Exhibit No.:
Issue: Rate of Return
Witness: Michael Gorman
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Missouri Industrial Energy Consumers
Case No.: GR-2007-0208
Date Testimony Prepared: July 20, 2010

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** Tariff No. YG-2010-0376

Surrebuttal Testimony and Schedules of

Michael Gorman

On Behalf of

Missouri Industrial Energy Consumers

July 20, 2010
Project 9260

BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

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** Tariff No. YG-2010-0376

STATE OF MISSOURI)
) **SS**
COUNTY OF ST. LOUIS)

Affidavit of Michael Gorman

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes are my surrebuttal testimony and schedules, which were prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. GR-2010-0171.

3. I hereby swear and affirm that the testimony and schedules are true and correct and that they show the matters and things they purport to show.

Michael Gorman

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

Notary Public

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2013
Commission # 09706793

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** Tariff No. YG-2010-0376

Surrebuttal Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael Gorman and my business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q ARE YOU THE SAME MICHAEL GORMAN WHO FILED DIRECT AND REBUTTAL TESTIMONY IN THIS PROCEEDING?

A Yes.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of the Missouri Industrial Energy Consumers (MIEC).

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to the rebuttal testimony of Laclede Gas Company's (Laclede or Company) witnesses Dr. Donald Murry, Mr. Glenn Buck and Mr. James Fallert.

Response to Dr. Donald Murry

Q PLEASE DESCRIBE THE FIRST ISSUE OR CONCERN YOU HAVE WITH DR. MURRY'S REBUTTAL TESTIMONY.

A At pages 1 and 2 of his rebuttal testimony, Dr. Murry states that Staff and I did not consider the domestic and international impacts of the financial crisis on investors' perceived level of risk and their willingness to invest in the utility industry. He asserts that we applied our models mechanically without compensating for the current market environment.

Q DO YOU BELIEVE DR. MURRY HAS ADEQUATELY EVALUATED THE REASONABLENESS OF YOUR RETURN ON EQUITY RECOMMENDATIONS?

A No. The domestic and international factors described by Dr. Murry are well recognized in the financial press, and considered by the investment community, credit rating agencies and other market participants in assessing the risk of utility investments and the general stock market in the current environment. I did consider this current market information and it was reflected in my return on equity analysis.

Specifically, in my direct testimony, I noted that equity security analysts find that utility stock investments are again perceived as low risk investment vehicles, and that regulation provides credit supportive treatment for utility companies, including Laclede Gas (Gorman Direct at 4-6). Hence, this information clearly establishes that utility investments in these troubled economic times continue to be perceived by investors as low risk, stable investments.

Q DR. MURRY ALSO ASSERTS THAT THERE IS EXPECTATION OF INCREASING INTEREST RATES WHICH WOULD HAVE AN IMPACT ON COST OF CAPITAL. DID YOU CONSIDER THESE INCREASED INTEREST RATES IN DETERMINING YOUR RETURN ON EQUITY?

A Yes. However, the accuracy of forecasted interest rates is at very best highly problematic. Nevertheless, I did consider projected increases to interest rates in deriving my return on equity. I also, however, considered current observable interest rates in deriving my recommended return on equity. Indeed, because of the highly uncertain outlook for interest rates, it is just as likely that current observable interest rates are as good a reflection of the interest rates during the period the rates determined in this case will be in effect as are projected interest rates.

Hence, it is necessary and reasonable to give consideration to both current observable interest rates and projected interest rates in order to establish a fair return on equity in this proceeding. Dr. Murry's proposal to ignore current observable interest rates, and only consider higher projected interest rates is without merit, biased and does not produce a balanced return on equity estimate.

Q WHY DO YOU BELIEVE THAT THE ACCURACY OF FORECASTED INTEREST RATES IS HIGHLY PROBLEMATIC?

A This is clearly evident by a review of projected changes to interest rates made over the last several years, in comparison to how accurate these projections turned out to be. This analysis clearly illustrates that observable interest rates today are as accurate as are economists' consensus projections of future interest rates.

An analysis supporting this conclusion is illustrated in Schedule MPG-S1. On this schedule, under Columns 1 and 2, I show the actual market yield at the time a

projection is made for Treasury bond yields two years in the future. In Column 1, I show the actual Treasury yield and in Column 2, I show the projected yield two years out.

