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 TRAVIS ALLEN

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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 testimony and opinions of Mr. Travis Allen ("Allen") regarding a calculated rate of return for MGE as inadmissible pursuant to Section 490.065, Revised Statutes of Missouri.

Preliminary Statement

In this natural gas rate proceeding, Allen, an employee of the Office of Public Counsel (OPC), has submitted written direct testimony ("Allen Direct"), with accompanying schedules ("Allen Schedules"), and rebuttal ("Allen Rebuttal") and surrebuttal ("Allen Surrebuttal") testimony, on behalf of the OPC to support his "opinions" on what the Commission should find to be a fair and reasonable rate of return for MGE.

However, Allen's "opinions" are only admissible in this proceeding if he is an expert in utility finance and his testimony comports with § 490.065 RSMo. From his own sworn testimony, it is clear that Allen – a 2003 graduate from business school who was employed by the OPC for approximately *one* month before submitting his direct testimony – is not such an expert. During his June 16, 2004, deposition, Allen conceded that his education did not involve the application of discounted cash flow ("DCF") or other financial models to utilities like MGE; that his first exposure to the field of utility finance was in March 2004, when he was employed by the OPC; and that he has never previously testified before this Commission. Indeed, it is Allen's position that in one month – a month in which he took no courses, seminars or classes – he nonetheless became an expert in the field of utility finance through his own review of materials and occasional discussions with a former OPC employee, John A. Tuck ("Tuck"). Given the significance and complexities of the issues involved in this proceeding – and the numerous considerations that are fundamental to utility finance and rate of return analysis (*e.g.*, whole textbooks have been written on the topic) – it is inconceivable that Allen has the "specialized knowledge" required by § 490.065.1. Indeed, if Allen can be an expert before this Commission based on one month's experience, then anyone with a finance degree can do the same, and the reliability of opinions made to this Commission will become nothing short of a mockery.

Second, even if Allen were assumed to be an expert in utility finance, his opinions are, not surprisingly, based on unreliable data and methodologies. As this Commission is aware, in *State Board of Registration for the Healing Arts v. McDonagh*, 123 S.W.3d 146 (Mo. 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. As just one example, in his DCF calculations, Allen sets out to punish MGE *for a capital structure that he himself attributes to MGE*. In addition, he recommends a rate of return for MGE based on a thoroughly non-comparable set of "proxy" companies and then refuses – against established utility finance authorities – to make any adjustments for this lack of comparability. Of course, Allen – who cites not a single authoritative source for his unreasonable positions – uses these tactics in an attempt to justify a lower than reasonable rate of return for MGE. Such result-oriented tactics directly violate the requirements of § 490.065.3.

Although MGE is mindful of the Commission's order on MGE's motion to exclude the testimony of Commission Staff ("Staff") witness David Murray ("Murray"), the lack of experience involved here is significantly greater. OPC is pushing the limits of due process and administrative procedure by even trying to offer an "expert" with one month experience to opine on matters that will have a dramatic impact on the financial integrity of one of Missouri's regulated utilities. MGE respectfully submits that in light of the directives in *McDonagh, supra,* some floor for expertise must be established, and that floor is significantly above the one month of reading and conversations that Allen has offered as the basis for his testimony. Under § 490.065 RSMo., Allen's 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.
>
> . . .
>
> 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 (8^{th} Cir. 1999). *See also Children's Broadcasting Corp. v. The Walt Disney Co.*, 245 F.3d 1008, 1018 (8^{th} 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 (7^{th} 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. Under § 490.065.1 RSMo., Allen <u>Is Not Qualified To Offer Expert Testimony</u>

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." Allen's recent deposition testimony demonstrates that he does not meet these requirements. In his deposition, Allen admitted that:

- During his education, he never applied DCF or other financial models to utilities like MGE (Transcript of the Deposition of Travis Allen, date June 16, 2004 ("Travis Dep."), at 24; attached as Appendix 1 hereto);
- He is not a certified rate of return analyst, does not have a Ph.D., has published no articles or textbooks and has taught no classes (*id.* at 4-5);
- His first job in utility finance was at the OPC (*id.* at 10-12);
- He was first employed with the OPC in March 2004 (*id.* at 12), one month before he submitted his direct testimony in this proceeding;
- He was told on his first day of work at the OPC that he would be an expert witness in this proceeding (*id.* at 33);
- During this one month of employment, he took no courses, programs, classes or seminars (*id.* at 27-28);
- The only "training" he received was one meeting, and "less than ten" telephone conversations with Tuck (*id.* at 28-32), a former OPC employee who had not testified for the OPC in a rate case since 1995; and
- Other than his conversations with Tuck, the only other thing Allen did to prepare himself as an "expert" was to review various textbooks and prior testimonies (*id.* at 37).

