

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

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

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

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

20           **MR. GLENN W. BUCK'S RECOMMENDED CAPITAL STRUCTURE**

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

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

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

6           **CURRENT MARKET CONDITIONS**

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

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

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

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

5                         Prices of energy and other commodities have  
6 declined somewhat in recent months, and underlying  
7 inflation has trended lower. With substantial resource slack  
8 continuing to restrain cost pressures and longer-term  
9 inflation expectations stable, inflation is likely to be  
10 subdued for some time.

11                        The Committee will maintain the target range for the  
12 federal funds rate at 0 to ¼ percent and continues to  
13 anticipate that economic conditions, including low rates of  
14 resource utilization, subdued inflation trends, and stable  
15 inflation expectations, are likely to warrant exceptionally  
16 low levels of the federal funds rate for an extended period.

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

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

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

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

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

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

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

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

21 **DCF ANALYSIS**

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

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<sup>1</sup> *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)*

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

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

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



1                   **DIVIDEND GROWTH ANALYSIS**

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

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

13                   **CONCLUSION**

14                  Q.     Please summarize the conclusions of your surrebuttal testimony.

15                  A.     Staff believes that it has effectively considered all the current market  
16 conditions, the financial market crisis and the impact of volatile markets on investors in the  
17 cost of capital recommendation for Laclede. Staff relied on financial data that captures  
18 investors' expectations of current and expected economic and capital market conditions. If  
19 Staff were to further adjust its DCF results as Dr. Murry suggests, then Staff would be  
20 double counting what investors have already factored into the price they are willing to pay  
21 for natural gas utility stocks. While Dr. Murry expressed concerns about the Federal  
22 Reserve implementing tighter monetary control tools in response to high levels of inflation  
23 in the near future, Staff reviewed recent and past Federal Reserve statements confirming

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1 that short-term interest rates will be kept at 0 to ¼ percent for extended periods of time.  
2 Regardless, even if the Fed indicated it might increase short-term interest rates, if this  
3 monetary tightening does not cause higher long-term interest rates, then long-term capital  
4 costs may not be impacted by these short-term monetary policy decisions. In fact, since  
5 Dr. Murry wrote his rebuttal testimony, U.S. Treasury's have declined from 4.49 percent to  
6 4.13 percent. This reflects investors' expectations of continued lower costs of long-term  
7 capital, which includes utility stocks.

8 Q. Does this conclude your surrebuttal testimony?

9 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     )     Case No. GR-2010-0171  
Gas Service     )

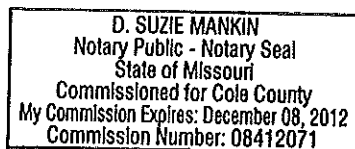
AFFIDAVIT OF ZEPHANIA MAREVANGEPO

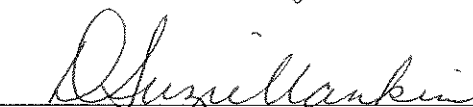
STATE OF MISSOURI     )  
                                      )     ss.  
COUNTY OF COLE     )

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 19<sup>th</sup> day of July, 2010.



  
\_\_\_\_\_  
Notary Public