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| *Exhibit No.:* | |
| *Issues:* | *Rate of Return and Capital Structure* |
| *Witness:* | *Zephania Marevangepo* |
| *Sponsoring Party:* | *MoPSC Staff* |
| *Type of Exhibit:* | *Surrebuttal Testimony* |
| *Case No.:* | *GR-2010-0171* |
| *Date Testimony Prepared:* | *July 20, 2010* |

# MISSOURI PUBLIC SERVICE COMMISSION

## UTILITY SERVICES DIVISION

# SURREBUTTAL TESTIMONY

# OF

# ZEPHANIA MAREVANGEPO

# LACLEDE GAS COMPANY

# CASE NO. GR-2010-0171

**Jefferson City, Missouri**
***July 20, 2010***

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**SURREBUTTAL TESTIMONY**

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**LACLEDE GAS COMPANY**

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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 Revue Requirement Cost of Service Report and rebuttal testimony as part of this rate proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to Laclede Gas Company (Laclede or Company) witness Mr. Glenn W. Buck's rebuttal testimony concerning capital structure issue on page 10, lines 6 through 12 and the rebuttal testimony of Company witness Dr. Donald A. Murry.

## **<u>EXECUTIVE SUMMARY</u>**

Q. Please summarize Mr. Buck's capital structure issue.

A. Mr. Buck stated in his rebuttal testimony, lines 6 through 10 on page 10, that Staff's Schedule 8 indicated that the Staff of the Missouri Public Service Commission (Staff) meant to update the capital structure to March 31, 2010, but Staff failed to do so.

Q. Please summarize Staff's position with regards to the capital structure issue raised by Mr. Buck.

A. Staff completed its direct testimony based on financial information that was available at the time; that is September 30, 2010, financial statements. Staff subsequently updated Schedule 8 (capital structure) in its rebuttal testimony. The updated capital structure is furnished on page 3 of Staff's rebuttal testimony.

Q. Please summarize Staff's response to Dr. Murry's rebuttal testimony.

A. Dr. Murry believes that Staff did not effectively consider the current economic environment, the financial market crisis and the impact of these markets on investors' required return on equity for natural gas utility companies such as Laclede. Staff diametrically disagrees with Dr. Murry. With the intention of providing reasonable investors' required return expectations, Staff averaged stock prices from the most recent three months to determine a stock price that reflects the investors' expectations regarding current and future market conditions. Because publicly-traded companies report financial information to investors at least quarterly, three months is a reasonable period to use when averaging stock prices that furnish investors' expectations regarding current and future market conditions.

Also, Dr. Murry mentioned in his rebuttal testimony that dividend growth ignores any investor's expectations of capital gains. This is not true and Staff finds Dr. Murry's statement to be fundamentally inconsistent with the theory of the Discounted Cash Flow (DCF) method that Dr. Murry uses himself to estimate the cost of equity.

## MR. GLENN W. BUCK'S RECOMMENDED CAPITAL STRUCTURE

Q. Did Staff fail to update its capital structure (Schedule 8) as suggested by Mr. Buck in his rebuttal testimony?

A. No. Staff finished preparing its direct testimony before the updated information became available. Staff updated the capital structure to March 31, 2010, when it filed its rebuttal testimony. Therefore, there are no capital structure differences between Staff and Mr. Buck.

**RESPONSE TO DR. MURRY'S TESTIMONY**

**CURRENT MARKET CONDITIONS**

Q. Did Staff consider the impact of current market conditions in its recommended cost of capital?

A. Yes. As Staff mentioned earlier, Staff and more importantly, investors, are aware of the Federal Reserve's (Fed) efforts to keep the Fed Funds Rate at 0 to ¼ percent for extended periods of time in response to the current market conditions, the financial market crisis and the impact of these markets on investors' required returns for natural gas utility equity investments. A fundamental principle underlying the DCF, and probably one of the reasons it tends to be one of the most accepted cost of equity methodologies, is that assuming an analyst uses relevant stock prices, these stock prices reflect all factors investors have considered in determining a fair price to pay for the stock. Consequently, a proper application of the DCF methodology measures investors' considerations of all these factors. Dr. Murry also fails to recognize that the current low short-term interest rate environment and any expectation of possible tightening of these short-term rates are already reflected in the long-term interest rates, which is informative considering the current low level of long-term interest rates.

Q. Is there any evidence that the Federal Reserve is planning on keeping these rates at 0 to ¼ percent for an extended period of time?

A. Yes. Below is an excerpt from the June 23, 2010, press release after the Federal Open Market Committee meeting.

> Prices of energy and other commodities have declined somewhat in recent months, and underlying inflation has trended lower. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time.
>
> The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

Q. Dr. Murry mentioned in lines 9 through 10 on page 3 of his rebuttal testimony, his concern about the Federal Reserve's prospects to shift to a tighter monetary policy in the near term. Does Staff believe that the Federal Reserve will implement this policy in the near term given the Federal Reserve's economic expectations?

A. No. A Value Line report affirms Staff's position. The following excerpt is from Value Line Selection & Opinion newsletter - Issue no. 7 dated July 7, 2010:

> The Federal Reserve is wary as well, with the central bank recently offering a subdued assessment of the economic recovery, and implying that short-term interest rates would stay near zero for an extended period, which we now take to mean well into 2011. The Fed is concerned that a premature monetary tightening could severely jeopardize the fragile upturn.

