Exhibit No.:	
Issues:	Return on Equity, Rate of Return, Cost of Service
Witness:	Michael Gorman
Type of Exhibit:	Rebuttal Testimony
Sponsoring Party:	Missouri Industrial Energy Consumers
Case No.:	GR-2007-0208
Date Testimony Prepared:	June 24, 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

Rebuttal Testimony and Schedules of

Michael Gorman

On Behalf of

Missouri Industrial Energy Consumers

June 24, 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 rebuttal 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 23rd day of June, 2010.

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

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
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Rebuttal 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 THAT FILED DIRECT 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 REBUTTAL TESTIMONY?

A The purpose of my rebuttal testimony is to respond to Laclede Gas's witness Dr. Donald Murry. I will also respond to Office of Public Counsel (OPC) witness Barbara Meisenheimer's class cost of service study.

Summary

Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND FINDINGS IN YOUR REBUTTAL TESTIMONY CONCERNING DR. MURRY'S RECOMMENDATIONS.

A In my testimony I make the following recommendations:

1. Dr. Murry's proposed return on equity in the range of 10.75% to 11.5% is severely flawed, unreliable and should be rejected.

2. Dr. Murry's own DCF studies prove that a return on equity of less than 10% would provide fair compensation to Laclede Gas in this proceeding.

3. Dr. Murry's CAPM results, when excluding unjustified small size risk premiums, indicate a return on equity of less than 10% would represent fair compensation.

4. Dr. Murry uses Laclede Group's capitalization mix to develop Laclede Gas's overall rate of return. This is inappropriate because Laclede Group's capital structure contains significant equity capital that is not invested in utility operations. Hence, using Laclede Group's capital structure will overstate Laclede Gas's cost of capital in supporting its utility operations.

5. Dr. Murry's proposed Laclede Group capital structure should be rejected.

6. Laclede Gas's capital structure during the test year is approximately 49.2% long-term debt and 50.8% common equity capital. This capital structure is reasonably comparable to industry averages, reasonably comparable to the utility operating affiliates of the publically traded companies included in my proxy group, and represents Laclede Gas's actual capitalization mix supporting its utility operations. For all these reasons, this capital structure should be used to set Laclede Gas's overall rate of return.

Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND FINDINGS IN YOUR REBUTTAL TESTIMONY CONCERNING OPC WITNESS MS. MEISENHEIMER'S CLASS COST OF SERVICE STUDY.

A In my testimony I will make the following recommendations:

1. Ms. Meisenheimer's class cost of service study is severely flawed and should be rejected.

2. Ms. Meisenheimer did not properly differentiate the size of mains with the customers for which those mains can provide service.

3. Ms. Meisenheimer did not properly allocate uncollectible expense between the rate classes.

4. Ms. Meisenheimer did not properly allocate certain customer-related costs between the rate classes.

5. Correcting Ms. Meisenheimer's study for these inappropriate cost allocations, will show that Transportation Class rates are reasonably aligned with Laclede Gas's cost of service to this rate class. Hence, Ms. Meisenheimer's proposal for a rate neutral revenue shift should be rejected as inappropriate.

6. A more reasonable spread of any revenue deficiency in this case should be based on an equal percent change to all classes' non-gas cost of service.

Response to Laclede Gas Witness Dr. Donald Murry

Q WHAT RETURN ON COMMON EQUITY IS LACLEDE GAS PROPOSING FOR THIS PROCEEDING?

A Laclede Gas's proposed return on equity is supported by its witness Dr. Donald Murry. He recommends a return on equity for Laclede Gas in the range of 10.75% to 11.50% (Murry Direct at 38-39).

Q PLEASE DESCRIBE DR. MURRY'S METHODOLOGY SUPPORTING HIS RETURN ON COMMON EQUITY.

A Dr. Murry estimates a return on equity for Laclede Gas using a Discounted Cash Flow (DCF) analysis and a Capital Asset Pricing Model (CAPM). He applies these models to two proxy groups: (1) Laclede Group, and (2) a comparable risk proxy group.

Dr. Murry's DCF and CAPM results are summarized in Table 1 below (columns 1 and 2).

TABLE 1

Summary of Dr. Murry's ROE Estimate

Description	Range (1)	Average (2)	Adjusted Results (3)
DCF	8.91% – 10.50%	9.71%	9.71%
CAPM	10.22% – 10.36%	10.29%	8.58%
Recommended ROE	**10.75 – 11.50%**		
Revised ROE			**8.58% - 9.71%**

Sources: Murry Schedules DAM-16 through DAM-19, DAM-21, DAM-22 and Table 2 of Mr. Gorman's Rebuttal Testimony

Q DO YOU BELIEVE DR. MURRY'S RESULTS SUPPORT HIS RECOMMENDED RETURN ON EQUITY RANGE FOR LACLEDE GAS?