As shown in Columns 1 and 2, over the last several years, Treasury yields were projected to increase relative to the actual Treasury yields at the time of the projection. In Column 4, I show what the Treasury yield actually turned out to be two years after the forecast. Under Column 5, I show the actual yield change at the time of the projections relative to the projected yield change.

As shown in this schedule, over the last several years, economists have been consistently projecting increases to interest rates. However, as demonstrated under Column 5, those yield projections have turned out to be overstated in virtually every case. Indeed, actual Treasury yields have decreased or remained flat over the last five years, rather than increase as the economists' projections indicated.

This review of the experience with projected interest rates clearly illustrates that interest rate projection accuracy is highly problematic. Indeed, current observable interest rates are just as likely a reasonable projection of future interest rates as are economists' projections.

Q DR. MURRY ALSO ASSERTS THAT UTILITY STOCKS HAVE TRAILED THE RETURNS EARNED ON THE S&P 500. PLEASE COMMENT.

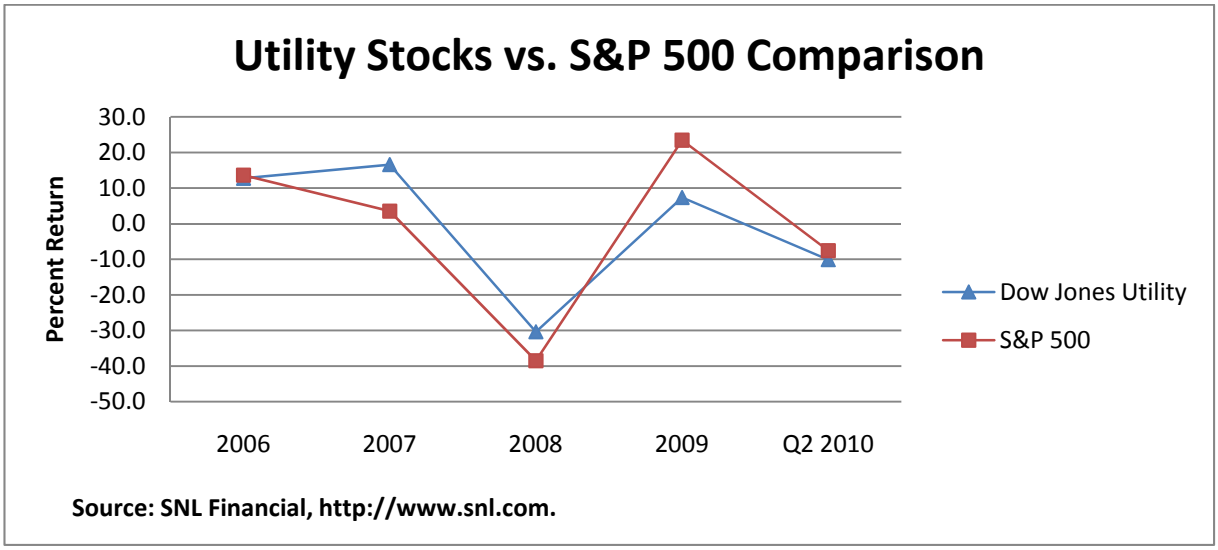
A Dr. Murry has not provided a complete assessment of the comparison of utility stock investments relative to those of the S&P 500. Indeed, a longer term perspective will show that utility stocks held their valuation much better than that of the S&P 500 during the turbulent financial times in 2008-2009. What is clearly evident from this

utility stock versus market stock index comparison is that utility stock prices have been far more stable than the overall stock market.

Q PLEASE DESCRIBE UTILITY STOCK PRICE PERFORMANCE OVER THE LAST FIVE YEARS.

A As shown in Figure 1, the Dow Jones Utility Index has recorded utility stock price performance compared to the market.

FIGURE 1



As shown in Figure 1 above, utility stocks held their value better than the overall market during calendar years 2007 and 2008, and increased less than the overall market from 2008 through the first quarter of 2010. This more moderate stock price variability indicates more stability in utility stock price valuation relative to the overall market and supports the notion that utility stocks are lower risk, and more stable investments than that of the market.

