*e.g.*, long term debt, equity, preferred stock), and then weighting and averaging those costs. The calculation of costs of long term debt and preferred stock should be relatively easy: it is equivalent to whatever the company's imbedded costs are for those forms of capital. Determining the cost of equity requires an assessment of the future "growth rate" expected by investors; this future growth rate is then added to a dividend yield to give a single return on equity.

Utility Reports 1988) ("It should be obvious that one can get any expected return on equity one wants simply by picking a particular growth rate. This is where most of the controversy arises among cost of capital witnesses. The first point to remember in evaluating the growth rate is that it is not what a witness thinks the growth rate should be that matters. What matters is what investors expect the growth rate to be").

In spite of these standards, Murray simply engages in a "mechanistic" approach to his DCF model which is devoid of any independent judgment. Inexplicably, Murray's direct testimony contains no analysis of the reliability of the historic or other data that he uses. Indeed, in his deposition testimony, Murray demonstrated not only a failure to critically analyze his data, but also a fundamental misunderstanding of what his data really are:

- Murray testified that he had "reviewed the information I have as far as growth rates and I noticed that the historical and projected were fairly close." (Murray Dep. at 88.) This cannot possibly be true: if Murray had truly conducted such a "review," he would have observed that certain of his historic data are completely at odds with his projected data. For example, Murray incorporates into his DCF model a 5 year earnings per share (EPS) growth rate of only 1.72 percent. (*See* Murray Schedule 15-2.) **Every projected growth rate he uses was at least twice, and sometimes three times, as much.** (Murray Schedule 16.) A disparity of 100 to 200 percent is not "fairly close" and is clear evidence of unreliable data.

- Murray also testified that he had not used, and did not intend to use, 2003 historic data because "I don't know that the – the growth prospects have fundamentally changed that much." (Murray Dep. at 88.) Clearly, Murray did no analysis on this point: if Murray had updated his 5-year EPS growth data to incorporate readily available 2003 data, his aberrational 5 year EPS growth rate of 1.72 percent would now be more than 7.5 percent. Such a difference is clearly a "fundamental change" and once again indicates that Murray is using unreliable data.

Why does Murray fail to engage in any reliability analysis of his data? The answer is not clear, but one obvious factor is his lack of expertise with respect to such an analysis. Murray testified that his experience with using DCF analysis to calculate utility rates of return began

with his employment by the Commission in June 2000. (Murray Dep. at 10, 13.) At that time and since, Murray's introduction to DCF analysis has been through "canned" Staff testimony that Murray has adopted and amended to fit the particular case on which he works. (Murray Dep. at 23-24, 39, 46.) Indeed, Murray agreed that "some portions" of his April 14, 2004 direct testimony regarding MGE had been "used back in 2001" and were "based on prior depositions . . . from years ago from other witnesses." (*Id.* at 12-13.)

The reuse of such "canned" testimony perpetuates an improper mechanistic approach to the DCF process and a lack of independent judgment. Murray simply plugs numbers into his DCF model, without regard to whether those numbers are reliable or not. Such an approach to estimating a fair and reasonable rate of return is wholly at odds with fundamental principles of utility finance and demonstrates that Murray – who, like just about any other person, is capable of plugging numbers into a formula – is not sufficiently educated or experienced in the requisite qualitative analyses of his data to render an opinion before this Commission.

B. Even If Murray Were Determined To Have Sufficient Expertise, His Unreliable Methodologies And Datasets Require Exclusion Of His Testimony

The Missouri Supreme Court's ruling in *McDonagh* – and the guidance of the United States Supreme Court's decision in *Daubert* – are based in large part on the principle that expertise does not, in and of itself, create admissible expert testimony. *See, e.g., Kumho Tire Co. v. Carmichael,* 526 U.S. 137, 157 (1999) ("[N]othing in either *Daubert* or the Federal Rules of Evidence requires a district court to admit opinion evidence that is connected to existing data only by the *ipse dixit* of the expert") (citation omitted). Experts' opinions must be based on (1) reliable methodologies that employ (2) reliable data. Murray's testimony fails on both counts.

