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| *Exhibit No.:* | |
| *Issues:* | *Rate of Return/Capital Structure* |
| *Witness:* | *David Murray* |
| *Sponsoring Party:* | *MoPSC Staff* |
| *Type of Exhibit:* | *Rebuttal Testimony* |
| *Case Nos.:* | *GR-2004-0209* |
| *Date Testimony Prepared:* | *May 24, 2004* |

**MISSOURI PUBLIC SERVICE COMMISSION**

**UTILITY SERVICES DIVISION**

# REBUTTAL TESTIMONY

# OF

# DAVID MURRAY

**MISSOURI GAS ENERGY**

**CASE NO. GR-2004-0209**

***Jefferson City, Missouri***
***May 2004***

**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

| | | |
|---|---|---|
| In the Matter of Missouri Gas Energy's<br>Tariffs to Implement a General Rate<br>Increase for Natural Gas Service | )<br>)<br>) | Case No. GR-2004-0209 |

AFFIDAVIT OF DAVID MURRAY

| | | |
|---|---|---|
| STATE OF MISSOURI | ) | |
| | ) | ss. |
| COUNTY OF COLE | ) | |

David Murray, being of lawful age, on his oath states: that he has participated in the preparation of the following rebuttal testimony in question and answer form, consisting of 46 pages to be presented in the above case; that the answers in the following rebuttal 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.

David Murray

Subscribed and sworn to before me this 21st day of May 2004.

D SUZIE MANKIN
Notary Public - Notary Seal
STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. JUNE 21,2004

Notary

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4 **MISSOURI GAS ENERGY**

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**REBUTTAL TESTIMONY**

**OF**

**DAVID MURRAY**

**MISSOURI GAS ENERGY**

**CASE NO. GR-2004-0209**

Q. Please state your name.

A. My name is David Murray.

Q. Are you the same David Murray who filed direct testimony in this proceeding for the Staff of the Missouri Public Service Commission (Staff)?

A. Yes, I am.

Q. In your direct testimony, did you recommend a fair and reasonable rate of return for the Missouri jurisdictional gas utility rate base for Southern Union Company's (Southern Union) Missouri Gas Energy (MGE) division?

A. Yes, I did.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Mr. John C. Dunn and Mr. Travis Allen. Mr. Dunn sponsored rate-of-return testimony on behalf of MGE. Mr. Allen sponsored rate-of-return testimony on behalf of the Office of the Public Counsel (OPC). I will address the issues of appropriate capital structure, embedded cost of long-term debt, the cost of short-term debt, and the cost of common equity to be applied to MGE for ratemaking purposes in this proceeding.

**Direct Testimony Revisions**

Q. Do you have any revisions to make to your direct testimony?

1 A. Yes. The following revision needs to be made:

2 • The common equity balance on Schedule 9 attached to my direct
3 testimony should be $946,502,000 not $920,418,000. I mistakenly
4 provided the common equity balance as of the end of the test year,
5 June 30, 2003 rather than as of the end of the update period,
6 December 31, 2003. This change affects the percentage of each
7 capital component in the capital structure on the same schedule. I
8 have attached this revised schedule to my rebuttal testimony. The
9 change in the common equity balance also affects Schedules 23 and 25
10 attached to my direct testimony. I have attached these revised
11 schedules to my rebuttal testimony. This revision also affects the
12 calculations that I performed on page 22 of my direct testimony
13 because the common equity balance that I used to make those
14 calculations was the lower June 30, 2003 balance. Therefore, the
15 capital structure on page 22, lines 8 through 9 should be 16.64 percent
16 common equity, 12.43 percent preferred stock, 56.12 percent long-
17 term debt and 14.81 percent short-term debt.

18 Q. Does the above revision change your recommendation?

19 A. Yes. As shown in the revised Schedule 25 attached to my rebuttal
20 testimony, my revised cost of capital recommendation is now 6.70 percent to 6.96 percent
21 rather than 6.68 percent to 6.94 percent.

**Cost of Common Equity, Capital Structure, Embedded Cost of Long-Term Debt, and Average Cost of Short-Term Debt**

Q. Is there agreement between Staff, MGE and OPC on the embedded cost of long-term debt and the average cost of short-term debt?

A. No. Mr. Dunn, MGE's witness, recommended an embedded cost of long-term debt of 7.348 percent. Mr. Dunn does not provide the supporting documentation for his recommended embedded cost of long-term with his direct testimony. Mr. Allen, OPC's witness, recommended an embedded cost of long-term debt of 7.170 percent. Mr. Allen relied on information provided by Southern Union in response to OPC Data Request No. 2002. He provided his supporting documentation on Schedule TA-12 attached to his direct testimony. I recommended an embedded cost of long-term debt of 6.383 percent based upon the long-term debt of all of Southern Union's operations, which includes the Panhandle Eastern Pipe Line Company, LLC (Panhandle). I relied on the calculated embedded costs of long-term debt for Southern Union on a consolidated basis provided in Southern Union's response to Staff Data Request No. 0102. My recommendation to include all of Southern Union's debt in my recommendation explains the difference between Staff and OPC on this issue. Since Mr. Dunn failed to provide supporting documentation for his embedded cost of long-term debt recommendation with his testimony, I do not know the debt that he utilized for his recommendation.

Mr. Dunn did not utilize short-term debt in his recommended capital structure. The cost of short-term debt of 1.89 percent that I utilized was based on Southern Union's response to Staff Data Request No. 0102. This is also the same cost that Mr. Allen utilized in his recommendation.

1 Q. Is there an agreement between Staff, Southern Union and OPC on capital
2 structure and cost of common equity for MGE?
3 A. No. Mr. Dunn recommends what he claims is Southern Union's capital
4 structure, exclusive of the Panhandle operations. I will discuss the serious flaw in his
5 recommended capital structure later in my rebuttal testimony. Mr. Dunn also did not
6 include any short-term debt in his capital structure recommendation. Although Mr. Allen
7 and I did not agree on a specific methodology of determining an appropriate capital
8 structure for purposes of our recommendations in this case, our capital structure
9 recommendations are quite similar. I am recommending Southern Union's consolidated
10 capital structure based on the end of the update period. My recommended capital
11 structure appropriately includes the amount of short-term debt in excess of construction
12 work in progress (CWIP) as of December 31, 2003. Mr. Allen's amount of short-term
13 debt in his recommended capital structure is based on an average of the amount of short-
14 term debt in excess of CWIP for the calendar year 2003. I am not sure how Mr. Allen
15 arrived at the amount of long-term debt he included in his recommended capital structure,
16 but the amount is quite similar to the amount of long-term debt that I recommended in my
17 capital structure.
18 Mr. Dunn recommends a cost of common equity of 12.00 percent.
19 Mr. Allen recommends a cost of common equity of 9.01 percent to 9.34 percent. Staff
20 recommends a cost of common equity of 8.52 to 9.52 percent.

1 **Updated Capital Structure and Embedded Costs**

2 Q. Did you use the updated the capital structure, embedded cost of long-term
3 debt, embedded cost of preferred stock and average cost of short-term debt through the
4 end of the test year update period (December 31, 2003) in your recommendation?
5 A. Yes. However, I had already used the updated information in my direct
6 testimony. Therefore, I do not need to provide an updated recommendation in my
7 rebuttal testimony, other than the correction of the common equity balance that I have
8 already discussed. Consequently, the recommendation contained in my direct testimony,
9 with the corrections noted above, is still appropriate.

10 **Mr. Dunn's Recommended Capital Structure for MGE**

11 Q. Please summarize Mr. Dunn's capital structure recommendation for MGE.
12 A. Mr. Dunn proposes the use of what he claims is Southern Union's pro
13 forma capital structure, exclusive of Panhandle Eastern Pipe Line LLC (Panhandle), as of
14 June 30, 2003. He claims this capital structure is composed of 46.13 percent long-term
15 debt, 10.53 percent preferred stock and 43.34 percent common equity.
16 Q. Assuming it is appropriate to exclude Panhandle from Southern Union's
17 capital structure, did Mr. Dunn exclude all of the capital that Southern Union associates
18 with Panhandle in his recommended capital structure?
19 A. No. Mr. Dunn vaguely indicates in his direct testimony that he excluded
20 Panhandle from his capital structure, but he did not indicate what capital he excluded. In
21 actuality, Mr. Dunn only excluded the debt associated with Panhandle from his capital
22 structure. He did not exclude any portion of equity capital that is supporting the

Panhandle operations. Mr. Dunn confirmed that this is what he did during his deposition taken on May 6, 2004 (Dunn Deposition at 22-23).

It would only be appropriate to exclude the debt of Panhandle, if the assumption of Panhandle debt was all that Southern Union paid for the Panhandle operations, but this was not the case. Southern Union paid an additional $662 million over the assumption of debt to acquire Panhandle. If Mr. Dunn were to fully exclude the capital that may be associated with Panhandle, then he also would have to exclude the equity associated with the Panhandle operations.

I performed this calculation on page 21, line 18 through page 22, line 9 of my direct testimony using Panhandle's 10K financial statement filed with the Securities and Exchange Commission. Although there may be some disagreement on the amount of equity capital that should be eliminated from the consolidated capital structure to try to estimate Southern Union's capital structure, exclusive of Panhandle, it is obvious that at least some equity should be excluded from Southern Union's capital structure. If one were to properly attempt to estimate Southern Union's capital structure without Panhandle, the resulting Southern Union capital structure would be much more leveraged than that proposed by Mr. Dunn.