Q DOES DR. MURRY OFFER ANY CONCERNS RELATED TO THE RELIABILITY OF THE DCF AND CAPM ESTIMATES WHICH SHOULD LIMIT THE COMMISSION'S RELIANCE ON THE RELIABILITY OF THESE MODELS?

A No. Dr. Murry raises several concerns he believes may result in the DCF and the CAPM return estimates understating the utility's cost of capital. However, these models are widely used in regulatory proceedings to support authorized returns on equity in setting utility prices. The market observable evidence clearly shows that the regulatory procedures have resulted in stable utility prices and relatively stable utility bond ratings. These stable prices and bond ratings are a clear indication that regulatory procedures are providing fair compensation, and have been maintaining the financial integrity of the underlying utility company. Hence, Dr. Murry's concerns are completely contradicted by clear market evidence that authorized returns on equity largely supported by DCF and risk premium studies including the CAPM, have contributed to the stability of utility security valuations, and have helped to maintain investment grade credit ratings for utility companies.

Q DR. MURRY ALSO STATES CONCERN WITH YOUR RECOMMENDED RETURN ON EQUITY IN THIS CASE BEING LOWER THAN THE RETURN ON EQUITY YOU PROPOSED IN THE 2007 CASE. PLEASE RESPOND.

A My return on equity in this case of 9.5%, is 30 percentage points lower than the 9.8% I recommended in Laclede's 2007 rate case. However, as shown in my direct testimony, this decline in the return on equity corresponds to a decline in other observable capital market costs. For example, "A" rated utility bond yields have decreased by approximately 20 basis points currently relative to 2007. (Gorman Direct, Schedule MPG-14). Hence, my return on equity in this case is lower because

capital market costs for utility companies are lower today than they were in 2007. Hence, Dr. Murry's assertions are without merit and should be disregarded.

Q DR. MURRY ALSO ARGUES THAT YOUR SUSTAINABLE GROWTH DCF MODEL IS BASED ON AN EXPECTED BOOK RETURN OF 12.2%, THEREFORE YOUR CONCLUSION OF THE DCF-DERIVED RETURN OF 10.1% IS ILLOGICAL. PLEASE RESPOND.

A Dr. Murry's argument is simply without merit. While the book return on equity of 12.2% is used to derive a long-term sustainable growth rate in this DCF model, it does not take away from the fact that the current market cost of equity is less than 10.0%, and not equal to the expected return on book equity. The sustainable growth DCF analysis was based on parent company publicly traded companies and not regulated utility operations. The earned return on book equity is not just for regulated utility operations, but is based on the consolidated enterprise including utility operations, and unregulated businesses. Hence, if the unregulated businesses contributed positively to the utility earnings, the earned return on book equity for the parent company would be different than that for the earned return on equity for the regulated utility operations. This would be particularly true in cases where the non-regulated business entities contribute to earnings, but are not capital intensive like utility companies. Hence, this could drive up the earned return on book equity for parent company structures, where most of the capital is supporting utility operations. The non-regulated companies simply contribute to earnings and increase the earned return on equity. For all these reasons, Dr. Murry's assessment and opinions are not credible and should be disregarded.

Q DID DR. MURRY HAVE ANY CRITICISMS OF YOUR PROPOSED CAPITAL STRUCTURE?

A Yes. Dr. Murry argued that my proposed capital structure considered short-term debt capital, which does not properly reflect the capitalization mix of Laclede Gas Company.

Q DID YOU REVISE YOUR CAPITAL STRUCTURE RECOMMENDATION IN YOUR REBUTTAL TESTIMONY?

A Yes. In my rebuttal testimony, I observed that the Company was proposing a capital structure based on Laclede Group's capital structure and not its utility subsidiary, Laclede Gas Company. Rates in this case are being set for Laclede Gas. For all the reasons outlined in my rebuttal testimony, it is not appropriate to use Laclede Group's more heavily common equity weighted capital structure in order to provide a rate of return on Laclede Gas's utility operations.

Q IF THE COMMISSION USES LACLEDE GROUP'S CAPITAL STRUCTURE CONSISTENT WITH THE COMPANY'S RECOMMENDATION IN THIS PROCEEDING, AND AWARDS LACLEDE GAS COMPANY A 10.0% RETURN ON EQUITY, WHAT WILL THE IMPLIED RETURN ON EQUITY BE FOR THE AMOUNT OF COMMON EQUITY ACTUALLY INVESTED IN LACLEDE GAS COMPANY?