A No. As shown above in Table 1, Dr. Murry's own results suggest a return on equity of 10% or less would be appropriate. Indeed, removing his inappropriate size premium adjustment to his CAPM, and considering all the results of his DCF studies, would suggest that a return on equity of 9.7% or less would be reasonable. Hence, Dr. Murry's proposed return on equity of 10.75% to 11.50% is excessive and should be rejected.

Q DID DR. MURRY PROPOSE ANY ADJUSTMENTS TO THE RESULTS OF THE DCF OR CAPM RETURN ESTIMATE?

A Dr. Murry states that he did not apply any mechanical adjustments to his DCF return estimates. However, he argues for a DCF return estimate at the higher end of his recommended range to provide for the marginal nature of the DCF model. For his CAPM, he adds a 1.74% premium ROE adder for a small size adjustment.

Q IS DR. MURRY'S PROPOSAL TO CONSIDER ONLY HIGH-END DCF ESTIMATES TO REFLECT THE MARGINAL NATURE OF THE DCF MODEL REASONABLE?

A No. The objective of regulation is to provide the utility an economic incentive to continue investing in utility plant by providing an opportunity to be fairly compensated. If a utility is permitted an opportunity to earn the same rate of return by making marginal utility plant investments, as it can earn by purchasing its own stock (or the stock of a comparable risk company), then it will have an economic incentive to invest in utility plant and will be fairly compensated. As such, awarding an authorized return on equity equal to its cost of capital gives the utility an opportunity to earn the same rate of return by making incremental utility plant investments, as it can earn by making incremental utility stock investments. As such, a DCF return produces a reasonable and fair earnings opportunity. Therefore, setting the allowed return on equity at a utility's current market equity cost of capital provides the utility an opportunity to earn a fair rate of return.

Q WHAT ARE THE RESULTS OF DR. MURRY'S DCF STUDIES?

A The results from Dr. Murry's DCF analyses are shown in the table below. As shown in this table, the DCF falls in the range of 8.91% to 10.50%. The midpoint of his DCF estimated range is 9.71%.

TABLE 2

Dr. Murry's DCF Results
(Comparable Group)

Line	DCF Study	Comparable Group Low	Comparable Group High
1	Schedule DAM-14	7.50%	9.10%
2	Schedule DAM-15	8.11%	8.20%
3	Schedule DAM-16	9.07%	10.67%
4	Schedule DAM-17	9.67%	9.76%
5	Schedule DAM-18	8.15%	11.23%
6	Schedule DAM-19	8.76%	10.32%
7	*Average (Excluding Lines 1 and 2)*	***8.91%***	***10.50%***
8	Midpoint	**9.71%**	

Sources: Murry Schedules DAM-14 through DAM-19.

Q DO YOU BELIEVE DR. MURRY'S DCF STUDIES SUPPORT HIS RETURN ON EQUITY RECOMMENDATION?

A No. As clearly shown in Table 2 above, Dr. Murry's DCF studies support a return on equity in the range of 8.9% to 10.5%. Indeed, out of the 12 DCF estimates, only three are above 10%. Dr. Murry's DCF results clearly show that a return on equity of less than 10% would be appropriate in today's capital market environment.

Q WHY DO YOU BELIEVE THAT THE DCF RESULTS MEASURED BY DR. MURRY THAT WERE ABOVE 10% REFLECT UNREASONABLE GROWTH OUTLOOKS?

A The growth estimates produced by Dr. Murry that exceed 10% reflect growth rates of 5.53% as shown on his Schedule DAM-16, 6.05% as shown on his Schedule DAM-18, and 6.05% as shown on his Schedule DAM-19. While these growth rate estimates might be reasonable estimates of growth over the next three to five years, they are not reasonable estimates of long-term sustainable growth as required by the

constant growth DCF model. Over the long-term, these companies cannot grow at a rate significantly higher than the expected growth of the U.S. GDP. Consensus economists project the U.S. GDP growth will be approximately 4.8% over the next 10 years.[1] Hence, Dr. Murry's DCF growth estimates above 10% reflect abnormally high growth, and inflate these DCF return estimates.

Q YOU DID NOT LIST THE DCF RETURN ESTIMATE FOR LACLEDE GROUP IN TABLE 2 ABOVE. DID DR. MURRY'S DCF RETURN ESTIMATES FOR LACLEDE GROUP PRODUCE MEANINGFUL INFORMATION TO DEVELOP A FAIR RETURN ON EQUITY FOR LACLEDE GAS IN THIS PROCEEDING?

A No. Indeed, Dr. Murry himself acknowledges that Laclede Group and Laclede Gas are not comparable in investment risk. At page 16 of his direct testimony, he states the financial community has noted recent favorable financial performance for Laclede Group which was largely affected by the earnings of the non-regulated sector of the company. He states that was in significant contrast to the relatively less favorable financial performance of Laclede Gas.