1. Murray's Unprincipled Use Of Southern Union's, And Not MGE's, Capital Structure

In calculating a "fair and reasonable" rate of return for MGE, Murray attributes to MGE, a natural gas distribution company, the capital structure of MGE's parent, Southern Union Company ("Southern Union"). In so doing, Murray includes in MGE's capital structure the pre-acquisition debt of Southern Union Panhandle Corporation ("Panhandle"), a natural gas pipeline company that Southern Union acquired in 2003. This artifice has the very real effect of reducing Murray's calculated rate of return for MGE, because MGE's percentage of common equity is greatly reduced by saddling it with Panhandle debt.[2]

What Murray never mentions in his direct testimony is that the Staff (including Murray himself), in 2003, went to great lengths to ensure that MGE was never "saddled" with Panhandle debt. In fact, the Commission approved a requirement that Southern Union commit to keeping the costs and risks of Panhandle separate and distinct from the operations of MGE. Among other things, Southern Union agreed:

> Southern Union Panhandle Corporation ("SUPC") and Successor Entities or any direct or indirect subsidiary of Southern Union that acquires or owns any equity interests in Panhandle, will be owned and operated as a separate subsidiary of Southern Union. Southern Union and MGE will not, directly or indirectly, allow any Panhandle debt to be recourse to them; pledge Southern Union or MGE equity as collateral or security for the debt of any Panhandle entity; give, transfer, invest, contribute or loan to any Panhandle entity, any equities or cash without Commission approval. Southern Union will not transfer to SUPC and Successor Entities or any subsidiary thereof, directly or indirectly, assets necessary and useful in providing service to MGE's Missouri customers without Commission approval. Southern Union will not enter, directly or indirectly, into any "make-well" agreements, or guarantee the notes, debentures, debt obligations or other securities of any Panhandle entity without Commission approval. Southern Union will not adopt, indemnify, guarantee or assume responsibility for payment of, either directly or indirectly, any of the current or future liabilities of any Panhandle entity without Commission approval. Southern Union will exercise its

[2] As a general proposition, a utility's cost of equity is greater than its cost of debt. Thus, imputing Panhandle's debt to MGE reduces any calculated rate of return for MGE.

best efforts to insulate MGE from any adverse consequences from its other operations or the activities of any of its affiliates.

Stipulation and Agreement, filed March 23, 2003, at § 2, in *The Matter of the Application of Southern Union Company d/b/a Missouri Gas Energy for Authority, etc.*, Case No. GM-2003-0328 ("Stipulation").[3] Implicit in the Stipulation's provisions, and the Staff's demands from Southern Union, is the recognition that Panhandle – a natural gas pipeline – is a business with different business risks, financial risks and capital requirements from that of MGE, a natural gas distribution company.

How then could Murray justify adding Panhandle back into MGE's operations for the purposes of his rate of return calculation? **Something he happened to read in Standards & Poors!** Murray contends that he read a comment in a Standard & Poors ("S&P") analysis of Southern Union that suggested that "cash is going to flow freely between Panhandle and Southern Union." (Murray Dep. at 64, *see also id.* at 61-66.) Murray then relied on this single, unsubstantiated and incorrect comment without contacting S&P or making any effort whatsoever to determine whether the S&P commentator was aware of the requirements imposed by the Stipulation on Southern Union (Murray Dep. at 66), restrictions about which Murray should have been uniquely familiar. In fact, Murray agreed that any "free flow" of cash to Panhandle would violate the Stipulation:

Q. And do you agree that the [S]tipulation and order from the Missouri Commission forbids the flowing of cash freely between the Panhandle and Southern Union entities?

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[3] In his recent deposition testimony, Murray agreed that under these provisions, Southern Union cannot, without Commission approval, guarantee any of Panhandle's obligations, that Panhandle's debt is nonrecourse to Southern Union and that Southern Union cannot give cash to Panhandle without Commission approval. (Murray Dep. at 60, 65, 68.)

A. I believe there was a condition that referred to restrictions on cash down to Panhandle, not necessarily cash up from Panhandle.

