Exhibit No.:	
Issue:	Revenue Requirement
Witness:	Michael P. Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Office of the Public Counsel
Case No.:	GR-2014-0007
Date Testimony Prepared:	March 28, 2014

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy, Inc.'s Filing of Revised Tariffs to Increase its Annual Revenues for Natural Gas	))))))	**CASE NO. GR-2014-0007**

Surrebuttal Testimony and Schedules of

Michael P. Gorman

On behalf of

The Office of the Public Counsel

March 28, 2014

BRUBAKER & ASSOCIATES, INC.

Project 9853

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy, Inc.'s Filing of Revised Tariffs to Increase its Annual Revenues for Natural Gas	)	**CASE NO. GR-2014-0007**

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

Affidavit of Michael P. Gorman

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

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

2. Attached hereto and made a part hereof for all purposes are my surrebuttal testimony and schedules which were prepared in written form for introduction into evidence in the Missouri Public Service Commission Case No. GR-2014-0007.

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

Michael P. Gorman

Subscribed and sworn to before me this 28th day of March, 2014.

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2017
Commission # 13706793

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
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Surrebuttal Testimony of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED TESTIMONY IN THIS CASE ON BEHALF OF THE OFFICE OF THE PUBLIC COUNSEL ("OPC")?

A Yes.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to Missouri Gas Energy, Inc. ("MGE" or "Company") rebuttal testimonies offered by witnesses Pauline Ahern and Steven Rasche, and I will also respond to the rebuttal testimony of Missouri Public Service Commission Staff ("Staff") witness Zephania Marevangepo.

Response to MGE Witness Ms. Pauline Ahern

Q AT PAGES 27 AND 28 OF HER TESTIMONY, MS. AHERN MAKES COMMENTS CONCERNING YOUR PROPOSAL TO ADJUST THE CAPITAL STRUCTURE TO REMOVE THE CAPITAL SUPPORTING A GOODWILL ASSET. PLEASE SUMMARIZE THE STATEMENTS MADE BY MS. AHERN.

A She disagrees that it is appropriate to exclude the common equity supporting a goodwill asset from the ratemaking capital structure. Rather, she believes it is appropriate to assume that goodwill is supported by both debt and equity utility capital.

Further, she concurs with Staff's recommendation that Laclede Group's ("LG") consolidated capital structure is fair and reasonable for purposes of setting MGE's rates because it is a market observable capital structure. She believes that because there is no indication that the goodwill on Laclede Gas Company's ("Laclede") balance sheet will be written down or impaired, there is no rationale to eliminate the common equity supporting the goodwill asset from the ratemaking capital structure.

Q PLEASE RESPOND TO MS. AHERN'S COMMENTS CONCERNING CAPITAL STRUCTURE.

A Ms. Ahern's acceptance of Staff's position that the publicly observable capital structure should be used to set rates has no merit. The reason the publicly observable capital structure is not appropriate for ratemaking capital structure in this case is quite simple. The capital structure used to set rates should reflect MGE's actual and reasonable cost of capital incurred to fund rate base investments. Because Laclede's and LG's publicly market observable capital structure includes capital costs that are not used to fund investments in utility rate base, the market

observable capital structure does not accurately measure Laclede's cost of capital supporting its regulated utility.

Laclede's capital structure includes capital supporting a goodwill asset. This goodwill asset is not an investment related to providing utility service. This goodwill asset can only be supported by equity capital, because it is an asset that has no economic value, does not produce cash flows, and cannot support the requirement to pay debt service. Failing to pay debt service will erode the financial integrity of Laclede, and drive up its cost of capital for regulated utility operations.

Further, as described later in this testimony, it is common practice for investors to pay market prices well above book value in acquiring an equity interest in utility companies. The goodwill represents a premium paid by Laclede to MGE shareholders to take control and ownership of MGE's utility assets. This premium equity component of the transaction cost should not be included in Laclede's cost of service for setting retail rates.

Q CAN A GOODWILL ASSET BE FUNDED BY BOTH DEBT AND EQUITY CAPITAL?