Further, Standard & Poor's (S&P) also acknowledges differences in investment risk between Laclede Gas and Laclede Group. In a credit report on Laclede Group Inc., dated October 30, 2009, S&P stated the following:

> **Major Rating Factors**
>
> **Strengths:**
>
> - Reasonably supportive regulation including a purchased-gas recovery and infrastructure cost recovery clauses,
> - A stable, largely residential customer base,
> - A diversified gas supply and significant storage capacity, and
> - Low operating risks.

[1] *Blue Chip Economic Indicators*, March 10, 2010 at 14.

Weaknesses:

- A relatively weak financial profile characterized by high leverage and somewhat weak cash flow measures,
- Higher risk unregulated activities at parent-Laclede Group, and
- Below-average customer growth.[2]

S&P recognizes that Laclede Group has higher risk related to its unregulated activities relative to Laclede Gas's relatively low-risk regulated utility operations.

Dr. Murry's own testimony and comments from S&P indicated that Laclede Gas and Laclede Group are not risk comparable. Therefore, Laclede Group is not a reasonable risk proxy to Laclede Gas, and a DCF return for Laclede Group will not produce a fair return for Laclede Gas.

Q ARE THERE OTHER REASONS TO REJECT THE USE OF A SINGLE COMPANY AS A PROXY RISK GROUP?

A Yes. Use of a single company proxy group introduces significant measurement risk, and makes the DCF return estimate reliability problematic. Market data necessary to perform a DCF return estimate for a single company may not reflect the market's long-term valuation because it could temporarily be affected by market factors that skew the market data and valuation. A proxy group composed of more than one company substantially minimizes this measurement error, and makes a proxy group DCF return estimate far more reliable than an estimate from a single company. Therefore, Dr. Murry's DCF return estimates for Laclede Group on a stand-alone basis should be disregarded.

[2] *Standard & Poor's RatingsDirect on the Global Credit Portal*: "Laclede Group Inc. (The)," October 30, 2009 at 2, emphasis added.

Q BASED ON DR. MURRY'S DCF ANALYSIS, WHAT RETURN ON EQUITY DO YOU BELIEVE IS INDICATED FOR LACLEDE GAS?

A As shown in Table 2 above, considering the average proxy group results and limiting the issues I have with Dr. Murry's analysis, his DCF model will produce a return no higher than 9.70%.

Q PLEASE DESCRIBE DR. MURRY'S CAPITAL ASSET PRICING MODEL.

A Dr. Murry applied two CAPM analyses. The first CAPM study used a market risk premium of 6.50%, beta of 0.66, and risk-free rate of 4.16%, and produces a return on equity of 8.48%, as shown on Schedule DAM-21. Dr. Murry increased this CAPM return to 10.22% by adding a size premium adder of 1.74%.

Dr. Murry's second CAPM estimated a market risk premium of 5.21% based on the historic differences between common stocks and long-term corporate bond yields. This CAPM produced a 10.36% return, as shown on Schedule DAM-22.

Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH DR. MURRY'S CAPM ANALYSIS.

A Dr. Murry's traditional CAPM return estimate produced a return of 8.48%, which was subsequently increased to 10.22% by including a 1.74% size premium CAPM return adder. Aside from his CAPM return adder, Dr. Murry's traditional CAPM return estimate is generally reasonable. However, he did use a market risk premium of 6.5%, which is a high-end market risk premium estimate. He did not consider other credible evidence of a lower market risk premium.

Dr. Murry's second CAPM return estimate is really not a CAPM estimate at all. In this analysis, Dr. Murry derives a market risk premium from the difference in stock

returns less long-term corporate bond yields. This market risk premium then includes significant amounts of systematic risk in the intercept variable, or the risk-free rate. This is unreasonable because all the market risk premium should be included in the estimate of the Company-specific risk premium. The Company-specific risk premium is set by the full market risk premium adjusted by the Company beta factor.

By including market risk in the intercept term, as Dr. Murry has done, he effectively excludes an adjustment of a portion of the market risk premium by the Company beta factor. In other words, the amount of the market risk premium that is included in the intercept term is implicitly adjusted by the market beta factor of 1. This, as a result, overstates a fair return on equity for a company like Laclede Gas that has a beta factor less than 1. As such, this CAPM return estimate is not reliable and should be disregarded.

Q IS DR. MURRY'S HISTORICAL RISK PREMIUM ESTIMATE OF 6.5% REASONABLE?