Q. Is Mr. Dunn's testimony vague about the exclusion of Panhandle?

A. Yes. In his direct testimony, Mr. Dunn did not specify that he only excluded debt that he associates with Panhandle. From Mr. Dunn's deposition testimony about why he did not exclude any equity along with Panhandle's debt, I believe that he recognized the fact that there is some common equity associated with Panhandle. In an earlier answer in his deposition on page 19, line 24 through page 21, line 21, Mr. Dunn

indicated that Standard and Poor's (S&P) would evaluate the individual capital structures of Southern Union's operations. This would leave the impression that S&P would specify Panhandle's capital structure and Southern Union's capital structure, exclusive of Panhandle, in its reports. However, I cannot find any such analysis in S&P's reports.

Q. If Mr. Dunn had used the capital structure that you estimated to be Southern Union's "stand-alone" capital structure, what would his recommended return on common equity need to be in order to achieve his overall recommended rate of return, assuming the use of your embedded costs?

A. The following table indicates what Mr. Dunn's recommended cost of common equity would have to be in order to achieve his overall recommended rate of return of 9.42 percent:

*Weighted Cost of Capital as of December 31, 2003 for MGE*
*Using Southern Union's Estimated Capital Structure Without Panhandle*

| Capital Component | % of Capital | Using ROE of 25.00% |
|---|---|---|
| Common Equity | 16.64% | 4.16% |
| Preferred Stock | 12.43% | 0.96% |
| Long-Term Debt | 56.12% | 4.02% |
| Short-Term Debt | 14.81% | 0.28% |
| Total | 100.00% | **9.42%** |

As illustrated above, Mr. Dunn must recommend a cost of common equity of 25.00 percent in order to achieve his overall recommended rate of return of 9.42 percent assuming he used Southern Union's estimated stand-alone capital structure and the embedded costs that I used in my recommendation. However, because I excluded the Panhandle debt for purposes of this example, I also excluded the cost of this debt in order to be consistent.

1 Q. Because Mr. Dunn chose to recommend a capital structure that wrongfully
2 includes equity used to support Panhandle's operations, what does it appear he has done
3 in order to minimize the focus on his recommended rate of return?
4 A. It appears that he has tried to divert attention from the fact that the
5 acquisition of Panhandle has caused Southern Union's capital structure to become even
6 more leveraged than its consistently highly leveraged capital structure before the
7 acquisition. If Mr. Dunn were to have appropriately excluded the equity associated with
8 Panhandle from his capital structure, then he would have had to recommend an upwardly
9 adjusted cost of common equity due to the additional leverage created by the acquisition
10 of Panhandle.
11 Q. Assuming that Mr. Dunn appropriately used the consolidated capital
12 structure with all of your embedded costs of long-term debt, preferred stock and
13 short-term debt, what would his recommended cost of common equity need to be to
14 achieve his overall recommended rate of return of 9.42 percent?
15 A. The following table indicates what Mr. Dunn's recommended cost of
16 common equity would have to be in order to achieve his overall recommended rate of
17 return of 9.42 percent:

18 *Weighted Cost of Capital as of December 31, 2003 for MGE*
19 *Using Southern Union's Consolidated Capital Structure With Panhandle*
20
21

| Capital Component | % of Capital | Using ROE of 19.03% |
|---|---|---|
| Common Equity | 25.91% | 4.93% |
| Preferred Stock | 6.13% | 0.48% |
| Long-Term Debt | 60.66% | 3.87% |
| Short-Term Debt | 7.30% | 0.14% |
| Total | 100.00% | **9.42%** |

22–28

1 As illustrated above, Mr. Dunn would have had to recommend a cost of
2 common equity of 19.03 percent if he had appropriately used Southern Union's
3 consolidated capital structure in order to achieve his overall recommended rate of return
4 of 9.42 percent.

5 Q. Is it appropriate for Mr. Dunn to request a higher cost of capital because of
6 the acquisition of Panhandle?

7 A. No. *In the Matter of the Application of Southern Union Company d/b/a*
8 *Missouri Gas Energy For Authority to Acquire Directly or Indirectly, Up to and*
9 *Including One Hundred Percent (100%) of the Equity Interests of Panhandle Eastern*
10 *Pipeline Company, Including Its Subsidiaries, and to Take All Other Actions Reasonably*
11 *Necessary to Effectuate Said Transaction*, Case No. GM-2003-0238, Southern Union
12 agreed to the following condition:

> 13 Southern Union will not recommend an increase or claim
> 14 Staff should make an adjustment to increase the cost of
> 15 capital for MGE as a result of the Transaction. Any
> 16 increases in cost of capital Southern Union seeks for MGE
> 17 will be supported by documented proof: (1) that the
> 18 increases are a result of factors not associated with the
> 19 Transaction; (2) that the increases are not a result of
> 20 changes in business, market, economic or other conditions
> 21 for MGE caused by the Transaction; or (3) that the
> 22 increases are not a result of changes in the risk profile of
> 23 MGE caused by the Transaction. Southern Union will
> 24 ensure that the retail distribution rates for MGE ratepayers
> 25 will not increase as a result of the Transaction.

26 Southern Union's capital structure has been directly affected by the
27 acquisition of Panhandle. Southern Union's request for an increased cost of capital,
28 whether it was requested directly through an increased cost of common equity or through
29 the use of an erroneously derived capital structure by Mr. Dunn, would be in direct
30 violation of this condition and the Order by this Commission in the aforementioned case.

1 Q. Is it appropriate to estimate Southern Union's capital structure exclusive
2 of Panhandle for purposes of recommending a rate of return in this case?
3 A. No. I explained my rationale for this on page 22, line 10 through page 23,
4 line 5 of my direct testimony. Because MGE is a division of Southern Union, it relies on
5 Southern Union for all of its capital needs. In such cases, the Staff has consistently
6 recommended the consolidated capital structure of the parent company. The Staff's
7 capital structure recommendation in the most recent Aquila rate cases, Case Nos.
8 ER-2004-0034 and HR-2004-0024 (electric and steam), and Case No. GR-2004-0072
9 (natural gas) was based on this same premise. In fact, in the most recent fully-litigated
10 UtiliCorp United, Inc.'s (since renamed "Aquila") Missouri Public Service rate case
11 (Case No. ER-97-394), the Commission stated in its Report and Order:

12 Based on substantial evidence of record, the Commission
13 finds that the consolidated capital structure proposed by the
14 Staff accurately reflects the correct capital structure of
15 UtiliCorp itself, and therefore MPS, during the actual test
16 year. (page 6).

17 Q. In the aforementioned cases was Aquila's corporate structure similar to
18 that of Southern Union's in the current case?
19 A. Yes. In the Aquila cases, the electric and natural gas utilities of Aquila
20 were divisions of Aquila. Aquila also had wholly-owned and partially-owned
21 subsidiaries. One Aquila subsidiary was its energy marketing and trading business,
22 which at the time was named Aquila Energy. Aquila also had interests in many
23 international subsidiaries. Many of these subsidiaries issued their own debt and received
24 capital from their parent company.
25 Aquila's corporate structure was similar Southern Union's is now.
26 Southern Union's regulated utilities are divisions and now Southern Union has a

1 subsidiary, Panhandle Energy, that issues its own debt and receives capital from its parent
2 company.
3 Q. Why is it important to recognize the similarities in Aquila's and Southern
4 Union's capital structures?
5 A. Because now Southern Union has a subsidiary that issues its own debt and
6 there is no company-specific precedent to rely on to determine an appropriate capital
7 structure for this case. However, the previous Aquila cases in which debt and its costs
8 from even partially-owned subsidiaries was included in the rate of return adopted by the
9 Commission provide a reasonable precedent for this proceeding.
10 Q. Is there any situation in which you would consider using something other
11 than the consolidated capital structure?
12 A. Yes. I addressed this in my direct testimony on page 22, line 17, through
13 page 23, line 5. Although not in exactly the same terms, I have also addressed this in the
14 last two Aquila electric rate cases, Case Nos. ER-2004-0034 and ER-2001-672. In those
15 cases I indicated the following:

16 If MPS were a subsidiary of UtiliCorp and it issued its own
17 debt capital, then the MPS capital structure would be a
18 reliable capital structure because MPS would have its own
19 capital structure.

20 Q. What capital structure currently supports Southern Union's investment
21 grade credit rating, which is the credit rating that is associated with the costs of Southern
22 Union's debt that is charged to MGE ratepayers?
23 A. Southern Union's on a consolidated basis, including Panhandle.
24 Q. What capital structure will support Southern Union's credit rating in the
25 future?

1 A. Southern Union's on a consolidated basis. Therefore, this is the
2 appropriate capital structure to use in this case for ratemaking purposes.

3 Q. Do you have any evidence that indicates that Standard & Poor's (S&P)
4 treats Southern Union and Panhandle as one in the same when evaluating their
5 creditworthiness?

6 A. Yes. In a research report published on June 11, 2003, S&P indicated the
7 following:

> 8 The corporate credit rating is based on the
> 9 consolidated business and financial profile of
> 10 Southern Union and its subsidiaries. The corporate
> 11 credit rating is assigned to the senior debt at both
> 12 Southern Union and its pipeline subsidiary. The
> 13 equal rating of senior debt at each entity reflects
> 14 Standard & Poor's view that management would
> 15 use available cash to support debt service at either
> 16 entity in order to avoid default, and therefore the
> 17 debt shares an equal risk of default.