A If Laclede Group's capital structure is used to develop the overall rate of return, recognizing that Laclede Group has far more common equity as a percentage of total capital than Laclede Gas Company does, then if the Commission were to find a 10.0% return on equity to be appropriate in developing that overall rate of return, it would result in providing Laclede Gas Company an opportunity to earn an 11.0%

return on equity on the amount of common equity actually invested in utility operations. (See Schedule MPG-S2.) Clearly, using Laclede Group's capital structure mix will provide excessive compensation on the amount of common equity actually invested in Laclede Gas's utility plant and equipment.

Q CONVERSELY, IF THE COMMISSION WANTED TO PROVIDE A 10.0% RETURN ON LACLEDE GAS COMMON EQUITY INVESTMENTS IN UTILITY OPERATIONS, BUT CHOSE TO USE LACLEDE GROUP'S CAPITAL STRUCTURE, WHAT RETURN ON EQUITY WOULD PRODUCE THE DESIRED RETURN ON EQUITY CAPITAL INVESTED IN UTILITY OPERATIONS?

A If the Commission's objective is to provide a 10.0% return on equity on common equity invested in utility operations, but use Laclede Group's capital structure to develop an overall rate of return, it would need to award a return on equity of 9.2% using Laclede Group's capital structure in order to provide a 10.0% return on the common equity invested in Laclede Gas utility operations. (See Schedule MPG-S3.)

Response to Glenn W. Buck

Q DID MR. BUCK MAKE ANY COMMENTS RELATED TO THE REASONABLENESS OF THE COMPANY'S PROPOSED CAPITAL STRUCTURE IN THIS CASE?

A Yes. Mr. Buck references Dr. Murry's conclusion that the proposed capital structure is in line with the peer group of publicly traded companies used to estimate Laclede Gas's return on equity in this proceeding. However, what Mr. Buck fails to recognize, as did Dr. Murry, is that publicly traded parent companies are not the regulated utility subsidiaries. Therefore, this comparison indicates a reasonable risk comparable

group to Laclede Group, and not a comparable capital structure to the regulated operations of Laclede Gas Company.

Further, Mr. Buck asserts that using the parent company's capital structure is a way to avoid double leveraging rate of return in developing a return for Laclede Gas Company. However, this assertion is without merit. As I outlined in my rebuttal testimony, on Laclede Group's consolidated capital structure, virtually all of the debt is for Laclede Gas Company. A double leverage adjustment is made when there are concerns the parent company issued debt in order to fund equity contributions to the utility. When doing this, the actual cost of capital is stated at the parent company's debt cost, but then is injected as equity in the utility capital structure and allowed to earn a pre-tax return on equity.

This is not happening in this case. To the contrary, a significant amount of Laclede Group's common equity capital is supporting non-regulated investments and not utility operations. Hence, when using Laclede Group's capital structure to set rates for Laclede Gas, customers are being asked to pay a return on equity capital that is not invested in utility operations.

Q DO CREDIT RATING AGENCIES RECOGNIZE THAT LACLEDE GAS'S BOND RATING IS BASED ON ITS CAPITAL STRUCTURE MIX, AND NOT THE CAPITAL STRUCTURE MIX OF LACLEDE GROUP?

A Yes. For example, Standard & Poor's (S&P) stated:

> Because the majority of debt is issued by Laclede Gas, the utility's stand-alone financial metrics are materially weaker than those of LG [The Laclede Group Inc.]. As a result, Laclede Gas's stand-alone credit metrics remain slightly weak for the rating. At June 30, 2009, Laclede Gas generated FFO interest coverage of 3.7x, FFO to total debt of 18%, and <u>total debt to capital of 57%</u>. At June 30, 2009, LG's credit metrics were appropriate for the rating with FFO interest

coverage of 5x FFO to total debt of 25%, and total debt to capital of 51%.[1]

As noted by S&P in assigning Laclede Gas Company's and Laclede Group's bond rating, it recognizes that Laclede Gas has greater financial leverage, and a higher total debt ratio (and lower common equity ratio) than its parent company, Laclede Group. Hence, Laclede Gas's and Laclede Group's bond ratings stand on their own capital structure.