A No. Ms. Ahern's contention that a goodwill asset can be supported by both debt and equity capital is erroneous. As outlined in my direct testimony, to which Ms. Ahern did not respond, goodwill cannot be supported by debt capital because it does not produce cash flows and, thus, cannot meet the annual debt service obligation if the goodwill asset were funded in part by debt. Issuing debt requires adequate cash flows to pay the annual debt service on the debt. If the annual debt service is not paid, the debt will go into default. If debt capital was issued to fund goodwill, the goodwill asset would not be capable of supporting the debt service obligations of the

debt used to fund the goodwill asset, and Laclede's financial integrity would be jeopardized.

Further, it would be imprudent for Laclede to have issued debt to fund the acquisition premium. Issuing debt to support an investment that does not produce cash flows and is not capable of servicing the debt, will erode Laclede's financial integrity, increase its financial risk and increase its cost of capital for utility operations. This increased financial risk will result in higher borrowing costs for the utility company simply because Laclede is using debt to fund investments in assets which are not capable of servicing the debt. Such a practice would erode the cash flows available to support the utility's obligations and weaken the utility's credit standing.

Q PLEASE DESCRIBE MS. AHERN'S COMMENTS CONCERNING THE DISCOUNTED CASH FLOW ("DCF") MODEL.

A Ms. Ahern takes issue with the widely accepted perspective that the long-term sustainable growth rate for a company cannot exceed the growth rate in the economy in which that company sells its goods or services.

Ms. Ahern provides two assertions in support of her belief that utility growth can exceed the growth of the U.S. economy. First, she states that growth of the utility sector over the period 2004 through 2012 has exceeded the growth of the U.S. economy. Over this period, Ms. Ahern asserts that the utility industry has grown by 5.79%, whereas nominal U.S. GDP growth has been 4.04%. She cites this as evidence that the utility sector can grow faster than the U.S. economy over a sustained long-term period of time.

Second, she comments on a quote from *Intermediate Financial Management* on the concept of long-term sustainable growth rates and observes that the authors

acknowledged the long-term sustainable growth cannot exceed the nominal growth rate of the U.S. GDP, but noted that the nominal growth rate of the U.S. GDP during the time of the publication ranged from 5% to 8%. From this, she erroneously extrapolates the authors' finding to mean that the long-term sustainable growth rate for utilities can be as high as 8%.

Q IN HER SCHEDULE PMA-11, TO HER REBUTTAL TESTIMONY, DID MS. AHERN PERFORM AN ACCURATE ANALYSIS TO COMPARE THE GROWTH OF THE NOMINAL U.S. GDP AND UTILITY INDUSTRY GROWTH?

A No. There are several fundamental flaws in her analysis. Indeed, the flaws in her analysis are highlighted by her criticism of Staff's use of historical data to develop future risk premium outlooks.

She relied on a short historical time period to draw conclusions about future expected relationships between GDP growth and growth in the utility industry. Using a short time period with actual historic data contradicts her testimony at page 34 where she argues that long periods of historical data are needed to draw accurate expectational conclusions.

Further, the data Ms. Ahern relied on from the Bureau of Economic Analysis ("BEA") is stale. As shown on her Schedule PMA-11, the data she used was revised on April 25, 2013. This data has been updated no less than one time since the published date on her Schedule PMA-11. The most recent revision to this data available from the same source was provided on January 23, 2014, as shown on my Schedule MPG-SR-1.

Q DOES THE USE OF A LONGER HISTORICAL TIME PERIOD SHOW THAT UTILITY STOCK GROWTH HAS EXCEEDED U.S. GDP GROWTH?

A No. As shown on my Schedule MPG-SR-1, I show the longest period of data available from Ms. Ahern's data source, a period stretching over 1997 through the end of 2012. This longer historical period shows that the average annual growth of the U.S. economy (4.32%) is greater than the average annual growth of the utility industry (3.18%).

Q WHY IS MS. AHERN'S ANALYSIS OF HISTORICAL GDP AND UTILITY GROWTH FLAWED?