18 Therefore, from a creditworthiness perspective, it is obvious that
19 S&P does not recognize Panhandle as being separate from Southern Union.

20 Q. Wasn't there an attempt to provide insulation of Southern Union's natural
21 gas distribution utility operations in the Stipulation and Agreement filed and approved by
22 the Commission in Case No. GM-2003-0238?

23 A. Yes, but S&P's does not recognize these conditions as providing
24 insulation to the natural gas distribution operations from Panhandle operations. This is
25 also evident from the fact that Southern Union's business profile has increased to a four
26 from a three, which was explained in my direct testimony on page 16, line 25 through
27 page 17, line 10.

1 Q. What is the implication of S&P's comment that "…management would
2 use available cash to support debt service at either entity in order to avoid default…?"
3 A. The implication is that regardless of where Southern Union raises its
4 capital, these funds may be used for any of Southern Union's operations, including the
5 Panhandle operations. This provides further support for utilization of a consolidated
6 capital structure that reflects the consolidated cost of debt to Southern Union.
7 Q. Is there currently any other capital in Mr. Dunn's recommended capital
8 structure and costs that may be associated, at least in part, with the Panhandle operations?
9 A. Yes. I have already addressed the fact that Mr. Dunn did not exclude the
10 equity that may be associated with Panhandle in his recommended capital structure.
11 However, there are other sources of financing included in Mr. Dunn's embedded costs
12 and capital structure that are or may be associated, either directly or indirectly, with the
13 Panhandle acquisition.
14 The first and most obvious is the equity units that were sold to fund part of
15 the acquisition of Panhandle. These equity units should not be confused with actual
16 shares of common stock. These units act much like convertible debt, in which the debt
17 can be converted to common equity at some future date at either a certain price or a
18 certain number of shares based on the price of the shares on the conversion date.
19 According to Southern Union's 2003 Annual Report, the Company was able to achieve
20 net proceeds of $121.3 million from the sale of these equity units, the cost of which is
21 carried at the parent company level and is reflected in the embedded cost of long-term
22 debt for Southern Union. Therefore, it is obvious that there is already some blurring of

1 the lines on whether certain financings at the parent company level are used for the
2 Panhandle operations or natural gas distribution operations.

3 Additionally, on October 8, 2003, Southern Union completed its offering
4 of its 7.55 percent noncumulative preferred stock. In its prospectus for this offering,
5 Southern Union indicated that it would use the proceeds from this issuance "initially to
6 pay down our long-term credit facility and the balance of the proceeds, if any, to pay
7 down our term loan." The prospectus then indicates that "[a]pproximately 30 days after
8 the closing of this offering, we will use our available cash and reborrow under our credit
9 facilities to redeem in full $100,000,000 principal amount of our 9.48% Subordinated
10 Deferrable Interest Notes, due May 17, 2025…"

11 In its 2003 Annual Report, Southern Union indicated that it would use
12 available working capital to help fund the acquisition of Panhandle. Additionally, in its
13 2003 Annual Report, Southern Union indicates that its long-term credit facility is
14 available for "Southern Union's working capital, letter of credit requirements and other
15 general corporate purposes." Therefore, it appears that the preferred stock offering was
16 also indirectly used to finance the acquisition of Panhandle.

17 Q. What do you conclude from many of the financing arrangements that you
18 reviewed?

19 A. There really is no separation in the financing between Southern Union and
20 Panhandle. The picture will only get fuzzier as more time elapses.

21 Q. What are the average common equity ratios for a representative sample of
22 the natural gas industry?

1 A. The April 2004 C.A. Turner Utility Reports indicates an average common
2 equity ratio of 40 percent for the 31 natural gas companies that it analyzes. The average
3 common equity ratio for the eight BBB-rated natural gas companies that it analyzes is
4 38.57 percent. It is important to review BBB-rated utilities because this is Southern
5 Union's current credit rating. The capital structure used for ratemaking purposes in this
6 case should be consistent with that of a BBB-rated utility, which is Southern Union's
7 current credit rating. The C.A. Turner Utility Reports also indicate an average common
8 equity ratio of 38 percent for the 42 combination electric and gas companies that it
9 analyzes. The average common equity ratio for the fourteen BBB-rated combination
10 electric and gas companies that it analyzes is 34.43 percent.

11 Additionally, according to the December 19, 2003 Value Line Summary
12 and Index on the natural gas distribution utility industry, the average common equity ratio
13 for the natural gas distribution utility companies it analyzes was 41.6 percent for 2002.

14 Q. What was the average common equity ratio for your comparable group of
15 natural gas utility companies?

16 A. The average common equity ratio for my comparable group of companies
17 was 49.68 percent. However, my comparable group of companies have an average credit
18 rating of A versus Southern Union's BBB credit rating.

19 Q. What do the above common equity ratios indicate about the
20 appropriateness of the capital structure that Mr. Dunn utilized for ratemaking purposes in
21 this case?

22 A. The above common equity ratios indicate that a 43.34 percent common
23 equity ratio is consistent with a gas utility that is rated somewhere between an A rating

1 and a BBB rating. However, it is higher than the average equity ratio for a BBB-rated
2 gas utility and the broader gas utility averages as indicated by Value Line and
3 C.A. Turner.

4 Q. Did Mr. Dunn make any downward adjustments to his recommended cost
5 of debt to take this into consideration?

6 A. No. Since Mr. Dunn is recommending a capital structure that is
7 inconsistent with the Southern Union capital structure that debt investors evaluate to
8 determine a required yield on their investment, then he should make a downward
9 adjustment to his cost of debt to reflect the reduced financial risk associated with this less
10 leveraged capital structure. This is the very reason that Staff chose to recommend
11 Southern Union's actual consolidated capital structure.

12 Q. Did you make any adjustments to your cost of debt to take into
13 consideration the fact that your comparable group of natural gas utility companies had an
14 average credit rating of an A versus Southern Union's BBB credit rating?

15 A. No, because I recommended Southern Union's actual consolidated capital
16 structure as of the end of the update period. Because Southern Union is still rated
17 investment grade, this capital structure is appropriate for ratemaking purposes. If I had
18 used a capital structure that was less leveraged than Southern Union's capital structure,
19 then I would have had to consider making a downward adjustment to my recommended
20 embedded cost of long-term debt.

21 Q. Did you make any adjustments to your cost of common equity
22 recommendation to take into consideration that your proxy group had a better credit
23 rating than Southern Union?

1 A. Yes. I made an upward adjustment of 32 basis points to my cost of
2 common equity recommendation for MGE to take into consideration the risk differential
3 between the risks that are associated with Southern Union and its more leveraged capital
4 structure versus the comparable group that I used.

5 Q. What do all of the common equity ratios that you reviewed indicate about
6 the reasonableness of your recommended rate of return, which includes your capital
7 structure recommendation?

8 A. All of the common equity ratios that I reviewed to evaluate the
9 reasonableness of my recommendation confirm that as long as I adjust my recommended
10 cost of common equity to take into consideration the increased risk associated with
11 Southern Union's BBB credit rating, my recommendation is appropriate and reasonable.

12 If the actual capital structure of the parent or subsidiary is reasonable,
13 verifiable and consistent and the Company has an investment grade credit rating, then this
14 capital structure should be used because it more accurately reflects the cost of capital to
15 MGE.

16 Q. Do you have any final concerns about Mr. Dunn's capital structure
17 recommendation?

18 A. Yes. His capital structure recommendation doesn't reflect any of the
19 short-term debt that Southern Union is using to fund its operations. As of December 31,
20 2003, Southern Union had $295,175,000 of short-term debt outstanding with $28,575,399
21 of Construction Work In Progress (CWIP) outstanding. Therefore, it is appropriate to
22 include a short-term debt balance of $266,599,601 in the capital structure, which is the
23 difference between the amount of short-term debt outstanding and the CWIP outstanding.

1 I used the difference between actual short-term debt outstanding and CWIP for the short-
2 term debt balance because it is assumed that CWIP is funded with short-term debt
3 because of its transitional nature and this amount is not allowed in rate base.

4 **Mr. Dunn's Comparable Companies**

5 Q. Do you have any concerns about the companies Mr. Dunn selected for his
6 proxy group that would make the application of his proxy group cost of common equity
7 to MGE questionable?

8 A. Yes. Five of his fifteen "comparable" companies are not considered
9 natural gas distribution companies by Edward Jones in its December 30, 2003
10 publication, *Natural Gas Industry Summary: Quarterly Financial and Common Stock*
11 *Information*. According to this publication, Keyspan Corporation, NICOR Incorporated,
12 NUI Corporation, Southwest Gas Corporation and UGI Corporation are all considered to
13 be diversified natural gas companies. According to Edward Jones a "diversified" natural
14 gas company is a company that receives at least 20 percent but less than 90 percent of its
15 net operating revenues from distribution operations. In contrast, a "distribution" natural
16 gas company is a company that receives at least 90 percent of its net operating revenues
17 from distribution operations, which describes MGE's operations. Therefore, Mr. Dunn's
18 companies are not "comparable" and not appropriate to use in a proxy group cost of
19 common equity analysis for MGE.