Q. Dr. Murry mentioned the impact of "wild movements" of the various world stock markets. Is Staff aware of any Federal Reserve reports that discusses the Fed's view regarding the interaction of U.S markets with that of world markets?

A. Yes. Staff discovered recent testimony from Federal Reserve Chairman, Mr. Ben Bernanke, explaining how and why the United States' capital markets enjoy some degree of immunity from adverse market conditions of other countries. The following is an excerpt from Mr. Bernanke's June 9, 2010 testimony on economic and financial conditions:

> Ongoing developments in Europe point to the importance of maintaining sound government finances. In many ways, the United States enjoys a uniquely favored position. Our economy is large, diversified, and flexible; our financial markets are deep and liquid; and, as I have mentioned, in the midst of financial turmoil, global investors have viewed Treasury securities as a safe haven.[1]

While Mr. Bernanke clearly stated that investors viewed treasury securities as a safe haven during the financial crisis, Staff confirmed the view that investors consider utility stocks/bonds as close alternatives to bond investments.

Although there tends to be a slight risk premium for default risk compared to treasury bonds, utility bond yields and treasury bond yields tend to closely follow the same trends (see Schedule 4-3 attached to Staff's Cost of Service Report).

**DCF ANALYSIS**

Q. Dr. Murry, on page 19, lines 11 through 12 of his rebuttal testimony, claims that averaging growth rates masks returns investors may expect. What growth rates did Staff average?

[1] *Chairman Ben S. Bernanke's testimony on economic and financial conditions and the federal budget (June 9, 2010, cite the website link in which the reader can find this information)*

A. Staff averaged Dividend Per Share (DPS), Earnings Per Share (EPS) and Book Value Per Share (BVPS) growth rates. DPS, EPS and BVPS growth rates of mature companies, such as utility companies, are expected to grow at almost the same rate into perpetuity. Therefore, short-lived anomalies are smoothed out by averaging the three growth rates, which gives a good proxy for estimating sustainable growth rates rather than focusing solely on EPS forecasts.

Q. On page 5, line 24 through page 6, line 9 of his rebuttal testimony, Dr. Murry expresses his concerns about utilities' unattractive earnings' prospects, reduced industrial demand and low customer consumption levels. Are Dr. Murry's concerns, which are clearly indicating lower growth for utilities due to the current economic environment, consistent with the approach he used in his direct testimony of using the of highest projected growth rates in his DCF analysis?

A. No. Dr. Murry seems to have forgotten his optimism in his direct testimony that his proxy companies should be able to achieve the highest projected growth rates from those in which he had to choose from. Now, when his motive is to criticize my cost of common equity recommendation, he emphasizes several times throughout his rebuttal testimony the lower growth prospects for utilities due to the current economic environment. Perhaps Dr. Murry needs to revisit the growth rates he used for purposes of his DCF estimated cost of common equity. Quite simply, Dr. Murry needs to explain how the high growth estimates in his direct testimony can be achieved considering all of the dampened earnings prospects described in his rebuttal testimony.

**DIVIDEND GROWTH ANALYSIS**

Q. Dr. Murry in lines 14 through 15 on page 17 of his rebuttal testimony claimed that dividend growth rates ignore any investors' expectations of capital gains. Does Staff share the same sentiment?

A. No. In a Dividend Discount Model (DDM), which is the same thing as the DCF methodology in utility ratemaking terminology, investors discount expected future dividends and the anticipated growth of these dividends in order to determine a fair current stock price. Under the basic theory of the DDM, the expected growth in stock price is simply based on the expected growth in dividends. Any earnings that are retained and not paid out in dividends are reinvested in the company and are assumed to earn at least the required return on equity. This is what allows for further growth in dividends and therefore, growth in the stock price.

**CONCLUSION**

Q. Please summarize the conclusions of your surrebuttal testimony.

A. Staff believes that it has effectively considered all the current market conditions, the financial market crisis and the impact of volatile markets on investors in the cost of capital recommendation for Laclede. Staff relied on financial data that captures investors' expectations of current and expected economic and capital market conditions. If Staff were to further adjust its DCF results as Dr. Murry suggests, then Staff would be double counting what investors have already factored into the price they are willing to pay for natural gas utility stocks. While Dr. Murry expressed concerns about the Federal Reserve implementing tighter monetary control tools in response to high levels of inflation in the near future, Staff reviewed recent and past Federal Reserve statements confirming that short-term interest rates will be kept at 0 to ¼ percent for extended periods of time. Regardless, even if the Fed indicated it might increase short-term interest rates, if this monetary tightening does not cause higher long-term interest rates, then long-term capital costs may not be impacted by these short-term monetary policy decisions. In fact, since Dr. Murry wrote his rebuttal testimony, U.S. Treasury's have declined from 4.49 percent to 4.13 percent. This reflects investors' expectations of continued lower costs of long-term capital, which includes utility stocks.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

| | | |
|---|---|---|
| In the Matter of Laclede Gas Company's Tariff to Increase Its Annual Revenues for Natural Gas Service | ) ) ) | Case No. GR-2010-0171 |

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 Surrebuttal Testimony in question and answer form, consisting of 8 pages 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.

Zephania Marevangepo

Subscribed and sworn to before me this 19th day of July, 2010.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D. Suzie Mankin
Notary Public