One month of reading – and the occasional conversation with a former OPC employee – cannot be sufficient to create expertise in a field as complex as utility finance. Courts, including the Missouri Supreme Court, have excluded testimony from experts with far more experience. *See, e.g., Johnson v. State*, 58 S.W.3d 496, 497-499 (Mo. 2001) (Department of Corrections employee with over 200 hours of training, 225 prisoner assessments and who had previously testified over 20 time still insufficiently experienced to offer diagnostic opinions about prison inmate); *Irwin v. St Louis-San Francisco Railway Co.*, 30 S.W.2d 56, 59 (Mo. 1930) (thirty-five years employment with railroad and understanding of the workings of train brakes insufficient qualifications for testimony regarding time necessary to apply such brakes); *see also Pan Am. World Airways, Inc. v. Port Authority of New York and New Jersey,* 995 F.2d 5, 9-10 (2d Cir. 1993) (air traffic expert properly excluded where he had failed to complete training, had little experience with large airports, was unfamiliar with procedures at airport in question and had worked with National Transportation Safety Board for eighteen months). Even under the "some qualification" language of *Whitnell v. State,* 129 S.W.3d 409 (Mo. App. 2004),[1] Allen's one month of reading and conversations cannot equate with expertise; if it does, then expertise has been watered down to something just about anyone reading this memorandum could assert by the third week of next month.

III. Even If Allen 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

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1 *Whitnell* involved an expert with obvious credentials and did not involve a challenge to that expert's basic qualifications to testify:

> [Defendant] *Whitnell* did not challenge psychiatrist's standing as an expert witness at trial. Psychiatrist testified that he is board certified in general psychiatry and in forensic psychiatry. . . .

129 S.W.3d at 412 n.2. Instead, *Whitnell* involved, among other things, a challenge to one opinion rendered by the expert and whether the expert failed to make a necessary psychiatric distinction in rendering that opinion. *Id.* at 412-413.

only by the *ipse dixit* of the expert") (citation omitted). Experts' opinions must be based on (1) reliable methodologies that employ (2) reliable data. Allen's testimony fails on both counts.

A. Allen's Unprincipled Use Of Southern Union's, And Not MGE's, Capital Structure

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

This tactic ignores the fact that this Commission went to great lengths to ensure that MGE was never "saddled" with Panhandle debt. As part of the Panhandle acquisition, the Commission approved the following requirements:

> 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

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2 In apparent recognition of his error in attributing Southern Union's capital structure to MGE, in his rebuttal testimony, Allen offers the Commission an alternative, "hypothetical" capital structure. (Allen Rebuttal at 11-15.) MGE disagrees with the method by which Allen generates this hypothetical structure, and in his surrebuttal testimony, Allen returns to the argument that Panhandle's debt should be included in MGE's capital structure. (Allen Surrebuttal at 8.)

> 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 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"). Implicit in the Stipulation's provisions 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.

Allen'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.

R. Morin, REGULATORY FINANCE ("REGULATORY FINANCE"), 344 (Public Utility Reports 1994). *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, Allen 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, Allen does not simply adopt Southern Union's cost of equity, but instead uses a proxy group of what purports to be comparable natural gas distribution companies. (Allen Direct at 10, Allen Schedules TA-5 and TA-6; *see also* REGULATORY FINANCE, *supra*, at 472-473.) Nonetheless, as to capital structure, he refuses to use a separate business unit methodology.

Allen's lack of understanding regarding capital structure and rate of return analysis is well demonstrated by his speculative and completely erroneous discussion of Southern Union's capital structure and its impact on ratepayers. In his deposition, Allen testified that Southern Union's capital structure should be imposed on MGE because (a) in light of that structure, MGE is seeking higher rates from ratepayers (Allen Dep. at 56), and/or (b) Panhandle's debt "increases risk" to ratepayers. (Allen Dep. at 55-56; *see also* Allen Surrebuttal at 8.)

On the first point, Allen is absolutely wrong. Increased debt does not result in higher rates, since debt is cheaper than equity. In fact, since Allen is attributing Southern Union's capital structure to MGE, he must make adjustments to his DCF calculation in order to avoid punishing MGE by improperly calculating its required return on equity by comparing MGE to a proxy group of companies which have much more equity in their capital structure.

On the second point, just what is Allen's basis for this speculation? How can a recent graduate with one month experience and no analytical work product argue that ratepayers in Missouri have – as a result of the Panhandle acquisition – such "increased risk" that MGE's allowed rate of return should be reduced by hundreds of basis points? Allen has done no critical analysis of Southern Union's business, its business plan, the operations of Panhandle or the operations of MGE. Southern Union is an investment grade company, Panhandle issues its own debt instruments and Southern Union is forbidden by the terms of the Stipulation from infusing capital into Panhandle without the Commission's permission. Where is the risk, other than in the self-serving conjecture of Allen himself?

Further, Allen makes no effort to examine whether the punishment he metes out on MGE – saddling it with Southern Union's capital structure and making no adjustments for doing so – is commensurate with the "increased risks" about which he speculates. Dr. Morin has calculated that the very same punishment recommended by Murray equates to as much as a 330 basis point reduction in MGE's return on equity. (Rebuttal Testimony of Roger A. Morin, dated May 18, 2004, at 37-38.) Clearly, Allen has not even considered the magnitude of the damage he is trying to inflict through his "increased risk" speculation. Even clearer, Allen is an ill-experienced witness who does not understand that broad and materially damaging accusations require data and real analysis.