20 Q. Do you have any specific examples from the companies that are
21 considered to be diversified by Edward Jones as to the types of operations that make
22 them incomparable?

A. Yes. For example, according to a Research Report on January 20, 2004 by S&P, Keyspan derives its operating income from the following business segments: 55 percent from regulated gas operations, 30 percent from owning and operating electric generating plants and serving several related functions for the Long Island Power Authority under long-term contracts, and 15 percent from non-regulated, diversified businesses that include midstream natural gas processing activities and natural gas exploration and production. Specific factors that S&P has indicated that elevate KeySpan's credit risk are:

- Continued exposure to gas E&P [Exploration and Production] activities through a 56% ownership interest in Houston Exploration;
- A growing dependence on electric generation beyond the company's original relationship with LIPA, as evidenced by the company's stated intention to acquire additional generation assets…

These activities add to the risk profile of KeySpan and therefore, increase its cost of capital. However, Mr. Dunn has not made any offsetting adjustment downward to his recommended cost of common equity to take this into consideration.

Q. Do you have any other specific examples for another one of the diversified companies that Mr. Dunn utilized that makes this company inappropriate to use in his comparable company analysis?

A. The most glaring issue with NUI Corporation is that it is likely a takeover target. Most rate of return witnesses would remove such a company from their comparable group analysis if they were aware of this possibility because such a circumstance will distort their results. NUI's board of directors is actively pursuing a sale of the company. Not only is the company a takeover candidate, but it currently has a

1 credit rating that is below investment grade and therefore, carries a higher cost of capital
2 than a "healthy" natural gas distribution company. The risk to the consolidated company
3 is being affected by an investigation of energy trading transactions by affiliate NUI
4 Energy Brokers. These are all characteristics of a company that would incur a higher cost
5 of capital than a "healthy" natural gas distribution company.

6 Q. Do you have another example of a company that you would like to point
7 out some specific characteristics that make it inappropriate to utilize as comparable to
8 MGE?

9 A. Yes. UGI Corporation has many non-regulated business activities that
10 increase its business risk profile. A few of these are: propane distribution, natural gas
11 and electricity marketing, and electricity generation. S&P indicated in its March 31,
12 2004 research report that UGI Utilities, Inc. (the regulated businesses of UGI) would be a
13 substantially stronger credit than its BBB rating as a stand-alone entity. Although S&P
14 recognizes that UGI Utilities deserves a credit rating of BBB versus the BB+ at domestic
15 propane distribution company AmeriGas Partners L.P., and BB at Antargaz, it still takes
16 the position that UGI Utilities is effected by the consolidated business profile of UGI
17 Corporation. S&P stated that "UGI's willingness to significantly enlarge its nonregulated
18 operations beyond their current scope indicates a desire to fuel company growth through
19 the expansion of higher-risk business segments, lessening the importance of UGI Utilities
20 in UGI's consolidated profile." It would appear that the rest of the non-regulated, higher-
21 risk businesses of UGI Corporation are those that are fueling the earnings growth of UGI
22 Corporation.

1 Q. Did Mr. Dunn make a downward adjustment to UGI Corporation's
2 estimated earnings per share growth rate, which is the highest on Schedule JCD-5, to take
3 into consideration that this company is not comparable to MGE's natural gas distribution
4 operations?

5 A. No.

6 Q. Do you have any additional concerns about the companies Mr. Dunn
7 selected for his proxy group?

8 A. Yes. Mr. Dunn includes Laclede Gas Company, which operates in the
9 state of Missouri. It has consistently been Staff's position that any Missouri jurisdictional
10 utility companies should be eliminated from a proxy group analysis because they are
11 directly impacted by decisions of this Commission. Staff's position on this issue has not
12 changed.

13 Q. Was Mr. Dunn concerned about whether he used companies in his
14 comparable group that may have a higher cost of capital than a company that has an
15 investment grade credit rating, which is Southern Union's current credit rating?

16 A. No. Mr. Dunn indicated in his deposition that he didn't think it was a
17 problem if any of his comparable companies didn't have an investment grade credit
18 rating. (Dunn Deposition at 54, lines 4-10) This indicates that Mr. Dunn was not
19 concerned with selecting companies that are comparable in risk to MGE. Actually, it is
20 because Southern Union has a BBB credit rating that I decided to make an adjustment to
21 my proxy group cost of common equity because the average credit rating of my
22 comparable group was A. The difference in credit ratings indicates that investors will

1 expect a higher rate of return because of the increased risk associated with Southern
2 Union.

3 Q. Was Mr. Dunn aware that some of his "comparable" companies were
4 more diversified than others in his comparable group and that this possibly made the
5 growth rates of some of his companies higher than is typical for a natural gas distribution
6 company?

7 A. Yes. In his deposition on May 6, 2004, on page 55, lines 1 through 12,
8 Mr. Dunn was asked about the reason why a couple of his companies had fairly high
9 estimated growth rates. At first he indicated he didn't know, but then he identified one
10 company, Atmos Energy, that he felt was less diversified than the two companies that he
11 was asked about, UGI and Southwest Gas. Therefore, it is obvious that Mr. Dunn was
12 aware that some of his comparable companies were more diversified than a pure play
13 natural gas distribution operation, yet he did not make any downward adjustments to his
14 recommended cost of common equity to account for this.

15 Q. Did Mr. Dunn indicate anything in his deposition that causes you concern
16 about his selection of comparable companies?

17 A. Yes. It appears that Mr. Dunn did not give much weight to whether his
18 comparable companies' business was actually confined as much as possible to the natural
19 gas distribution industry. He relied on Value Line's classification of these companies,
20 but he didn't know the criteria that Value Line used to classify a company as a natural
21 gas distribution company. This explains why some of his comparable companies have
22 higher than normal growth rates for a natural gas distribution company.

1 **Mr. Dunn's Recommended Cost of Common Equity for MGE**

2 Q. Please summarize Mr. Dunn's recommended cost of common equity for
3 the gas operations of MGE.

4 A. Mr. Dunn utilized the Discounted Cash Flow (DCF) model to estimate a
5 "benchmark, industry cost of capital." Mr. Dunn estimated this "benchmark, industry
6 cost of capital" based on his group of "comparable" companies. He then used this data
7 and "judgment" in finalizing his recommendation. Mr. Dunn calculated a dividend yield
8 of 4.90 percent, of which 0.30 percent was the result of the addition of flotation costs, and
9 then he chose a growth rate range of 6 percent to 7 percent to arrive at his initial cost of
10 common equity range for MGE of 10.90 percent to 11.90 percent. After Mr. Dunn took
11 into consideration what he felt were risks specific to MGE, he chose to recommend a cost
12 of common equity for MGE of 12.00 percent. He also suggested an additional arbitrary
13 0.25 percent addition to the overall cost of capital for a "management efficiency"
14 adjustment.

15 Q. Does Staff agree with Mr. Dunn's 25 basis point adjustment to the cost of
16 capital for " management efficiency " of MGE?

17 A. No. Staff witnesses Deborah A. Bernsen's and Mark L. Oligschlaeger
18 address this issue in their rebuttal testimony.

19 Q. Does Staff agree with Mr. Dunn's 30 basis point adjustment to the
20 dividend yield to take flotation costs into consideration?

21 A. No. It is Staff's opinion that flotation costs should be recovered on a
22 dollar for dollar basis when they are incurred and not as an adjustment to the cost of
23 common equity. Staff's position has not changed regarding this issue.

1 Q. What is the implication of Mr. Dunn's upward adjustment to his
2 recommended return on common equity for flotation costs?
3 A. Mr. Dunn is effectively requesting MGE ratepayers to pay part of
4 Southern Union's costs for acquiring the Panhandle properties. The reason Southern
5 Union has issued additional common equity and equity units is because of the increased
6 leverage on its balance sheet caused by the Panhandle acquisition. When Southern Union
7 submitted an application with the Commission for approval to acquire Panhandle, it
8 indicated that it would have a partner that would share the costs of the acquisition.
9 However, this partner later backed out of the plan to acquire Panhandle, leaving Southern
10 Union to pay for the entire cost of the acquisition. As a result, Southern Union had to
11 seek out more financing for this acquisition, which included issuing 3 million additional
12 shares of Southern Union stock to CMS Energy Corporation to fund approximately
13 $49 million of the purchase price; 9.5 million additional shares issued to the public,
14 which provided approximately $146.7 million in proceeds; and 1.425 million in shares
15 for over-allotment to the underwriters, which resulted in an additional $22 million in
16 proceeds. If Southern Union had not had to issue these additional shares, then it would
17 not have faced what Mr. Dunn refers to as "flotation costs" and "pre-offering pressure."
18 Q. Did Southern Union agree to a condition in the Stipulation and Agreement
19 in Case No. GM-2003-0238 that it would not request a higher cost of capital as a result of
20 the transaction?
21 A. Yes. The condition is as follows:

22 Southern Union will not recommend an increase or claim
23 Staff should make an adjustment to increase the cost of
24 capital for MGE as a result of the Transaction. Any
25 increases in cost of capital Southern Union seeks for MGE

> will be supported by documented proof: (1) that the increases are a result of factors not associated with the Transaction; (2) that the increases are not a result of changes in business, market, economic or other conditions for MGE caused by the Transaction; or (3) that the increases are not a result of changes in the risk profile of MGE caused by the Transaction. Southern Union will ensure that the retail distribution rates for MGE ratepayers will not increase as a result of the Transaction.