A No. Dr. Murry's use of historical data to estimate a market risk premium produced only a very high-end market risk premium estimate. A more complete use of historical data shows that a market risk premium should fall in the area of 5.2% to 6.7%. This historical data derived market risk premium was discussed in my direct testimony at pages 30-32. In that data, I outlined Ibbotson Associates historical data based on various market indices and recognizing abnormal valuations that took place over time. Ibbotson opines that a market risk premium generally could fall in the area of 5.2% to 6.7%. Other market risk premiums based on historical data used in Ibbotson data would support a market risk premium of 5.6%, which represents the

total achieved return on market stock investments versus that on Treasury bond investments over the period 1926 through 2009.

Q IS DR. MURRY'S PROPOSAL TO ADJUST HIS CAPM RETURN ESTIMATE FOR A SIZE PREMIUM OF 1.74% REASONABLE?

A No. This adjustment is unreasonable, and should be disregarded. The size risk of the Company is already captured in the valuation of the Company stock, reflected in its bond rating, and other risk factors. Therefore, an adjustment to the CAPM return estimate is unreasonable, and results in an inflated CAPM return estimate for Laclede Gas.

Q PLEASE EXPLAIN HOW DR. MURRY DERIVES HIS SIZE PREMIUM ADJUSTMENT OF 1.74% SHOWN ON SCHEDULE DAM-21.

A In order to estimate the appropriate return on equity for Laclede Gas, Dr. Murry applies a size premium adjustment to account for the additional risk of the company caused by its relatively smaller size. Dr. Murry fails to provide any information on how he has arrived at the size premium adjustment. He only makes reference to the Ibbotson Associates' *2009 Valuation Edition Yearbook*, but provided no details or explanation.

Q IS DR. MURRY'S PROPOSED SIZE PREMIUM REASONABLE?

A No. Small company risk is part of a company's total investment risk. By selecting companies with similar total risk to Laclede Gas, the proxy group can be used to estimate a fair return to compensate investors with Laclede Gas's investment risk characteristics. Most importantly, Laclede Gas's investment risk characteristics

include the increased risks that are attributable to the size of its operations, and access to capital. Therefore, no external adjustments to the proxy group estimated return are necessary or reasonable.

Q HOW WERE YOU ABLE TO SELECT A COMPARABLE GROUP THAT ENCAPSULATED LACLEDE GAS'S SMALL COMPANY RISK IN ESTIMATING A FAIR RETURN FOR LACLEDE GAS IN THIS CASE?

A These small company risk factors certainly are considered by credit rating analysts and security analysts in assessing a utility's investment risk and valuation. Hence, when selecting a group of comparable risk companies, if one relies on a group of companies with bond ratings that are comparable to the proxy company and business profile scores, in particular, that reasonably compare to the utility's business profile score, then the proxy group itself would reflect these risk factors.

As such, it is unreasonable and would be redundant to add a size premium to a proxy group return if that proxy group already reasonably captures Laclede Gas's total investment risk. For example, Laclede Gas's small company risk can be offset by differences in other risk elements. As such, focusing on a single aspect of investment risk, rather than reviewing proxy groups on the basis of total investment risk, is inappropriate and produces unreasonable results.

Since my proxy group and Dr. Murry's proxy group reasonably emulate an investment grade bond rating, the proxy group reasonably captures Laclede Gas's small size risk and all other risk factors. As such, there is no need to add a size premium to the return on equity estimated from this proxy group.

Q DO YOU HAVE ANY OTHER COMMENT CONCERNING DR. MURRY'S SIZE PREMIUM ADJUSTMENT?

A The adjustment is not based on companies with risks comparable to Laclede Gas. Therefore, the adjustment should be rejected.

Dr. Murry makes this adjustment using small company data from Ibbotson Associates. A 174 basis-point adjustment is based on Ibbotson Associates' small company equity risk premium. The average beta estimate, or market risk assessment, of Ibbotson's "Low Capitalization" is 1.22.[3] Beta estimates for the Ibbotson Associates Low and Medium Cap indices clearly demonstrate that these indices have significantly more risk than Laclede Group, in particular, and Laclede Gas, specifically. Laclede Group has a beta estimate of 0.60. Laclede Group has greater risk than Laclede Gas due to its investments in non-regulated higher risk activities. Therefore, a beta estimate of 0.60 overstates Laclede Gas's risk. In significant contrast, the beta estimates for the Ibbotson Associates Small Company indices are dramatically higher than even that of Laclede Group. Therefore, the 174 basis-point adjustment substantially overstates a fair return based on Laclede Gas's very low investment risk.

Q HOW WOULD DR. MURRY'S CAPM ANALYSIS CHANGE CORRECTING FOR THE FLAWS DISCUSSED ABOVE?

A Using an updated risk-free rate of 4.62%,[4] excluding his unreasonable size premium, using a market risk premium in the range of 5.2% to 6.7%, and a group average beta of 0.66, will reduce his CAPM estimate in the range of 8.05% to 9.04%.