A Ms. Ahern's use of a very short historical time period produced an erroneous result because it is severely impacted by an outlier, or anomalous year, in her short time period study. This is precisely why Ibbotson Associates recommends, and Ms. Ahern supportively points to several times in her testimony, the need for a long historical time period in reviewing actual achieved returns in order to derive meaningful and reliable outlooks for future expectations.

The short time period relied on by Ms. Ahern reflected a significant increase in the annual growth in the utility industry of 14.20% in 2006. That year the GDP growth was 5.82%. The annual return in the utility industry is an anomalous result as clearly shown by a review of the annual growth for all other years in her study. The anomalous results produced in this one year of Ms. Ahern's studies explains why her study produces a false result.

The 2006 result is clearly an anomalous result as the utility industry did not exceed a growth rate higher than 4.42% for any rolling 10-year period throughout the time analyzed on my Schedule MPG-SR-1.

Further, Ms. Ahern knows that the accepted practice for use of historical period actual results requires long periods to smooth out these anomalous years' influence on the study period result. Specifically, she quotes Ibbotson Associates' book which outlines (Rebuttal at 32) the reasons why long time periods are necessary when using actual achieved investment returns to draw meaningful conclusions about future growth or investment returns.

Moreover, using Ibbotson's long historical time period data, as I described at page 26 of my direct testimony, the growth of the U.S. stock market over the period 1929 – 2013 did trail the growth of the U.S. GDP. Further, if you use all of the data available in the data source relied on by Ms. Ahern, the growth of the U.S. GDP over the period 1997 through 2012 averaged 4.32%, and the growth of the utility industry was 3.18%. This data was available to Ms. Ahern but for some reason she chose not to use it. In any event, historical data does support the conclusion that the U.S. stock market, U.S. utilities' growth, trail the growth of the U.S. GDP.

Q PLEASE RESPOND TO MS. AHERN'S CLAIM THAT THE INTERMEDIATE FINANCIAL MANAGEMENT TEXTBOOK CONCLUDES THAT IT IS REASONABLE TO EXPECT LONG-TERM SUSTAINABLE GROWTH TO BE IN THE RANGE OF 5% TO 8%.

A Ms. Ahern misquotes the textbook. As quoted at page 30 of her testimony, the authors state that future dividend growth can sustain a growth level equal to the "nominal" growth of the U.S. GDP. In the past, specifically during the 1970s-1980s, the U.S. economy's nominal GDP growth was in the range of 5% to 8%. This supports the author's finding of what the range in GDP growth has been. However, current outlooks for future U.S. nominal GDP growth are less than 5%.

This decline in U.S. GDP growth is largely attributable to a reduction in inflation outlooks. In any event, the consensus of economists is projecting U.S. GDP growth to be under 5% now and into the future.

The cited textbook supports the use of GDP growth as an estimate of a mature or sustainable long-term growth rate. Ms. Ahern's claim that the authors have endorsed an 8% growth rate as a reasonable long-term sustainable growth rate is simply in direct contradiction to the clear language of the authors' text, and is an erroneous assertion.

Q AT PAGE 31 OF MS. AHERN'S TESTIMONY, SHE DISPUTES YOUR TESTIMONY THAT NOMINAL GDP GROWTH IS A CONSERVATIVE PROXY FOR UTILITY SALES GROWTH, RATE BASE GROWTH AND EARNINGS GROWTH. PLEASE COMMENT.

A The reference in the testimony is in response to an analysis that describes utilities' need to make capital investments in order to meet demands by customers for more utility service. In effect, utilities do not make investments in utility plant and equipment in a haphazard and unexplainable manner. Rather, utilities make investments in plant and equipment in order to meet growth in customer demand, and to maintain high quality and reliable utility service. Utilities' earnings grow in proportion to their growth in rate base. Rate base grows in proportion to utility customers' demands for service. Customer demand for service grows in proportion to the economy in which they operate, as measured by the U.S. GDP. As such, there is a strong correlation between U.S. GDP growth and utilities' earnings growth. This phenomenon is widely recognized within the utility industry, and is an appropriate benchmark.