If Southern Union has incurred flotation costs and price pressures because it had to issue additional common equity, it is because of the Panhandle transaction. This is clear from the following comment in Southern Union's 2003 Annual Report:

> Our joint securities offerings netted us approximately $290 million, a significant portion of which was used to fund the Panhandle acquisition.

This was also confirmed by Mr. Dunn during his deposition page 31, lines 5 through 8. However, on page 49, lines 20 through 21 of his direct testimony, Mr. Dunn claims that the sale of new equity would benefit MGE. Mr. Dunn did not provide any documented proof of this claim. The request for an increase in the cost of capital because of flotation costs is in direct conflict with the above condition.

Q. Do you agree with Mr. Dunn's assessment that MGE faces additional risk because it is a small company when compared to the proxy group?

A. No. The study that Mr. Dunn discusses in his direct testimony at page 54, line 5 through page 55, line 4 is based on a study of all of the stocks in the New York Stock Exchange, the American Stock Exchange and the Nasdaq National Market. The study did not apply specifically to regulated utilities. Annie Wong, associate professor at Western Connecticut State University, performed a study that was published in the Journal of the Midwest Finance Association, Volume 22, that refutes the need for an adjustment based upon the smaller size of public utilities. She indicates:

> First, given firm size, utility stocks are consistently less risky than industrial stocks. Second, industrial betas tend to decrease with firm size but utility betas do not. These findings may be attributed to the fact that all public utilities operate in an environment with regional monopolistic power and regulated financial structure. As a result, the business and financial risks are very similar among the utilities regardless of their size. Therefore, utility betas would not necessarily be expected to be related to firm size.

Because smaller utilities operate in a regulated environment, just as large utilities do, making an adjustment for firm size is not appropriate.

Additionally, because MGE receives its capital from the parent company, Southern Union, it is appropriate to use companies that have capitalization levels similar to that of Southern Union. The studies that have been done about the "small size effect" relate to stand-alone, publicly-traded companies, not divisions of larger companies.

Q. Has Mr. Dunn performed any type of analysis to confirm whether the "small size effect" applies to divisions of larger companies?

A. No. Mr. Dunn indicated this in his deposition on page 53, line 15.

Q. What can an analyst do to limit his concerns about the impact the size of the comparable companies may have on the cost of common equity?

A. The analyst can utilize a criterion to put an upper limit on the size of comparable companies that are used in his analysis. This will avoid the need for these types of disputable risk adjustments. This is exactly why I chose to limit my comparables to those companies with total capitalization of less than $5 billion (see Schedule 13 of my direct testimony). Mr. Dunn included Keyspan in his proxy group which, in addition to being classified as a diversified company by Edward Jones as of December 31, 2003, is a large capitalization company with a total capitalization level of $9,061,913,000 according to Edward Jones *Natural Gas Industry Summary*, December 31, 2003. If Mr. Dunn were

1 concerned about firm size, then I believe he should have excluded Keyspan from his
2 comparable group for at least this reason.

3 Q. Do you have any concerns with the Mr. Dunn's recommended growth rate
4 range?

5 A. Yes, I do. On page 37, line 21 through page 45, line 7 of his direct
6 testimony, Mr. Dunn explains his determination of the growth rate. From this discussion
7 on historical and projected growth rates, he indicates on page 50 of his direct testimony a
8 growth rate range of 6 percent to 7 percent for his proxy companies. His selection of the
9 6 percent to 7 percent growth rate for his proxy companies appears to be quite arbitrary.
10 It does not appear that he placed much, if any, weight on the historical growth rates, other
11 than the highest Value Line historical growth rate, which was the five-year historical
12 growth in earnings per share. However, it is hard to determine this because Mr. Dunn did
13 not show any calculations on how he achieved his growth rate range. Further, if one were
14 to remove the companies from the proxy group that I have explained as inappropriate and
15 averaged the negative growth rates along with some of the higher growth rates that would
16 not be considered sustainable, then the five-year historical growth rate would have been
17 4.31 percent, almost 300 basis points lower than Mr. Dunn's indicated five-year historical
18 growth rate.

19 It also appears that Mr. Dunn gave some weight to Value Line's projected
20 growth rates for earnings per share (EPS) and book vale per share (BVPS) indicated on
21 Schedule JCD-5 attached to his direct testimony, as these growth rates are within his
22 range of 6.00 percent to 7.00 percent. However, if one were to eliminate the companies
23 that I previously mentioned as inappropriate to include in the proxy group, the

1 Value Line projected EPS would be 5.63 percent and the Value Line projected BVPS
2 growth rate would be 5.50 percent, which is below the lower end of Mr. Dunn's range of
3 6 percent to 7 percent. Consequently, if one were to rely exclusively on these projected
4 growth rates from Value Line, then the recommended growth rate would be closer to
5 5.50 percent. If one were to give some consideration to the five-year historical average
6 EPS growth rate in this estimation, then the future projected growth rate would be
7 somewhere below 5.00 percent. This is quite close to the average Thomson Financial
8 expected EPS growth rate of 4.90 percent that Mr. Dunn indicates on page 43 of his
9 direct testimony. If one were to exclude the companies that are inappropriate for the
10 comparable group, the average projected growth rate from Thomson Financial would be
11 4.88 percent.

12 Q. Is it important to consider multiple growth rates when projecting a
13 possible future growth rate to be used in the DCF model?

14 A. It is important to consider historical growth rates because, as stated in
15 David C. Parcell's book, The Cost of Capital - A Practitioner's Guide, "investors, as a
16 group, do not utilize a single growth estimate when they price a utility's stock. Thus rate
17 of return analysts should consider multiple growth estimates in order to better capture the
18 growth embodied in a utility's stock price." It is important to note that Mr. Parcell
19 emphasizes that analysts should consider multiple growth estimates. This applies to
20 projected as well as historical growth rates. Additionally, Mr. Parcell states: "Analysts
21 should recognize that individual investors have different expectations regarding growth
22 and therefore no single indicator captures the growth expectations of all investors."
23 Therefore, it is important to not only give weight to multiple projected growth rates, but

1 to also give weight to historical growth rates because that is in fact what investors as a
2 group will do.

3 Q. On page 53, line 19 through page 58, line 16 of his direct testimony,
4 Mr. Dunn discusses issues related to his heading "MGE Specific Risk." Do you agree
5 with Mr. Dunn's assessment that he uses to justify his recommendation of a return on
6 equity that is even higher than his already upward adjusted cost of common equity for his
7 comparable group?

8 A. No. Although Mr. Dunn states this on page 57, line 18 of his direct
9 testimony, it should be emphasized that Mr. Dunn recognizes the fact that the business
10 risks he identifies are "common to the natural gas distribution business." Therefore,
11 although he is trying to determine if MGE is more exposed to these business risks than
12 his proxy group, he does recognize that these risks are common to all natural gas
13 distribution utilities. It is important to clarify this because the analysis of the proxy
14 groups' cost of common equity through the DCF analysis already captures these risks by
15 means of the price investors are willing to pay for the proxy companies' stocks.

16 Although I do not agree with Mr. Dunn's approach to measuring the risk
17 differential between his chosen proxy group and MGE, I do agree a risk adjustment is
18 warranted if the average credit ratings of the proxy group are different from that of the
19 company subject to the recommended cost of common equity. However, I believe that
20 the approach that I explained on page 32, lines 8 through 22 of my direct testimony is
21 superior and free from arbitrary judgment as compared to the approach used by
22 Mr. Dunn. The approach I used allows for a specific quantification of the adjustment that
23 should be made to the cost of common equity, whereas Mr. Dunn's approach rests on a

1 vague recommendation that 12 percent is an appropriate cost of common equity for
2 MGE. Of course, it is important to emphasize that a risk premium adjustment is
3 contingent on the selection of a proxy group that is as similar as possible to the subject
4 company's business.

5 Q. Why is it important to emphasize that a risk premium adjustment is
6 contingent on the selection of a proxy group that is as similar as possible to the subject
7 company's business?

8 A. Because if an analyst selects companies that have growth rates that are
9 higher than normal for a natural gas distribution company, such as Southwest Gas
10 Corporation and UGI Corporation in Mr. Dunn's proxy group, then the analyst already
11 has a cost of common equity that is upwardly biased. If the analyst adds an additional
12 risk premium adjustment to this already biased proxy group cost of common equity, then
13 he is compounding the upward bias. Quite simply, Mr. Dunn has made several upward
14 adjustments to his estimated cost of common equity for MGE, but he has not made any
15 downward adjustments to take into consideration the fact that some of his comparable
16 companies are more heavily involved in non-regulated activities.

17 Q. Do you agree with Mr. Dunn's comment on page 39, lines 20 through 21,
18 that "dividend growth will be replaced by earnings growth as the stock price driver?"

19 A. I believe this comment may hold some truth for companies that do not pay
20 any or low dividends. However, one of the primary reasons investors still buy certain
21 utility stocks is for the payment of a dividend. In light of the current interest rate
22 environment, where the federal funds rate is now at 1.00 percent and 30-year treasury
23 bonds are yielding 5.47 percent as of May 7, 2004, a dividend yield in the range of 3.30

1 to 5.30 percent could be considered quite attractive to investors considering that this
2 dividend yield is also likely to be combined with some growth in the stock price.