[3] SBBI Valuation Edition 2009 Yearbook at 96.
[4] *Blue Chip Financial Forecasts*, June 1, 2010 at 2.

Response to Laclede Gas's Proposed Capital Structure

Q WHAT IS LACLEDE GAS'S PROPOSED CAPITAL STRUCTURE?

A Laclede Gas's proposed capital structure is shown in the table below.

TABLE 3

Laclede Gas's Proposed Capital Structure
(September 30, 2009)

Description	Weight
Long-Term Debt	42.5%
Common Equity	57.5%
Total Capital Structure	100.0%

Source: Laclede Gas's Cost of Capital, Schedule 3.

Q DID DR. MURRY REPRESENT THAT THIS CAPITAL STRUCTURE WAS BASED ON LACLEDE GAS'S CAPITAL STRUCTURE?

A Yes. At pages 11 and 12 of his testimony, where he introduces the Company's proposed capital structure, he asserts this capital structure is representative of "Laclede." At page 3, line 18 of his testimony, he defines "Laclede" as "Laclede Gas Company." In fact, however, the Company's proposed capital structure is not for Laclede Gas Company. Rather, Dr. Murry's proposed capital structure is for its parent company, Laclede Group. Laclede witness Mr. Glenn Buck acknowledged this at page 9 of his direct testimony.

Therefore, in my direct testimony I was mistakenly led to believe that this capital structure represented the long-term capitalization mix for Laclede Gas Company. However, as set forth below, it does not.

Q WHY IS LACLEDE GAS'S PROPOSED CAPITAL STRUCTURE NOT REASONABLE?

A The Company's proposed capital structure is not reasonable for several reasons. First, the capital structure is based on its parent company's capital structure, Laclede Group's, and not on Laclede Gas Company regulated distribution utility operations. As such, the proposed capital structure is heavily weighted with equity capital that supports investments in unregulated parent company operations.

Second, Laclede Gas's proposed common equity ratio of 57.5% significantly exceeds the gas common equity ratio of 48.3% authorized by other regulatory jurisdictions over the last five years.

Third, Laclede Gas's proposed capital structure significantly exceeds the capital structure approved in its last rate case. Finally, this capital structure is significantly more expensive than the capital structure approved for Missouri Gas Company in its most recent Missouri rate case.

Q DO YOU BELIEVE THE COMPANY'S PROPOSED CAPITAL STRUCTURE SUPPORTS ITS PARENT COMPANY'S NON-REGULATED OPERATIONS?

A Yes. Laclede Group and Laclede Gas capital structures are shown on Schedule MPG-R1. As shown on this schedule, Laclede Group's total consolidated debt ($389 million) is approximately the same as Laclede Gas utility debt ($389 million) as recorded on its FERC Form 2 at the same point in time. In significant contrast, as shown on this schedule, the amount of Laclede Group common equity capital of $517 million is nearly $114 million more than the common equity capital recorded on Laclede Gas's utility stand-alone balance sheet from its FERC Form 2 of $402 million.

Hence, Laclede Group has over $114 million of common equity capital that is not invested in its utility operations.

Because the Company is proposing Laclede Group's capital structure, and almost all the debt on Laclede Group's consolidated capital structure are utility-related debt, the capital structure proposed by the Company includes significant amounts of common equity that is used to support investments in non-regulated utilities. Therefore, use of the Laclede Group capital structure is not reasonable and will inflate the rate of return above Laclede Gas's actual utility cost of capital.

Q WHY WOULD A CAPITAL STRUCTURE TOO HEAVILY WEIGHTED WITH COMMON EQUITY UNNECESSARILY INCREASE LACLEDE GAS'S COST OF SERVICE IN THIS PROCEEDING?

A A capital structure too heavily weighted with common equity unnecessarily increases Laclede Gas's claimed revenue deficiency because common equity is the most expensive form of capital and is subject to income tax expense. For example, if Laclede Gas's authorized return on equity is set at 9.5%, the revenue requirement cost to customers would be approximately 15.2%, or 9.5% adjusted by a tax revenue conversion factor of approximately 1.6x. In contrast, the cost of debt capital is not subject to an income tax expense. Laclede Gas's current marginal cost of debt is around 5.8%. Common equity is more than twice as expensive on a revenue requirement basis than is debt capital.

A reasonable mix of debt and equity (50% debt /50% equity) is necessary in order to balance Laclede Gas's financial risk, support an investment grade credit rating, and permit Laclede Gas access to capital under reasonable terms and prices.

However, a capital structure too heavily weighted with common equity will unnecessarily increase its cost of capital and revenue requirement.

Q WHY DO YOU BELIEVE THAT LACLEDE GAS'S PROPOSED CAPITAL STRUCTURE CONTAINS A COMMON EQUITY RATIO SIGNIFICANTLY ABOVE THE INDUSTRY AVERAGE COMMON EQUITY RATIO AUTHORIZED BY REGULATORY COMMISSIONS?