I would also note, earlier in this same report, S&P noted Laclede Group's higher operating risk relative to Laclede Gas, which indicates that Laclede Gas can have higher financial risk because it is offset by lower operating risk relative to its parent company, Laclede Group.

Response to James A. Fallert

Q DO YOU HAVE ANY COMMENTS RELATED TO MR. FALLERT'S REBUTTAL TESTIMONY?

A Yes. Mr. Fallert asserts that Laclede Group has flowed the capital associated with virtually all Laclede Group's common equity issuances to Laclede Gas Company. He concludes that therefore, Laclede Gas benefits from positive perceptions engendered among investors by enhanced corporate visibility.

[1]Standard & Poor's Ratings Direct on the Global Credit Portal: "Laclede Gas Co.," October 30, 2009 at 2-3, emphasis added.

Q PLEASE COMMENT ON MR. FALLERT'S ASSERTION THAT VIRTUALLY ALL OF LACLEDE GROUP'S CAPITAL ASSOCIATED WITH ITS COMMON EQUITY ISSUANCES HAS BEEN TRANSFERRED TO LACLEDE GAS COMPANY.

A First, Mr. Fallert has not substantiated the accuracy of this claim. Second, a review of Laclede Gas Company's cash flows over the last five years, indicates that over $156 million of dividends have been paid from Laclede Gas Company up to Laclede Group. Laclede Gas dividends to Laclede Group have largely supported Laclede Group's ability to pay public dividends. Hence, a significant amount of common equity that has been generated via earnings in Laclede Gas Company has been paid up to the parent company for either payment of public dividends, or to support investments in non-regulated companies.

Hence, any assessment of the proceeds from public stock issuances is not a complete assessment of the overall equity mix of Laclede Group versus Laclede Gas Company. Therefore, Laclede Gas Company's rate of return in this proceeding should be based on the regulated utility operations of Laclede Gas Company, and not on Laclede Group's publicly traded capital structure.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

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Laclede Gas Company

Accuracy of Interest Rate Forecasts
(Long-Term Treasury Bond Yields - Projected Vs. Actual)