3 Q. Did you offer any evidence in your direct testimony that would indicate
4 that investors may actually see more dividend increases since the tax on dividends have
5 been cut?

6 A. Yes. On page 15, lines 20 through 26, I quoted the following portion of
7 commentary from S&P's Chief Technical Analyst, Mark Arbeter in *The Outlook*:

> 8 Howard Silverblatt of S&P Quantitative Services says that
> 9 since the tax cut was enacted, dividend payouts have been
> 10 on an unmistakable upward trend. A disproportionately
> 11 large number of dividend increases get made early in the
> 12 year, when companies want to put shareholders in a good
> 13 mood before their annual meetings. Through March 18,
> 14 there were 86 dividend increases for stocks in the S&P 500
> 15 vs. 67 for the first three months of 2003.

16 When one combines the attractiveness of dividend paying stocks in a low
17 interest rate environment with the fact that taxes on dividends have been cut, investors
18 will be more inclined to direct their capital to traditional dividend paying stocks, such as
19 utilities. This translates into utilities having a lower cost of common equity, which is
20 reflected in my recommendation, but not Mr. Dunn's.

21 Q. On page 35, lines 11 through 12 of his direct testimony, Mr. Dunn quotes
22 information from *Value Line Investment Service* as of March 24, 2000 to support his
23 argument that earnings are going to replace dividends as the primary driver of the value
24 of natural gas industry stocks. What has happened since March 24, 2000 that may make
25 this support tenuous?

26 A. The dividend tax cut was enacted. This makes dividend paying stocks
27 more attractive because investors are no longer requiring as much before-tax return since

1 the tax rate on dividends has decreased. This is such a fundamental change that to rely on
2 comments that occurred before the dividend tax cut to support the position that dividends
3 are not important is flawed.

4 Q. On Schedules 6, 7 and 8 of Mr. Dunn's direct testimony, Mr. Dunn
5 calculates an average of the one-year growth rates for the period 1993 to 2002. Do you
6 have any concerns with how he calculated these growth rates?

7 A. Yes. Mr. Dunn uses an arithmetic mean to determine the historical growth
8 rates for earnings per share (EPS), dividends per share (DPS) and book value per share
9 (BVPS) for each of his comparable companies. This averaging technique averages all of
10 the one-year growth rates to determine what the average growth was for a given period,
11 in this case 10 years. The fallacy of relying on this type of averaging to determine an
12 investors' expected growth is best illustrated by reviewing the average growth of earnings
13 per share of Northwest Natural Gas on Schedule 6 of Mr. Dunn's direct testimony. In
14 this calculation, Mr. Dunn calculated an historical average rate of growth of 2.81 percent.
15 However, if you were to invest in this company in 1993 ($1.74 EPS), and still held this
16 stock in 2002 ($1.62 EPS), you would have a hard time accepting someone claiming that
17 your earnings increased by 2.81 percent because in fact earnings actually decreased by
18 12 cents during this period. This equates to a .79 percent decrease in earnings.

19 Perhaps a more simple example to show the fallacies of this
20 averaging technique is to consider an investment of $1 in a stock over a three-year period.
21 If an investor pays $1 for a stock in year 1 and in year 2 the stock increases to $1.50,
22 then the investor would have a 50 percent growth rate. In year three the price of the
23 stock decreases by 50 percent to $.75. If an investor performed a simple

1 arithmetic average of these two returns, then he would think that he received 0 percent
2 [(50 percent + -50 percent)/2] growth in his investment over the three-year period.
3 However, in reality the investor actually had a 25 percent decline in his investment over
4 this three-year period. This is why using the arithmetic mean is questionable.

5 Q. Does Mr. Dunn include the 49.14 percent average earnings per share
6 growth for Southwest Gas Corporation in his average historical earnings per share growth
7 rate of 11.99 percent on Schedule JCD-6 of his direct testimony? If so, should he?

8 A. Yes, he did. I have already explained my concerns with how he calculated
9 this growth rate. However, in light of the fact that Mr. Dunn chose to exclude negative
10 growth rates in his calculations, because apparently Mr. Dunn believes that investors will
11 ignore this possibility in their estimation of future growth, he should not include an
12 abnormally high growth rate in his average growth rate calculations. If Mr. Dunn's
13 opinion is that investors don't consider certain historical growth rates because they are
14 not what investors expect for the future, then he should exclude the 49.14 percent
15 arithmetic average earnings per share growth rate from his average. If Mr. Dunn were to
16 exclude the three highest growth rates as he excluded the three lowest growth rates
17 because they were negative, the average growth rate would be 5.25 percent. This growth
18 rate is less than half of the 11.99 percent growth rate indicated on Mr. Dunn's
19 Schedule JCD-6.

20 Q. Did you calculate the dividend yield for your proxy companies from
21 Mr. Dunn's Schedule JCD-10? If so, what was the result?

22 A. Yes. For column B on Schedule JCD-10, which is the June 20, 2003
23 Value Line dividend yield, I calculated a dividend yield of 4.35 percent for my

1 comparable companies. For column C on Schedule JCD-10, which is the September 19,
2 2003 Value Line dividend yield, I calculated a dividend yield of 4.33 percent for my
3 comparable companies.

4 Q. Is a further adjustment to this dividend yield necessary as Mr. Dunn
5 proposes on page 47, line 15 through page 48, line 17 of his direct testimony?

6 A. No. Mr. Dunn has already included the expected dividends over the next
7 12 months by using Value Line's dividend yields for each of his comparable companies.
8 Therefore, Mr. Dunn is adding growth to a dividend yield that has already been adjusted
9 to consider the dividends expected for the next year.

10 Q. Do you have any evidence to support your contention that the Value Line
11 dividend yield already considers the dividends that are to be received next year?

12 A. Yes. The following definition of dividend yield is contained in the *Value*
13 *Line Investment Survey for Windows: User's Manual*, © 1995 through 2002:

> 14 The common dividends declared per share expressed as a
> 15 percentage of the average annual price of the stock.
> 16 Dividend yield = common dividends declared per share
> 17 divided by the average annual price of a stock. **The year-**
> 18 **ahead estimated dividend yield (shown in the top right-**
> 19 **hand corner of the Value Line page) is the estimated**
> 20 **total of cash dividends to be declared over the next 12**
> 21 **months, divided by the recent price of the stock.**
> 22 (emphasis added)

23 Therefore, it is clear that Value Line already has factored in the expected
24 dividend for the next 12 months. Consequently, no additional adjustment is necessary.

25 Q. Based on your review of the growth rates and dividend yields associated
26 with the companies that you consider comparable within Mr. Dunn's comparable group,
27 what would be the upper bounds of your estimated DCF estimate using the information
28 that Mr. Dunn primarily relied upon?

1 A. Based on my critical review of the growth rate information that Mr. Dunn
2 relied on for his recommendation, I believe the upper bounds of his proxy group growth
3 rate would be somewhere around 5 percent. The dividend yield that would be
4 appropriate, which excludes flotation costs and a redundant growth adjustment, would be
5 4.35 percent as I indicated in my testimony above. This would result in an upper part of
6 the range of 9.35 percent and if I adjusted this by the 32 basis point adjustment that I
7 proposed in my direct testimony, then the upper part of the recommendation would be
8 9.67 percent.

9 Q. Are you proposing that the Commission make its recommendation based
10 on the estimation you provided in the previous answer?

11 A. No. I have reviewed the growth rates that I believe Mr. Dunn relied upon
12 the most in his recommendation and eliminated the companies that I do not believe
13 should be in his comparable group. I did not take into consideration all of the historical
14 growth rates that I considered in my direct testimony nor did I take into consideration
15 some of the lower projected growth rates in my direct testimony. Therefore, the analysis
16 in my direct testimony is much more comprehensive and should be relied upon by the
17 Commission.

18 Q. Did Mr. Dunn make any predictions about the cost of capital in the last
19 MGE rate case that did not materialize?

20 A. Yes. Mr. Dunn had the following question and answer in his
21 direct testimony on page 36, lines 11 through 19 in the last MGE rate case, Case No.
22 GR-2001-292:

23 Q. Do market conditions require consideration of any other
24 factors?

> A. Yes. The rates which will be established as a result of this procedure will go into effect sometime during 2001 and be effective for subsequent periods. It is very important that the rates be established anticipating the facts which will be in effect during the time that the rates will be in effect. It is reasonable to anticipate that the cost of equity will be increasing from its current lower levels to higher levels during the period these rates will be in effect. This leads me to believe that a higher return than that indicated by the raw DCF calculation is appropriate because the probability of a worsening of equity market conditions for utilities increases each day.

Q. Did Mr. Dunn indicate in his deposition that he believes that the cost of capital has come down since the last rate case?

A. Yes. Mr. Dunn stated the following in his deposition on page 16, lines 7 through 16:

> Now, that economic environment is clearly a matter that we are at a turnoff [trough] as far as capital costs are concerned today. We're moving out of the turnoff [trough] rather rapidly, I think. Everybody sees the paper every day that says interest rates on home mortgages have gone up weekly for the last five or six weeks. The Federal Reserve has changed their policy. They forecasted increases in interest rates. They've dropped the word "patience," they're proposing that there will be increases in interest rates.