A I have summarized the industry average common equity ratios authorized by regulatory commissions over the last five years for electric and gas utilities on Schedule MPG-R2. As shown on this schedule, the five-year average common equity ratio for regulated gas distribution companies was 48.3%. Indeed, the common equity ratio during this period never exceeded 50.5%. Laclede Gas's proposed common equity ratio of 57.5% is significantly higher than common equity ratios found reasonable by regulatory commissions for regulated gas distribution companies like Laclede Gas. However, Laclede Gas's actual capital structure common equity ratio of 50.8% is comparable to the industry average and, thus, more reasonable.

Q WHAT WAS THE CAPITAL STRUCTURE MIX FOR LACLEDE GAS IN ITS LAST RATE CASE?

A Laclede Gas's Infrastructure System Replacement Surcharge (ISRS) capital structure authorized in the last rate case proceeding consisted of 52.37% common equity ratio, 0.10% preferred stock and 47.53% long-term debt.[5]

[5]Missouri Public Service Commission, Laclede Gas (Case No. GR-2007-0208), Stipulation and Agreement, July 19, 2007, Attachment 5.

Q WHAT WAS THE CAPITAL STRUCTURE MIX FOR MISSOURI GAS ENERGY'S RECENT RATE APPROVED BY THE MISSOURI PUBLIC SERVICE COMMISSION?

A The Commission approved a capital structure with long-term debt capital of 56.16%, short-term debt of 3.26%, preferred equity of 1.92% and common equity of 38.66%.[6]

Q WHAT IS YOUR REVISED PROPOSED CAPITAL STRUCTURE?

A My proposed capital structure is set in the table below.

TABLE 4

MIEC's Proposed Capital Structure
(September 30, 2009)

Description	Weight
Long-Term Debt	49.2%
Common Equity	50.8%
Total Capital Structure	100.0%

Source: Schedule MPG-R1.

As shown in this table, my proposed capital structure is based on Laclede Gas's actual long-term debt and equity balances.

Q WHAT IS THE REVENUE IMPACT ON CUSTOMER RATES OF USING THE COMPANY'S ACTUAL CAPITAL STRUCTURE INSTEAD OF THE CAPITAL STRUCTURE OF ITS PARENT COMPANY?

A The revenue impact of reducing the common equity ratio from 57.1% to 50.8% is $5.0 million.

[6]Missouri Public Service Commission, Missouri Gas Energy (Case No. GR-2009-0355), Report and Order, February 10, 2010 at 15.

Cost of Service Study

Q DO YOU HAVE ANY COMMENTS CONCERNING THE COST OF SERVICE STUDY SPONSORED BY OFFICE OF PUBLIC COUNSEL (OPC) WITNESS BARBARA MEISENHEIMER?

A Yes. Ms. Meisenheimer sponsored a class cost of service study which I believe is flawed and does not properly allocate costs among Laclede Gas's customer classes. Specific issues I have with Ms. Meisenheimer's class cost of service study include the following:

1. In allocating main costs between customer classes she failed to make any recognition of distribution mains size and customer load requirements. This is important because certain significant investments Laclede Gas has in mains, are for smaller distribution mains that cannot be used to serve larger customers including transportation customers. Ms. Meisenheimer, however, allocated mains across all customers based on her customer and volume/peak day allocator with no distinction on groupings of main cost that are dedicated to specific size classes of customer. As such, she substantially over-allocated mains cost to large customers including the Transportation Class.

2. Ms. Meisenheimer also used a factor based on non-gas cost of service to allocate uncollectible cost between classes. This is inappropriate because a large portion of the uncollectible cost of Laclede Gas includes its cost of gas. Hence, allocating uncollectible cost between classes one must use total cost of service, including gas, and not simply non-gas cost of service.

3. She over-allocated certain customer-related expense to transportation customers. For customer records in collection, and miscellaneous customer accounts miscellaneous expense, she allocated between classes based on customer accounts expense. This is inappropriate because it does not properly spread this cost over the number of customers Laclede Gas has which is causing this expense to be incurred. Therefore, she over-allocates these costs to larger customers.

Q DID YOU ATTEMPT TO CORRECT THE DEFICIENCIES IN MS. MEISENHEIMER'S CLASS COST OF SERVICE STUDY?

A Yes. However, an appropriate breakout of main cost by small main and large main was not possible based on the information in Ms. Meisenheimer's study. Therefore, I

simply approximated the need to recognize that a significant investment Laclede Gas has in small distribution mains is dedicated to its smaller customers. Since Laclede Gas has more small customers than large customers, I attempted to correct this misallocation of these costs by simply increasing the percentage of customer allocation used in Ms. Meisenheimer's cost of service study. As such, I modified her cost of service study to allocate mains based on 50% customers and 50% peak hour requirements. I removed volumetric allocations from this allocator entirely because pipes are sized for peak hour requirements, not average flow conditions.