Q DOES MS. AHERN TAKE ISSUE WITH YOUR RISK PREMIUM STUDY?

A She makes several criticisms of my risk premium study including the following:

1. The time period of 1986 through September 2013 is too short a time period.

2. The data should have been adjusted to reflect an inverse relationship between interest rates and equity risk premiums.

Q DID YOU RESPOND TO THE LENGTH OF THE TIME PERIOD USED IN YOUR RISK PREMIUM STUDY?

A Yes. In my direct testimony at pages 31-32, I commented on the appropriateness of the time period used in my study, but Ms. Ahern failed to acknowledge or respond to this testimony. In that testimony, I explained that there are two types of equity risk premium studies. First, there are risk premium studies based on actual realized historical investment returns, which is the risk premium study used in the Ibbotson reference book cited by Ms. Ahern. Second, an expectational equity risk premium study, which is the study I offered, estimates a risk premium based on expected returns, which are derived from shorter periods of time.

An equity risk premium based on historic actual realized investment returns typically requires a very long time period of return data to smooth out annual variations in the return data. This allows for the development of a reasonable forward-looking equity risk premium estimate. I did not perform a historic return risk premium analysis. This is the type of risk premium analysis used and described by the Ibbotson source as cited by Ms. Ahern, but it does not relate to my study.

My expectational risk premium study was based on a shorter time period, which is generally consistent with expectational risk premium studies. Indeed, one of the sources referenced by Ms. Ahern recognizes the two types of risk premium studies I just described. In his textbook *New Regulatory Finance*, Dr. Roger Morin

finds that historical risk premium studies require long-term time periods in order to produce reliable estimates of forward-looking expectations. However, Dr. Morin also recognizes that expectational risk premium studies can be performed on relatively short time periods.[1]

Ms. Ahern's testimony in this regard simply is inaccurate because she fails to recognize different types of equity risk premium studies, and fails to differentiate the proper constructs of a risk premium study.

Q DO YOU BELIEVE MS. AHERN'S PROPOSAL TO ADJUST YOUR EQUITY RISK PREMIUM FOR AN INVERSE RELATIONSHIP BETWEEN INTEREST RATES AND EQUITY RISK PREMIUMS IS REASONABLE?

A No. Academic literature has supported the notion that equity risk premiums change over time, and largely relate to the difference in investment risk of an equity versus a debt security. Indeed, Ms. Ahern's own PRPM™ study attempts to measure an equity risk premium relative to differences in investment risk by measuring the variability of historical achieved returns. Albeit, her study is flawed because she failed to reflect the true investment return variability and risk of bond investments in her study.

While changes in interest rates is a factor that can help describe an appropriate equity risk premium, it is not the only risk factor that can change the relative risk differentials between equity and debt securities. Therefore, Ms. Ahern's proposal to measure an equity risk premium based on only changes in nominal interest rates is not accurate and does not produce a useful or accurate estimate of a fair return for MGE.

[1] *New Regulatory Finance,* Roger A. Morin, PhD, 2006 Public Utilities Reports, Inc., Vienna, Virginia, at 110-123.

Q CAN YOU PROVIDE AN EXAMPLE OF WHY CHANGES IN NOMINAL INTEREST RATES MAY NOT BE THE ONLY FACTOR THAT TRANSLATES INTO CHANGES IN EQUITY RISK PREMIUMS?

A Yes. One factor can be simply a change in outlook for inflation expectations. If everything else is held constant, and inflation outlooks are changed from 4% down to 3%, then the 1 percentage point decline in inflation outlooks would cause a decrease in the equity and debt security in a comparable manner if a long-term debt instrument is used in risk premium measurement. Specifically, equity and debt required returns are composed of: (1) a real return, and (2) an inflation return. If the real return components of the equity and debt required return are left unchanged because risks did not change, and inflation outlook rates declined by 1 percentage point, then the equity risk premium would not change even though the expected return on equity and debt securities declined by 1 percentage point.