It is clear that Mr. Dunn believes that the cost of capital is at its lowest level currently because he indicates that it is at its "trough." Although the transcript indicates it is at a "turnoff," this is clearly an error. Although at the time of writing my rebuttal testimony, I had not received the errata sheets from Mr. Dunn's deposition to determine if he had made this correction, I was present at Mr. Dunn's deposition and recall that he indicated that capital costs are at a "trough." Therefore, Mr. Dunn's prediction on the future direction of capital costs was incorrect and he apparently agrees that he was incorrect.

1 Q. Has Mr. Dunn made the same prediction in this case that he made in the
2 last rate case?
3 A. Yes. On page 50, line 20 through page 51, line 5, Mr. Dunn had the
4 following question and answer:

> 5 Q. Do market conditions require consideration of any other
> 6 factors?
>
> 7 A. Yes. The rates which will be established as a result of
> 8 this procedure will go into effect sometime during 2004
> 9 and be effective for subsequent periods. It is very
> 10 important that the rates be established anticipating the
> 11 facts which will be in effect during the time that the
> 12 rates will be in effect. It is reasonable to anticipate that
> 13 the cost of equity will be increasing from its current
> 14 lower levels to higher levels during the period these
> 15 rates will be in effect. This leads me to believe that a
> 16 higher return than that indicated by the raw DCF
> 17 calculation is appropriate because the probability of a
> 18 worsening of equity market conditions for utilities (i.e.
> 19 rising interest rates) increases each day.

20 The only difference in the wording between this case and the last case is
21 the substitute of the year in his testimony and the addition of the language in parentheses
22 in Mr. Dunn's testimony for this case. However, his prediction is the same.
23 Q. What has been the trend in the level of interest rates since MGE's last rate
24 case and, therefore, the cost of common equity capital for utilities?
25 A. It has been decreasing. This is fully reflected in my recommendation in
26 this case. Actually, this explains the reason why Southern Union has been able to
27 refinance some of its debt at very attractive interest rates. It also has refinanced its trust
28 originated preferred securities (TOPrS) with regular preferred stock at a much lower cost.
29 The TOPrS had a coupon of 9.48 percent, while the traditional preferred securities that
30 Southern Union recently issued, in part to refinance the TOPrS, was issued at a coupon of

1 7.55 percent. This provides some insight as to the decreased cost of capital, especially
2 considering the fact that traditional preferred is generally considered to be riskier than
3 TOPrS, holding all else equal. This is also reflected in the low interest rate of
4 1.89 percent that Southern Union is paying on its short-term debt.

5 Q. Regardless of whether Mr. Dunn's predictions should materialize, isn't it
6 true that investors' expectations about the future of interest rates will be reflected in the
7 price they are willing to pay for stocks?

8 A. Absolutely. That is the appealing nature of the DCF model. The stock
9 price used to determine the dividend yield of the company fully reflects investors'
10 expectations about the future, whether it be specifics about the industry or
11 macroeconomic issues. Therefore, it is inappropriate for an analyst to make any
12 additional adjustments to the output of the model for his own expectations. It is the goal
13 of the rate of return witness to determine what investors expectations are, not to substitute
14 his own expectations.

15 Q. Mr. Dunn indicates that the current "trend in the cost of capital is currently
16 up" on page 3, line 23 of his of his direct testimony. How long had interest rates been
17 increasing at the time Mr. Dunn wrote his direct testimony?

18 A. They had risen for five months from their low in June 2003. However, the
19 same thing occurred with mortgage rates in September 2002 when some homeowners
20 believed that they may have missed the opportunity to refinance at lower interest rates.
21 After increasing for a few months, mortgage rates dropped to below the levels in
22 September 2002, meaning that the trend in interest rates was still down. Therefore,
23 drawing conclusions from a few months of increases in interest rates is questionable.

1 Q. On page 30, lines 13 through 17 of his direct testimony, Mr. Dunn
2 emphasizes the importance of a risk adjustment to the recommended cost of common
3 equity to reflect the increased financial risk of MGE because of its lower equity ratio as it
4 compares to his proxy group. Do you agree that the focus should be on financial risk?

5 A. No. If one were able to hold all things equal for a company, then I would
6 agree with the principle that an investor will require a higher return on common equity if
7 there is increased financial risk. However, one cannot hold all else equal when
8 comparing a subject company to a proxy group for the obvious reason that they are all
9 different companies. This is why I believe it is appropriate to rely on the credit rating
10 agencies to quantify the total risk of the company, which includes the business risk as
11 well as the financial risk, in determining an appropriate adjustment to make to the proxy
12 group cost of common equity for the subject company. Southern Union has been able to
13 maintain its investment grade credit rating for quite some time even though it has always
14 been an aggressively leveraged company. Therefore, it appears that the credit rating
15 agencies have given quite a bit of weight to factors other than financial risk in order to
16 maintain this investment grade credit rating for Southern Union. However, I did
17 recognize that MGE does face more risk in its totality than the comparable group and this
18 is why I decided to make an adjustment to my recommendation based on the spread
19 between the yields of A-rated utility bonds and BBB-rated utility bonds.

20 Q. Mr. Dunn discusses allowed returns and earned returns for other utility
21 companies in other states as reported by Regulatory Research Associates (RRA) on
22 page 52, line 4 through 26 of his direct testimony. How do you respond?

1 A. I have done a thorough and complete analysis of the cost of common
2 equity for a comparable group of companies, primarily using the DCF model, which
3 incorporates the current capital and economic environments. I utilized this proxy cost of
4 common equity to recommend a fair rate of return to be applied to the rate base of MGE.
5 I have reservations about drawing inferences from the allowed ROEs in other
6 jurisdictions. There are many reasons why an allowed return on equity may be higher
7 than the cost of common equity for utility companies specific to each case in question.
8 The Staff of the Missouri Public Service Commission does not use allowed ROEs in
9 other jurisdictions in order to recommend a fair and reasonable ROE for utility
10 companies in Missouri. We predominately utilize the Discounted Cash Flow model in
11 order to make a fair and reasonable recommendation based on the capital and economic
12 environments. If a Commission were to constantly rely on what other Commissions were
13 authorizing, or even its own authorizations in prior cases, in order to determine what is
14 fair, then the allowed return on equity would never reflect the current capital and
15 economic environment.

16 Q. On page 51, line 12, through page 52, line 2, Mr. Dunn compares his cost
17 of common equity recommendation to the historic returns on common equity produced
18 for the past ten years. Should such comparisons as a test of reasonableness for
19 determining a fair recommended return on equity in a rate case proceeding be used with
20 caution?

21 A. Yes. One doesn't need to look any further than the Commission's recent
22 complaint case against AmerenUE, Case No. EC-2002-1, to understand this concept. If
23 Staff measured the reasonableness of its recommended return on equity based on

1 AmerenUE's recent return on common equity before its rates were reduced, then
2 AmerenUE would be in a perpetual overearnings situation because the test of
3 reasonableness would have been the return on equity that Staff and this Commission
4 determined to be excessive. Of course, this analogy presumes that the Staff would have
5 let this test of reasonableness influence its cost of common equity recommendation in the
6 AmerenUE complaint case, which wasn't the case. This is the very reason that the
7 recommended return on equity in a rate case proceeding is based on the cost of common
8 equity and not on what past returns on common equity have been.

9 **Mr. Allen's Embedded Cost of Long-Term Debt**

10 Q. Do you agree with Mr. Allen's exclusion of the Panhandle debt issuances
11 from his embedded cost of long-term debt?

12 A. No. Mr. Allen included the amount of these debt issuances in his capital
13 structure recommendation. However, he excluded them from his embedded cost of
14 long-term debt recommendation. In order to be consistent, if one is going to include the
15 amount of debt in his capital structure recommendation, he should also include the costs
16 associated with this debt in his embedded cost of debt recommendation. Otherwise there
17 is a mismatch in capital structure and the costs associated with that capital structure. The
18 capital structure and operations that allowed Southern Union to be able to refinance the
19 debt at Panhandle at fairly attractive interest rates are the consolidated operations of
20 Southern Union. Therefore, the costs associated with this capital structure should be
21 included in Mr. Allen's recommendation.

22 Q. Other than the inconsistency of including the amount of debt in his capital
23 structure, but not including the costs associated with this debt in his recommended

embedded cost of debt, what other evidence do you have that proves that Southern Union's financing is commingled?

A. I have already explained this in quite a bit of detail in my rebuttal testimony on Mr. Dunn. However, I will reiterate some of these issues to emphasize the fact that there is a blurring of the lines between Southern Union and its subsidiary, Panhandle.

Mr. Allen included the equity units that were sold to fund part of the acquisition of Panhandle in his embedded cost of debt recommendation. The reason these equity units are reflected in his recommended cost of long-term debt is because they are convertible debt and currently have an explicit cost associated with them. According to Southern Union's 2003 Annual Report, the Company was able to achieve net proceeds of $121.3 million from the sale of these equity units. Therefore, Mr. Allen is already including certain securities that are associated with the Panhandle operations in his recommendation.