I modified the allocation of uncollectible expense to reflect for current rate revenue allocator factor 1. While it is not clear from her study, it appears that it reflects total rate revenue (including gas cost) under existing rates.

Finally, I adjusted her allocation for Accounts 903 and 905 to be allocated on bills, rather than customer accounts expense. Again, cost-causation for these costs is number of bills and not the customer expense itself.

Q WHAT ARE THE RESULTS OF YOUR MODIFICATION IN MS. MEISENHEIMER'S CLASS COST OF SERVICE STUDY?

A This is shown on my Schedule MPG-R3. As shown on this schedule, these corrections significantly modify the disparity between current rates and cost of service between classes. Specifically, with respect to large transportation users, Ms. Meisenheimer's estimate that a revenue neutral shift to this class of $4 million is justified, is shown to be inaccurate. With the adjustments I just discussed, a revenue neutral shift of only $252,000 would be appropriate to ensure transportation customers' rates are providing full recovery of cost of service.

Q DID ANY OTHER PARTIES' CLASS COST OF SERVICE STUDY ALSO SHOW THAT TRANSPORTATION CUSTOMERS WERE FAIRLY CLOSE TO COST OF SERVICE?

A Yes. Staff witness Thomas Imhoff shows that the transportation customers and interruptible customer classes are producing very close to the class cost of service study.[7]

Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A Yes, it does.

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[7]Missouri Public Service Commission, Laclede Gas Company, Case No. GR-2010-0171, Rate Design and Class Cost-of-Service Report, May 24, 2010, Schedule MJE-1.

Laclede Gas Company

Laclede Group, Inc.
(September 30, 2009)

Line	Description	($ 000) Amount (1)	Weight (2)
1	Long-Term Debt	$ 389,240	42.9%
2	Common Equity	$ 517,030	57.1%
3	**Total**	**$ 906,270**	**100.0%**

Source: SEC 10K, September 30, 2009.

Laclede Gas Company
(September 30, 2009)

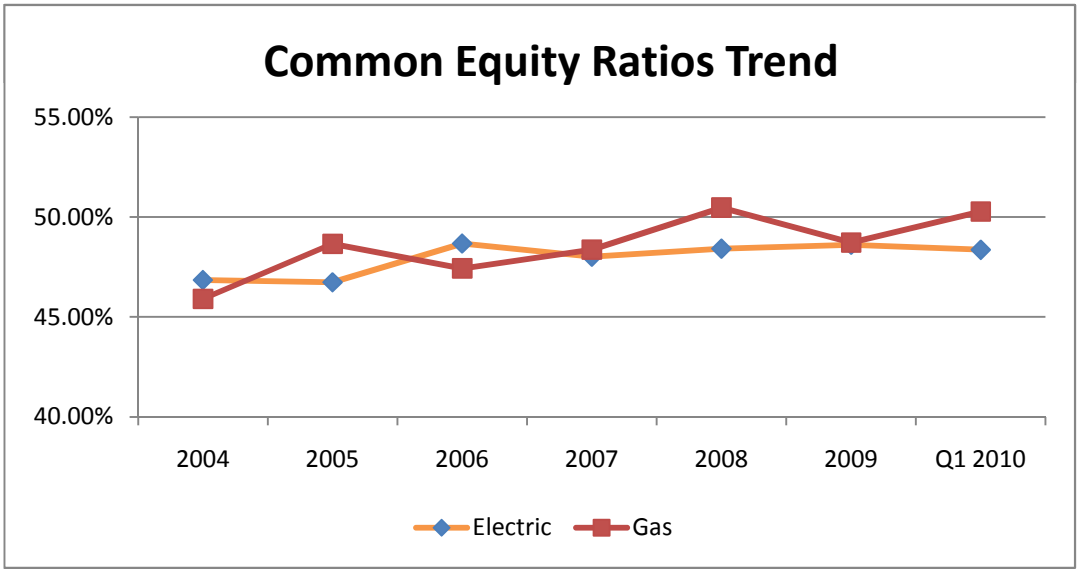
Line	Description	($ 000) Amount (1)	Weight (2)
5	Long-Term Debt	$ 389,240	49.2%
6	Common Equity	$ 402,585	50.8%
7	**Total**	**$ 791,825**	**100.0%**

Source: FERC Form 2, September 30, 2009.

Laclede Gas Company

Authorized Common Equity Ratios

Line	Year	Electric (1)	Gas (2)
1	2004	46.84%	45.90%
2	2005	46.73%	48.66%
3	2006	48.67%	47.43%
4	2007	48.01%	48.37%
5	2008	48.41%	50.47%
6	2009	48.61%	48.72%
7	Q1 2010	48.36%	50.27%
8	**'04 - '09 Average**	**47.88%**	**48.26%**



Source:
Regulatory Research Associates; Regulatory Focus, Major Rate Case Decisions, April 1, 2010.