(Murray Dep. at 68.)

Murray's position is not only at odds with the Commission's order approving the Stipulation – which was designed to separate financially MGE and Panhandle – it also violates basic principles of corporate finance. Authorities have repeatedly recognized that accurate calculations of capital structure for diversified or conglomerate corporations require a business unit-by-business unit calculation of capital structure and cost of capital:

> Figure 14-1 [re Corporate-Wide v. Risk-Adjusted Cost of Capital] bears a crucial message: the cost of capital for a division, investment project, or specific asset investment depends on the riskiness of that investment, and not on the identity of the company undertaking that project. *The cost of capital depends on the use of funds and not the source of funds*. This is because the cost of capital is fundamentally the opportunity cost of the investor, that is, the foregone return on comparable risk investments.

REGULATORY FINANCE, *supra,* at 344 (emphasis added). *See also id.* at 472 (demonstrating inequity of using parent company capital structure to calculate subsidiary's cost of capital); R. Bruner, K. Eades, R. Harris & R. Higgins, *Best Practices in Estimating the Cost of Capital: Survey and Synthesis*, 8 Finance Practice & Education Journal, 17 (Spring/Summer 1998) (100 percent of surveyed analysts and textbooks used distinct capital structure calculations for each division of a company); R. Harris, T. O'Brien & D. Wakemen, *Divisional Cost-of-Capital Estimation for Multi-Industry Firms,* Financial Management, 74 (Spring/Summer 1989) (addressing divisional capital structure methodology); L. Gitman, M. Joehnk & G. Pinches, MANAGERIAL FINANCE, 726 (1985) ("Because of the vast differences in business and financial risk among various lines of business, and because of the growth of conglomerates and other diversified firms, many companies have begun to use risk-adjusted divisional costs of capital").

In fact, Murray concedes the importance of a business unit-by-business unit methodology by focusing on MGE as a stand-alone business in his calculation of MGE's cost of equity. In other words, for the purpose of the cost of equity, Murray does not simply adopt Southern Union's cost of equity, but instead uses a proxy group of what purports to be stand alone (or "pure play") natural gas distribution companies. (Murray Direct at 26-28, Murray Schedules 15-1 and 15-2; *see* also REGULATORY FINANCE, *supra*, at 472-473.) Nonetheless, as to capital structure, he refuses to use a separate business unit methodology. Murray does nothing to reconcile these inimical approaches in his rate of return analysis, and the only apparent explanation is impermissibly result-oriented: it artificially lowers Murray's calculated rate of return for MGE.

2. Murray's Use Of Unreliable Data In His DCF Model

Once Murray wrongfully attributes Southern Union's capital structure to MGE, he then utilizes a DCF model and "stand alone" natural gas distribution companies in a purported effort to estimate the cost of the equity he imputes to MGE. As noted above, however, Murray uses unreliable data in his DCF model, and thus, the resulting cost of equity estimation is equally unreliable and should be excluded from this proceeding.

a) Failure to use 2003 historic data[4]

As noted *supra* pp. 7 and 12-13, Murray refuses to review 2003 data because he believes it would not impact his DCF model. (Murray Dep. at 80.) However, the impact of 2003 data is striking. As just one example of how one year impacts the data, of the eight companies in Murray's proxy group, seven experienced material to significant growth in earnings between

[4] The DCF model assumes, among many other things, a constant future growth rate for the company or companies at issue. (Murray Direct at 26.) Accordingly, Murray's analysis of historic growth rates must be for the sole purpose of estimating a future constant growth rate expected by investors in MGE. If that historic data is inaccurate, aberrational or at odds with other available data, it must be rejected.