Line	Date	Publication Data: Prior Quarter Actual Yield (1)	Publication Data: Projected Yield (2)	Publication Data: Projected Quarter (3)	Actual Yield in Projected Quarter (4)	Projected Yield Higher (Lower) Than Actual Yield* (5)
1	Dec-00	5.8%	5.8%	1Q, 02	5.6%	0.2%
2	Mar-01	5.7%	5.6%	2Q, 02	5.8%	-0.2%
3	Jun-01	5.4%	5.8%	3Q, 02	5.2%	0.6%
4	Sep-01	5.7%	5.9%	4Q, 02	5.1%	0.8%
5	Dec-01	5.5%	5.7%	1Q, 03	5.0%	0.7%
6	Mar-02	5.3%	5.9%	2Q, 03	4.7%	1.2%
7	Jun-02	5.6%	6.2%	3Q, 03	5.2%	1.0%
8	Sep-02	5.8%	5.9%	4Q, 03	5.2%	0.7%
9	Dec-02	5.2%	5.7%	1Q, 04	4.9%	0.8%
10	Mar-03	5.1%	5.7%	2Q, 04	5.4%	0.3%
11	Jun-03	5.0%	5.4%	3Q, 04	5.1%	0.3%
12	Sep-03	4.7%	5.8%	4Q, 04	4.9%	0.9%
13	Dec-03	5.2%	5.9%	1Q, 05	4.8%	1.1%
14	Mar-04	5.2%	5.9%	2Q, 05	4.6%	1.4%
15	Jun-04	4.9%	6.2%	3Q, 05	4.5%	1.7%
16	Sep-04	5.4%	6.0%	4Q, 05	4.8%	1.2%
17	Dec-04	5.1%	5.8%	1Q, 06	4.6%	1.2%
18	Mar-05	4.9%	5.6%	2Q, 06	5.1%	0.5%
19	Jun-05	4.8%	5.5%	3Q, 06	5.0%	0.5%
20	Sep-05	4.6%	5.2%	4Q, 06	4.7%	0.5%
21	Dec-05	4.5%	5.3%	1Q, 07	4.8%	0.5%
22	Mar-06	4.8%	5.1%	2Q, 07	5.0%	0.1%
23	Jun-06	4.6%	5.3%	3Q, 07	4.9%	0.4%
24	Sep-06	5.1%	5.2%	4Q, 07	4.6%	0.6%
25	Dec-06	5.0%	5.0%	1Q, 08	4.4%	0.6%
26	Mar-07	4.7%	5.1%	2Q, 08	4.6%	0.5%
27	Jun-07	4.8%	5.1%	3Q, 08	4.5%	0.7%
28	Sep-07	5.0%	5.2%	4Q, 08	3.7%	1.5%
29	Dec-07	4.9%	4.8%	1Q, 09	3.5%	1.4%
30	Mar-08	4.6%	4.8%	2Q, 09	4.0%	0.8%
31	Jun-08	4.4%	4.9%	3Q, 09	4.3%	0.6%
32	Sep-08	4.6%	5.1%	4Q, 09	4.3%	0.8%
33	Dec-08	4.5%	4.6%	1Q, 10	4.6%	0.0%
34	Jan-09	3.8%	4.0%	2Q, 10		
35	Feb-09	3.7%	3.9%	2Q, 10		
36	Mar-09	3.7%	4.1%	2Q, 10		
37	Apr-09	3.5%	4.3%	3Q, 10		
38	May-09	3.5%	4.3%	3Q, 10		
39	Jun-09	3.5%	4.6%	3Q, 10		
40	Jul-09	4.0%	5.0%	4Q, 10		
41	Aug-09	4.0%	5.0%	4Q, 10		
42	Sep-09	4.0%	5.0%	4Q, 10		
43	Oct-09	4.3%	5.1%	1Q, 11		
44	Nov-09	4.3%	5.0%	1Q, 11		
45	Dec-09	4.3%	5.0%	1Q, 11		
46	Jan-10	4.3%	5.2%	2Q, 11		
47	Feb-10	4.3%	5.2%	2Q, 11		
48	Mar-10	4.3%	5.2%	2Q, 11		
49	Apr-10	4.6%	5.3%	3Q, 11		
50	May-10	4.6%	5.3%	3Q, 11		
51	Jun-10	4.6%	5.2%	3Q, 11		
52	Jul-10	4.4%	5.1%	4Q, 11		

Source:
Blue Chip Financial Forecasts , Various Dates.
* Col. 2 - Col. 4.

Laclede Gas Company

Capital Structure

1. Proposed Capital Structure

Line	Description	Amount (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
1	Common Stock	$ 553,526	59.1%	**10.0%**	5.91%	9.62%
2	Long-Term Debt	$ 383,754	40.9%	6.5%	2.67%	2.67%
3	Total	$ 937,280	100.0%		**8.58%**	**12.30%**
4	Tax Conversion Factor					1.62959

2. Laclede Gas - FERC Capital Structure

Line	Description	Amount (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
5	Common Stock	$ 402,585	50.8%	**11.0%**	5.58%	9.09%
6	Long-Term Debt	$ 389,240	49.2%	6.5%	3.21%	3.21%
7	Total	$ 791,825	100.0%		**8.79%**	**12.30%**

Source:
[1] Beck Rebuttal, Schedule GWB-1.

Laclede Gas Company

Capital Structure

1. Proposed Capital Structure

Line	Description	Amount (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
1	Common Stock	$ 553,526	59.1%	**9.2%**	5.41%	8.82%
2	Long-Term Debt	$ 383,754	40.9%	6.5%	2.67%	2.67%
3	Total	$ 937,280	100.0%		**8.09%**	**11.50%**
4	Tax Conversion Factor					1.62959

2. Laclede Gas - FERC Capital Structure

Line	Description	Amount (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
5	Common Stock	$ 402,585	50.8%	**10.0%**	5.08%	8.29%
6	Long-Term Debt	$ 389,240	49.2%	6.5%	3.21%	3.21%
7	Total	$ 791,825	100.0%		**8.29%**	**11.50%**

Source:
[1] Beck Rebuttal, Schedule GWB-1.