Laclede Gas Company

Revised Class Cost Of Service Study Results

Line	Description	Formula	Total	Residential	General Service C&I 1	General Service C&I 2	General Service C&I 3	Large Volume	Transport	Interruptible
			(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	O & M Expenses		$ 162,186,419	$ 133,697,336	$ 8,681,831	$ 8,459,424	$ 5,043,757	$ 1,510,470	$ 4,415,591	$ 378,011
2	Depreciation and Amortization Expenses		$ 47,808,972	$ 38,950,201	$ 3,031,130	$ 2,475,286	$ 1,364,524	$ 496,570	$ 1,368,043	$ 123,218
3	Taxes		$ 32,222,072	$ 25,751,509	$ 1,891,717	$ 1,861,711	$ 1,146,450	$ 375,772	$ 1,099,671	$ 95,243
4	Total - Expenses and Taxes	(a)	$ 242,217,463	$ 198,399,047	$ 13,604,677	$ 12,796,420	$ 7,554,731	$ 2,382,812	$ 6,883,305	$ 596,471
5	Current Revenue									
6	Rate Revenue		$ 279,816,075	$ 220,102,085	$ 14,885,010	$ 21,009,873	$ 10,857,701	$ 4,237,312	$ 8,053,843	$ 670,252
7	Other Revenue		$ 14,232,988	$ 11,185,161	$ 758,034	$ 1,076,388	$ 555,789	$ 216,140	$ 406,885	$ 34,592
8	Total - Current Revenues	(b)	$ 294,049,063	$ 231,287,245	$ 15,643,044	$ 22,086,261	$ 11,413,490	$ 4,453,452	$ 8,460,728	$ 704,844
9	Current Revenue Percentage		100.00%	78.66%	5.32%	7.51%	3.88%	1.51%	2.88%	0.24%
10	Operating Income	(c) = (b) - (a)	$ 51,831,600	$ 32,888,199	$ 2,038,366	$ 9,289,841	$ 3,858,759	$ 2,070,640	$ 1,577,423	$ 108,373
11	Total Rate Base	(d)	$ 700,131,549	$ 555,939,304	$ 41,836,178	$ 41,469,762	$ 25,505,548	$ 8,514,350	$ 24,714,480	$ 2,151,928
12	Current Rate Of Return	(e) = (c) ÷ (d)	7.40%	5.92%	4.87%	22.40%	15.13%	24.32%	6.38%	5.04%
13	Operating Income Needed To Equalize Class Returns	(f) = 7.40 × (d)	$ 51,831,600	$ 41,156,871	$ 3,097,184	$ 3,070,058	$ 1,888,207	$ 630,328	$ 1,829,643	$ 159,310
14	Revenue Percentage Needed To Equalized Class Returns	(g) = (f) +(a)	$ 294,049,063	$ 239,555,918	$ 16,701,861	$ 15,866,478	$ 9,442,938	$ 3,013,140	$ 8,712,948	$ 755,781
			100.00%	81.47%	5.68%	5.40%	3.21%	1.02%	2.96%	0.26%
15	Rev. Neutral Shift to Equalize Class ROR	(h) = (g) - (b)		$ 8,268,672	$ 1,058,818	$ (6,219,783)	$ (1,970,552)	$ (1,440,312)	$ 252,220	$ 50,937
16	**Rev. Neutral Shift Percentage to Equalize Class ROR**			**3.58%**	**6.77%**	**-28.16%**	**-17.27%**	**-32.34%**	**2.98%**	**7.23%**
17	Recommended Revenue Neutral Shift = 1/2 Indicated Shift	(i) = (h) ÷ 2		$ 4,134,336	$ 529,409	$ (3,109,892)	$ (985,276)	$ (720,156)	$ 126,110	$ 25,469
18	**OPC Maximum Recommended Revenue Neutral Shift Percentage**			**1.88%**	**3.56%**	**-14.80%**	**-9.07%**	**-17.00%**	**1.57%**	**3.80%**
19	Class Revenue Percentages After Rec. Rev. Neutral Shift			80.06%	5.50%	6.45%	3.55%	1.27%	2.92%	0.25%

Source:
Schedule BAM DIRECT RD-1.

Adjustments:
1.) Allocator 5 was changed to be weighted 50% customer share and 50% peak share.
2.) Allocator 3 was changed to show zero allocation to Transport customers.
3.) Uncollectibles was changed to be allocated on Rate Revenue instead of Cost of Service.
4.) Accounts 903 and 905 were changed to be allocated on bills instead of Customer Account Expense.