2002 and 2003, as the economy continued to recover from the 2001 recession (AGL Resources, Inc: EPS from $1.82 to 2.08; New Jersey Resources Corp.: EPS from $2.09 to 2.38; Northwest Natural Gas: EPS from $1.62 to 1.76; Peoples Energy Corp.: EPS from $2.80 to 2.87; Piedmont Natural Gas Co.: EPS from $1.89 to 2.22; South Jersey Industries, Inc.: EPS from $2.43 to 2.73; and WGL: EPS from $1.14 to 2.30). Murray's calculated EPS growth rates – by ending in 2002 (in the midst of the economic recovery) – ignore this growth, even though 2003 performance is the most relevant data to what investors reasonably expect from 2004 and beyond. (*See* Murray Schedules 15-1 and 15-2.)

b) Use of aberrational historic data

Aberrational Earnings Data: Even if it were assumed that Murray could simply end his historic data analysis in 2002, much of his calculated growth data is clearly at odds with other more reliable data and would not be relied upon by reasonable practitioners of utility finance.

For example, Murray calculates an average five-year EPS growth rate of 1.72 percent for his comparable companies and uses this number in his calculation of reasonable investor expectations for MGE. (Murray Direct at 26-27; Murray Schedule 15-2.) However, this figure is at odds with every other indicator of investor EPS expectation he incorporates into his model: his ten year EPS growth rate is more than two and half times higher, at 4.38 percent, and his three datasets of projected future EPS growth – from Valueline, Standards & Poors and Institutional Brokers Estimate System (IBES) – predict even greater growth rates of 5.75, 4.75 and 4.81 percent, respectively. (Murray Schedules 15-1 and 16.) Clearly, the years 1997 and 2002 created an aberrational, downward trend for most of Murray's proxy group, and any data utilizing those years as a starting and endpoint is inherently unreliable.[5]

[5] One of Murray's proxy companies, WGL Holdings, Inc. ("WGL") is a useful example. Murray artificially deflates his calculation of future investor expectations with respect to MGE by incorporating into his calculation a

Nonetheless, Murray does nothing to analyze these disparities in his data and never considers recalculating his five-year EPS growth data or rejecting it as misleading. This is directly contrary to industry practice:

> Past growth rates in earning or dividends may be misleading, since past growth rates may reflect changes in the underlying relevant variables that cannot reasonably be expected to continue in the future, or may fail to capture known future changes.
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> . . .
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> The major point of all this is that it is perilous to apply historic growth when a utility [or utilities] is in a transition between growth paths. When payout ratios, equity return, and market-to-book ratios are changing, reliance on historical growth is hazardous. . . .

R. Morin, UTILITIES' COST OF CAPITAL ("UTILITIES"), 128, 130 (Public Utilities Report 1984). *See also* REGULATORY FINANCE, *supra*, at 244 ("Any inconsistency between historically-based growth estimates, analysts' forecasts, and sustainable growth estimates should be explainable by objective common-sense economic reasoning"); *In re Kern River Gas Transmission Co.*, 66 F.E.R.C. ¶ 63,014, at 65,095 (1994) (rejecting use of aberrational historic growth rates and stating that "[a]lthough Staff's witness remains faithful to Commission precedent by relying on both historical and projected data, he does not rely on the real effect of the historical data. The data must be used accurately, not just thrown into the analysis regardless of its predictive value").

Aberrational Dividends Data: Utility finance authorities recognize that various historic growth rates may serve as indicators of future investor expectations. For example, EPS, dividends per share ("DPS") and book value per share ("BVPS") are often mentioned in the literature. *See, e.g.*, UTILITIES, *supra*, at 124-125.

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historic five-year EPS growth rate of -9.23 percent for WGL, even though every analyst upon which Murray relies projects a *future* EPS growth rate for WGL Holdings of +4 percent. (Murray Schedules 15.2 and 16.)

However, as noted above, such datasets cannot be used mechanistically. Indeed, where a particular historic growth rate is at odds with future trends, a reasonable utility finance expert must question its usefulness in the DCF model. Here, DPS growth rates – which are understood throughout the utility industry to be relatively flat and no longer an indicator of investor growth expectations – are nonetheless incorporated into Murray's DCF model for the apparent result-oriented purpose of lowering his calculated rate of return for MGE.

For example, Murray calculates a ten-year EPS growth rate of 4.38 percent for his proxy group of utilities and uses projected EPS growth rates that average over 5 percent. (Murray Schedules 15-1 and 16.) Nonetheless, he also derives a ten-year DPS growth rate of 1.66 percent and mechanistically "averages" it into his investor expectation calculations. (Murray Schedule 15-1.)