Additionally, on October 8, 2003, Southern Union completed its offering of its 7.55 percent noncumulative preferred stock. In its prospectus for this offering, Southern Union indicated that it would use the proceeds from this issuance "initially to pay down our long-term credit facility and the balance of the proceeds, if any, to pay down our term loan." The prospectus then indicates that "[a]pproximately 30 days after the closing of this offering, we will use our available cash and reborrow under our credit facilities to redeem in full $100,000,000 principal amount of our 9.48% Subordinated Deferrable Interest Notes, due May 17, 2025…"

1 In its 2003 Annual Report, Southern Union indicated that it would use
2 available working capital to help fund the acquisition of Panhandle. Additionally, in its
3 2003 Annual Report, Southern Union indicates that its long-term credit facility is
4 available for "Southern Union's working capital, letter of credit requirements and other
5 general corporate purposes." Therefore, it appears that the preferred stock offering was
6 also indirectly used to finance the acquisition of Panhandle. This security is also
7 included in Mr. Allen's recommended rate of return for MGE.

8 Q. What other support do you have for including the Panhandle debt in your
9 overall embedded cost of long-term debt recommendation?

10 A. As I stated earlier in my rebuttal testimony on page 10, lines 6 through 16,
11 on June 11, 2003, S&P does not recognize Panhandle as being separate from Southern
12 Union from a creditworthiness perspective. S&P stated that cash can flow freely between
13 Southern Union and its subsidiary, Panhandle. Consequently, it is appropriate to include
14 the cost of debt held at the Panhandle level.

15 Q. Is there any Commission precedent regarding the use of a consolidated
16 capital structure and its associated debt costs?

17 A. Yes, in the most recent fully-litigated UtiliCorp United, Inc.'s (since
18 renamed "Aquila") Missouri Public Service rate case (Case No. ER-97-394), the
19 Commission also adopted Staff's recommended embedded cost of long-term debt which
20 included the debt of all of UtiliCorp's subsidiaries. In the Commission's Report and
21 Order it stated the following:

> 22 The Commission finds the cost of long-term debt, including
> 23 the cost of embedded short-term debt as proposed by Staff,
> 24 to be the most reasonable proposal and will adopt Staff's
> 25 position.

In Case No. ER-97-394, Staff recommended an embedded cost of long-term debt that included all of UtiliCorp's subsidiaries, including its international subsidiaries. Therefore, there is Commission precedent for authorizing both the amount of debt and the cost of debt from a company's subsidiaries for a Missouri utility when that utility is a division of the operating parent.

**Mr. Allen's Cost of Common Equity**

Q. Do you have any concerns with Mr. Allen's discounted cash flow cost of common equity recommendation?

A. No. I am not implying that I agree with his methodology, but because his recommended cost of common equity falls within my range, I am not going to further analyze his position.

Q. Do you have any concerns about Mr. Allen's use of the Capital Asset Pricing Model (CAPM)?

A. Yes. Mr. Allen chose to subtract a current yield, whether it be the 3-month treasury bill, the 10-year treasury bond or the 30-year treasury bond, from a market return of 12.2 percent to arrive at a market risk premium, which is shown on his Schedule TA-9. The fundamental flaw that Mr. Allen made in his calculation of the CAPM is that he used a long-term market return and a current risk-free rate to determine what the market risk premium should be. If Mr. Allen were trying to measure the long-term market risk premium, then he should have subtracted the long-term annual total return of the treasury securities he chose to utilize from the long-term annual market return. When determining the market risk premium it is important to use the same time period for the return on the market and the return on the risk-free rate in order to

1 accurately measure the expected risk premium over time. Anytime one is trying to
2 compare returns for specific securities, it is important to match the time periods used for
3 each security. Otherwise the analyst is mixing and matching different economic and
4 capital market environments. The methodology that I used, in which the risk premium is
5 measured using the historical risk premium between stocks and treasury bonds, is
6 consistent with most of the valuations done in the textbook by Aswath Damodaran,
7 INVESTMENT VALUATION: Tools and Techniques for Determining the Value of *Any*
8 Asset, 1996, which is a textbook used in the curriculum for students seeking the
9 Chartered Financial Analyst (CFA) designation.

10 **Summary and Conclusions**

11 Q. Please summarize the conclusions of your rebuttal testimony.

12 A. My conclusions regarding the capital structure, embedded cost of long-
13 term debt and cost of common equity are listed below.

14 1. The use of the capital structure proposed by MGE is inappropriate.
15 Although he eliminated debt held at Panhandle, Mr. Dunn did not
16 subtract any equity that is associated with Panhandle from his
17 capital structure. Regardless, it is more appropriate to utilize the
18 consolidated capital structure of Southern Union. OPC utilized
19 this capital structure with some minor differences from Staff.
20 However, the calculation of the cost of capital for MGE should be
21 based on Southern Union's actual consolidated capital structure as
22 of December 31, 2003, as shown on my revised Schedule 9
23 attached to this testimony;

1 2. Mr. Allen's use of the consolidated capital structure without the
2 inclusion of the costs of debt associated with this capital structure
3 is inappropriate and inconsistent with Commission precedent. My
4 embedded cost of long-term debt which reflects all of Southern
5 Union's debt is the appropriate cost of debt to utilize in the
6 recommended rate of return.
7 3. My cost of common equity stated in revised Schedule 25 attached
8 to this testimony, which is 8.52 percent to 9.52 percent, would
9 produce a fair and reasonable rate of return of 6.70 percent to
10 6.96 percent for the Missouri jurisdictional natural gas utility rate
11 base for MGE.
12 Q. Does this conclude your rebuttal testimony?
13 A. Yes, it does.

**MISSOURI GAS ENERGY**
**CASE NO. GR-2004-0209**

**Capital Structure as of December 31, 2003**
**for Southern Union Company**

| Capital Component | Amount in Dollars | | Percentage of Capital |
|---|---|---|---|
| Common Stock Equity | $946,502,000 | | 25.91% |
| Preferred Stock | 223,828,509 | | 6.13% |
| Long-Term Debt | 2,216,067,767 | * | 60.66% |
| Short-Term Debt | 266,599,601 | ** | 7.30% |
| **Total Capitalization** | **$3,652,997,877** | | **100.00%** |

**Gas Distribution Financial Ratio Benchmarks**
**Total Debt / Total Capital - Including Preferred Stock**

| Standard & Poor's Corporation's Utility Rating Service, Financial Statistics as of July 7, 2000 (median) | Lower Quartile **BBB** | Median **BBB** | Upper Quartile **BBB** |
|---|---|---|---|
| | 52% | 56% | 61% |

Note: * See Schedule 10 for the amount of Long-Term Debt at December 31, 2003.
**Short-term debt balance equals short-term debt as of December 31, 2003 less Construction Work in Progress (CWIP)

Source: Southern Union Company's response to Staff's Data Request No. 0102.

**MISSOURI GAS ENERGY**
**CASE NO. GR-2004-0209**

## Pro Forma Pre-Tax Interest Coverage Ratios for Southern Union Company

| | 8.52% | 9.02% | 9.52% |
|---|---|---|---|
| 1. Common Equity ( Schedule 10 ) | $946,502,000 | $946,502,000 | $946,502,000 |
| 2. Earnings Allowed ( ROE * [ 1 ] ) | $80,641,970 | $85,374,480 | $90,106,990 |
| 3. Tax Multiplier ( 1 / { 1 - Tax Rate } ) | 1.6231 | 1.6231 | 1.6231 |
| 4. Pre-Tax Earnings ( [ 2 ] * [ 3 ] ) | $130,889,982 | $138,571,319 | $146,252,656 |
| 5. Preferred Dividends | $17,365,000 | $17,365,000 | $17,365,000 |
| 6. Annual Interest Costs ( Schedule 10 & Schedule 12 )* | $143,700,907 | $143,700,907 | $143,700,907 |
| 7. Avail. for Coverage ( [ 4 ] + [ 5 ] + [ 6 ] ) | $291,955,889 | $299,637,226 | $307,318,563 |
| 8. **Pro Forma Pre-Tax Interest Coverage** ( [ 7 ] / [ 6 ] ) | **2.03 x** | **2.09 x** | **2.14 x** |

**Natural Gas Distribution Financial Medians - Pretax Interest Coverage (x)**

| | Lower Quartile | Median | Upper Quartile |
|---|---|---|---|
| Standard & Poor's Corporation's Utility Rating Service as of July 7, 2000 | **BBB** | **BBB** | **BBB** |
| | **1.98** | **2.85** | **3.01** |

Note: * Long-term debt interest expense plus short-term debt interest expense.

**MISSOURI GAS ENERGY**
**CASE NO. GR-2004-0209**

# Weighted Cost of Capital as of December 31, 2003 for Missouri Gas Energy

| | | | Weighted Cost of Capital Using Common Equity Return of: | | |
|---|---|---|---|---|---|
| Capital Component | Percentage of Capital | Embedded Cost | **8.52%** | **9.02%** | **9.52%** |
| Common Stock Equity | 25.91% | ----- | 2.21% | 2.34% | 2.47% |
| Preferred Stock | 6.13% | 7.76% | 0.48% | 0.48% | 0.48% |
| Long-Term Debt | 60.66% | 6.38% | 3.87% | 3.87% | 3.87% |
| Short-Term Debt | 7.30% | 1.89% | 0.14% | 0.14% | 0.14% |
| | **100.00%** | | **6.70%** | **6.83%** | **6.96%** |

Notes:

See Schedule 9 for the Capital Structure Ratios.

See Schedule 10 for the Embedded Cost of Long-Term Debt.

See Schedule 11 for the Embedded Cost of Preferred Stock.

See Schedule 12 for Weighted Average Cost of Short-Term Debt.