B. Allen'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, Allen uses virtually no substantive guidelines for filtering out non-comparable companies based on differences in business or financial risk. (Allen Direct, Appendix F.) *See also* J. Bonbright, A. Danielson & D. Kamerschen, PRINCIPLES OF PUBLIC UTILITY RATES ("PUBLIC UTILITY RATES"), 321 (Public Utility Reports 1988) (listing various potential risk filters for a proxy group, including "bond ratings," "betas," "equity ratios," "variability in equity returns" and safety issues).

As a result, Allen ends up with a proxy group of companies which has a significantly different capital structure than that which Allen attributes to MGE. According to Allen, MGE's capital structure includes only 25.98 percent common equity. (Allen Direct at 4.) In contrast, on average, Allen's comparable group of utilities has a capital structure in which he calculates 40 percent equity. (Allen Schedule TA-2.)[3]

Equity investors bear both business (operational) and financial (leverage) risk. R. Morin, UTILITIES' COST OF CAPITAL ("UTILITIES"), 30-32 (Public Utilities Report 1984). 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).[4] Here, Allen 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 Allen has attributed to MGE.

Once Allen determined to use his 26 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:

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3 MGE does not agree with the method employed by Allen for calculating equity in a capital structure, and it should be noted that Allen and Murray differ in their calculations of equity for the very same proxy companies.

4 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.

> 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 30-32. *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 be applied to [the subsidiary] Arkla, without an adjustment for the difference in risk between the two"); *see also* Morin Rebuttal at 36-38.

By ignoring an established step in rate of return calculations, Allen 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.

C. <u>Allen's Other Unreliable Datasets And Methodologies</u>

Allen's rate of return calculations are unreliable for additional reasons, including his failure to (a) account for equity flotation costs in his DCF calculation, (b) recognize the inherent circularity of his use of retention growth rates to predict future growth for a regulated utility, (c) recognize that the betas of his comparable companies are too disparate, without adjustment, for their use in either his DCF analysis or Capital Asset Pricing Model (CAPM), and (d) adjust his CAPM analysis for the fact that any beta for MGE – with the capital structure Allen attributes to it – would clearer be higher than the betas of his purported comparable companies. (*See, e.g.,* Allen Direct at 7-19, Allen Schedule TA-9.)

The result of all of these mistakes and unreliable methodologies is fundamentally unreliable testimony. A good example of this arose during Dr. Morin's deposition in this proceeding. Although in his surrebuttal testimony, Allen selectively picks bits of Dr. Morin's deposition testimony in an effort to bolster his own rate of return calculations, Allen notably fails to mention one of the more insightful comments in Dr. Morin's testimony:

> Q. [OPC counsel:] Let me say that you have a DCF analysis and you come up with a DCF range of 9.01 percent to 9.34 percent. Can you make that assumption?
>
> A. Yes.
>
> Q. Let's say that you do a capital asset pricing method analysis and you come up with a result of 9.17 percent. Can you make that assumption?
>
> A. Yes.
>
> Q. What does that tell you?
>
> A. That tells you that something's wrong, because I can't visualize a rate of return of 9 percent when the long-term treasury bonds are expected to be 6 percent.
>
> Q. Well, that wasn't my question about whether or not -- my question was, what does that tell you about the reliability of the DCF method and the CAP-M method?
>
> A. It tells you that those two are consistent with one another, but it doesn't tell you that that's the – that that's the cost of equity. It's not implemented properly.
>
> Q. What does it mean if they're consistent with one another from a statistical standpoint?
>
> A. Roughly within the same range, maybe within 50 basis points of one another.
>
> Q. And if you had that example that I just gave you of DCF range of 9.01 to 9.34 percent and a CAP-M result of 9.17 percent, wouldn't that indicate that your CAP-M and your DCF were compatible?
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> A. It would probably indicate to me that they're both wrong.

(Deposition of Roger A. Morin, dated June 10, 2004, at 105-106; Appendix 2 hereto.) Of course, the numbers that OPC counsel used in his questioning of Dr. Morin were the very numbers generated by Allen in his DCF and CAPM models. (*See* Allen Direct at 19.)

Dr. Morin's point is an important one. *Allen is so caught up in mechanically applying his methodologies that he cannot step back and analyze his data or his results.* Riskless investment has a projected long-term return of 6 percent, but the required return on equity for a company to which Allen attributes only 26 percent equity is a mere 9 percent? Such a result is entirely unreasonable and defies common sense. Dr. Morin's many years of experience allows him to step back and engage in qualitative analysis of data and calculated results. Allen's brief tenure at the OPC does not. MGE should not be punished by the OPC's failure to retain and use a true expert.

Conclusion

Allen's one month of employment at the OPC did not qualify him as an expert, and nothing he has done since he submitted his direct testimony has changed that fact. Further, even if he were an expert in utility finance and rate of return calculations, his testimony and opinions regarding a rate of return for MGE would still be inadmissible as fundamentally unreliable. Accordingly, MGE respectfully submits that the Commission should exclude Allen's opinions and testimony regarding a rate of return for MGE from this proceeding.

Dated: June 18, 2004

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 June, 2004, to all parties of record.

James C. Grenegen