Clearly, Murray's DPS growth rate – which is almost flat – is not a reasonable indicator of future investor expectations. In fact, Valueline (the very source of most of Murray's information) has published data showing the general downward trend in dividend payouts for gas distribution companies and projects that by 2006, the ratio of dividend payout to earnings will be only 55 percent, down from over 80 percent in 1993. *See* R. Rosenberg, *The Dividend Bust? A Close Look at the Effect of the Dividend Tax Cut Reveals a Disappointing Investor Reaction,* Public Utilities Fortnightly, at 47 (Oct. 15, 2003) (citing Valueline data and concluding: "For whatever reason (possibly a greater need for internal generation of cash or concern about the higher risk of earnings fluctuations), utility companies have been increasing their dividends at a slower rate than earning. *Thus, while earnings growth reflects the actual growth of the firm, dividend growth reflects a change in utilities' payout policies*") (emphasis added). Clearly DPS growth rates are not a reasonable indicator of investor expectations for the *future.* Murray's

testimony contains no analysis of the disparity between his EPS and DPS data or of his mechanistic "averaging" technique.[6] In short, Murray's "averaging" is based on unreliable data upon which no utility finance expert would reasonably rely, and is itself an unreliable methodology.

c) Use of negative historic data

The DCF model is meant to predict a constant *positive* future growth rate expected by investors. Nonetheless, Murray inexplicably incorporates negative growth rates into his DCF model. (*See* Murray Schedules 15-1 and 15-2.)

How does a negative growth rate possibly represent future investor expectations, particularly when such negative rates are at odds with other datasets? Murray offers no explanation because there is no explanation. *See, e.g.,* UTILITIES, *supra,* at 124 ("negative growth rates" can be one of the "unreasonable results" of using historic data in DCF calculations). Such an unprincipled calculation – which, once again, results in an artificial deflation of MGE's overall rate of return – is based on unreliable data upon which no utility finance expert would reasonably rely.

d) Use of "spot" historic data

Murray, in discussing dividend yields for his proxy group of utility companies, recognizes the risk inherent in using a "spot" price for a security. (Murray Direct at 28.) Accordingly, Murray uses four monthly high/low stock price averages in determining a dividend yield for each of his proxy companies. (*Id.*; *see also* Murray Schedule 17.)

However, in calculating historic growth rates, Murray freely uses "spot" data. All of his historic EPS, DPS and BVPS growth rates are calculated using single points in time – *i.e.*, for his

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[6] Murray also averages in growth in BVPS, without engaging in any critical analysis of whether BVPS is a better or worse indicator of investor expectations than EPS. (Murray Schedules 15-1 and 15-2.)

ten year rates, data from only 1992 and 2002, and for his five-year rates, data from only 1997 and 2002. (Murray Schedules 15-1 and 15-2.)

Such an arbitrary methodology is entirely unnecessary. Valueline, the source of much of Murray's data, averages the data points at both ends of its growth calculations to avoid single and potentially aberrational data points. For example, unlike the manner in which Murray's 10-year EPS growth rate is calculated, Valueline would average EPS data for each proxy company from 1991, 1992 and 1993 to arrive at a single starting data point and from 2001, 2002 and 2003 to arrive at a single ending data point. Murray does nothing of the sort.[7]

3. Murray's Failure To Use A Representative Proxy Group Or Make Adjustments For Capital Structure Differences In His Proxy Group

In selecting a proxy group of companies for the purpose of determining historic growth rates and calculating investor expectations, Murray uses virtually no substantive guidelines for filtering out non-comparable companies based on differences in business or financial risk. *See, e.g.* PUBLIC UTILITY RATES, *supra*, at 321 (listing various potential risk filters for a proxy group, including "bond ratings," "betas," "equity ratios," "variability in equity returns" and safety issues). Indeed, all but one[8] of Murray's criteria for his proxy group are criteria of convenience, not substance. (*See* Murray Direct at 27.)

As a result, Murray ends up with a proxy group of companies which has a significantly different capital structure than that which Murray attributes to MGE. According to Murray, MGE should be saddled with the debt of Panhandle, resulting in a capital structure for MGE in which Murray calculated only 25.38 percent common equity. (Murray Direct at 23, 34.) In

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[7] The unreliability of Murray's methodology is evident from his standard deviation calculations. For example, Murray calculates a five year EPS growth rate of 1.72 percent, with a standard deviation of 5.23 percent (Murray Schedule 15-2), meaning that his data inherently fluctuates from -3.51 percent to 6.95 percent.

[8] Murray limits the size of his comparable companies to under $5 billion in capitalization. (Murray Direct at 27.)

contrast, on average, Murray's comparable group of utilities has a capital structure with almost double the amount of common equity: 49.68 percent. (Murray Schedule 22.)

Equity investors bear both business (operational) and financial (leverage) risk. UTILITIES, *supra*, at 30-32. Accordingly, as a firm's leverage increases, investors demand more return on their equity investment. *See, e.g.,* L. Kolbe, J. Read & G. Hall, *The Cost of Capital: Estimating the Rate of Return for Public Utilities*, 17 (MIT Press 1984).[9] Here, Murray uses his proxy group of "comparable" companies without even considering the higher return on equity that investors necessarily demand from the more leveraged capital structure that Murray has attributed to MGE.

Once Murray determined to use his 25.38 percent equity figure for MGE, his comparable group became non-comparable. A different group or – if a different group is not available – appropriate remedial adjustment was therefore required. As Professor Morin recognizes:

> A measurement problem . . . can arise when using the cost of equity capital of other companies as a check against estimates based on the market data for the utility itself. If the group of comparable companies has been carefully designed using adequate risk filters for both business risk and capital structure differences, this will not be a problem. But if substantial capital structure differences exist between the utility and the reference companies, all else being equal, [a] remedial correction . . . is necessary . . . .

UTILITIES, *supra*, at 282. *Cf. In re Arkansas Louisiana Gas Company, a Division of Arkla, Inc.*, 31 F.E.R.C. ¶ 61,318, at 61,730 (1985) (where parent capital structure was imputed to subsidiary pipeline, "the risk adjustment factors used by the presiding judge to adjust the DCF return of Arkla, Inc., [we]re appropriate, because, these factors [we]re supported by the record, and as noted in Arkla's previous cases, a return on equity calculated for [the parent] Arkla, Inc. cannot

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[9] This economic axiom makes perfect sense: if any particular firm were liquidated, equity investors in that firm would recover only after the satisfaction of all creditors. The more creditors to satisfy, the more risk to those investors.

be applied to [the subsidiary] Arkla, without an adjustment for the difference in risk between the two").

Professor Morin's remedial correction is quite easy to calculate and is set forth in detail in Morin's UTILITIES textbook at page 281-282.[10] If Murray had adjusted his MGE cost of equity as required, it would have resulted in a recalculated equity cost of almost 14 percent, and not the artificially low number he actually generated – *i.e.*, 8.52 to 9.52 percent. Once again, by ignoring an established step in rate of return calculations, Murray artificially deflates the rate of return he ultimately recommends for MGE. Such unreliable and unprincipled methodologies are flatly inconsistent with the requirements of Section 490.065.

4. Murray's Unprincipled Use Of Southern Union's, And Not MGE's, Cost Of Long-Term Debt

Murray also refuses to use the readily ascertainable cost of long term debt for MGE. Even the Office of Public Counsel recognized that MGE's imbedded cost of long-term debt is 7.17 percent. (Direct Testimony of Travis Allen, dated April 15, 2004, at 5); Murray, however, inexplicably uses 6.38 percent, a substantially lower number. (Murray Direct at 23, 34; Murray Schedule 25.)

How did Murray come to this lower number? He added in the cost of Panhandle's debt. In fact, after the Staff insisted that Southern Union isolate the debt and operations of Panhandle from MGE, Murray opportunistically adds that debt back into his calculation of MGE's rate of

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[10] Professor Morin explains that where a proxy group of companies has, on average, a different capital structure than the company at issue, the calculated return on equity should be adjusted using the following formula:

$$K = p + (p - i)(1 - T)B/S$$

UTILITIES, at 280-281. K is rate of return, p is the cost of capital of an all-equity firm, i is the current borrowing rate, T is the corporate tax rate, B is percent debt and S is percent equity. First, the analyst must solve the equation for p using the K, B and S imputed to MGE; then the equation is solved again for a recalculated K using the average capital structure of the proxy group. *Id.* at 281.

return for only one possible purpose: to further lower that rate. Such unprincipled opportunism is facially unreliable.

IV. Should It Become An Issue In This Proceeding, The Commission Should Also Exclude Murray's Arbitrary Imputation Of Equity To Panhandle

Lastly, in an apparent attempt to thwart any criticism of his use of Southern Union's capital structure for MGE, Murray purports to calculate a capital structure for Southern Union with Panhandle removed. (Murray Direct at 21-22.) Murray does not actually use this calculated capital structure in his rate of return analysis; however, it is possible that at some point in this proceeding, the calculation will become significant and thus, MGE addresses its inherent unreliability here.

First, Murray concedes that he is not a certified public accountant and does not know whether his methodology for removing Panhandle from Southern Union's financial statements complies with generally accepted accounting principles. (Murray Dep. at 83, 85.) Those two admissions alone demonstrate that his testimony on this accounting issue should be excluded.

Second, Murray's methodology is fundamentally flawed. Murray attempts to calculate the capital structure of Southern Union without Panhandle by deducting from *Southern Union's* total consolidated capitalization as shown in public filings as of December 31, 2003, the amounts shown as owner's equity and long term debt in Panhandle's public filings as of December 31, 2003.

Murray's calculation grossly distorts both Southern Union's and Panhandle's balance sheets and violates basic accounting principles. Pursuant to the consolidated financial statement requirements of Accounting Research Bulletin (ARB) 51, the owner's equity shown in Panhandle's public filings as of December 31, 2003, has already been eliminated from Southern Union's total consolidated capitalization as shown in Southern Union's public filings as of

December 31, 2003. For Southern Union's shareholders, Panhandle is merely an asset that, under Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements (CON 6), must be booked as an asset. Southern Union's total consolidated capitalization ratios – both before and after the Panhandle acquisition – are determined by independent considerations of, among other things, paid-in equity capital and retained earnings. R. Hermanson, J. Edwards & R. Salmonson, ACCOUNTING PRINCIPLES, 576-590 (1983). As CON 6 states:

> Equity is originally created by owners' [here, shareholders'] investments in an enterprise and may from time to time be augmented by additional investments by owners. . . .
>
> . . .
>
> Investments by owners are increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable *to obtain or increase ownership interests (or equity) in it*. . . .

(Paragraphs 63, 66) (emphasis added).

Southern Union's purchase of Panhandle created Southern Union equity in Panhandle, but it did not create additional equity in Southern Union. Indeed, if Murray's calculation was accepted by the Commission, it would mean that over $594 million in pre-acquisition Southern Union equity simply disappeared when the Panhandle acquisition took place.[11] This absurd result highlights Murray's gross miscalculation.

[11] Pre-Panhandle acquisition Southern Union had $922 million in shareholder equity; post-Panhandle acquisition, Southern Union had $922 million. Since Murray attributes over $646 million of this post-acquisition equity to Panhandle alone, some $594 million in Southern Union's pre-acquisition equity simply disappeared.

Conclusion

Murray's testimony exhibits none of the qualitative analysis required from a utility finance expert and is based on data and applications of methodologies upon which no reasonable utility finance expert would rely. Under § 490.065 RSMo., Murray is not a qualified expert and, even if he were, his testimony and opinions regarding a rate of return for MGE would still be inadmissible. Accordingly, MGE respectfully submits that the Commission should exclude Murray's opinions and testimony regarding a rate of return for MGE from this proceeding.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was hand-delivered, mailed by U.S. mail or electronically transmitted on this 18TH day of May, 2004, to all parties of record.