In this case, the equity risk premium would stay the same, but Ms. Ahern's flawed inverse relationship regression study would suggest that the equity risk premium would increase only because nominal interest rates had declined. Ms. Ahern's inverse relationship method is too simplistic, and does not consider changes in investment risk which is the critical factor in measuring risk premiums.

Q DID MS. AHERN HAVE ANY COMMENTS CONCERNING YOUR CAPITAL ASSET PRICING MODEL ("CAPM")?

A Yes. Here again, she proposes to use her PRPM™ analysis to inflate the market risk premium used in this study. Her PRPM™ analysis is highly unreliable and does not measure an accurate rate of return. All this was addressed in my rebuttal testimony

at pages 6-11. For all these reasons, her comments concerning my CAPM analysis should be disregarded as inaccurate and biased.

Q DO YOU HAVE ANY ADDITIONAL CONCERNS OF MS. AHERN'S PRPM™ IN ADDITION TO THOSE DESCRIBED IN REBUTTAL TESTIMONY?

A Yes. Another problem with her PRPM™ methodology is the PRPM™ analysis compensates investors for nonsystematic risk. Nonsystematic risk is also known as diversifiable risk. The PRPM™ analysis producing a return that compensates for nonsystematic risk means that it produces a return that compensates for risk that can be eliminated by efficient investment management.

In an efficient market, customers would not receive compensation for risks that can be diversified away by efficient investment management. Nonsystematic risk is a diversifiable risk. As such, the PRPM™ analysis produces an excessive rate of return because it includes compensation for both systematic risk and nonsystematic risk.

It is evident that the PRPM™ return is excessive, as Ms. Ahern herself acknowledges that the PRPM™ analysis consistently produced return estimates in excess of those found to be reasonable from DCF and traditional risk premium studies.

Q WHAT EVIDENCE DO YOU HAVE TO SUPPORT THAT MS. AHERN'S PRPM™ ANALYSIS INCLUDES NONSYSTEMATIC RISK?

A In response to OPC Data Request 5023, Ms. Ahern provided as an attachment, an article that Ms. Ahern co-authored from *The Electricity Journal* that was published in May 2013. On page 5 of the attachment (page 88 of *The Electricity Journal*), the

authors explain that "[…] the PRPM produces a higher average indicated ROE than both the DCF and CAPM. This is due to the fact that the PRPM prices *all* of the risk that investors actually face collectively. In contrast, the CAPM prices systematic risk (that investors face only if they have a perfectly diversified portfolio, which does not exist) and the DCF uses accounting-based, not market-based, I/B/E/S consensus five-year projected EPS growth rates."

Again, this results in an excessive return on equity because it provides a return that compensates investors for both unavoidable risk (systematic) and avoidable risk (nonsystematic). Investors should not be compensated for risk that can be eliminated through efficient investment management, that eliminates some risk via market actions such as diversification.

Q DOES MS. AHERN RESPOND TO YOUR CRITICISMS OF HER ECAPM ANALYSIS?

A Yes. She quotes the Dr. Roger Morin textbook which asserts that an ECAPM analysis adjusts the CAPM results for something other than an adjusted beta result. However, I've been in regulatory proceedings with Dr. Morin, and he has failed to provide any academic support for the assertions contained in his textbook. Further, Ms. Ahern provided no academic literature subject to academic peer review that supports her development of an ECAPM study using adjusted utility betas.

Further, Dr. Morin's assertion that an ECAPM analysis adjusted CAPM results differently than adjusted betas simply lacks mathematical merit. Mathematical makeup of an ECAPM analysis with unadjusted betas, produces a similar impact on the security market line and the resulting CAPM return estimate as using a traditional CAPM analysis using the *Value Line* adjusted betas. Indeed, comparison is made of

the implied ECAPM beta estimate, versus traditional *Value Line* beta estimates on my Schedule MPG-SR-2, for the proxy group companies. The suggestion that ECAPM is a different adjustment to the CAPM results, simply defies mathematical reality.

I would also note, that Ms. Ahern's quotation of Dr. Morin is not her reliance on independent academic literature on this issue. Rather, Ms. Ahern and Dr. Morin are both utility rate of return witnesses. The articles she is quoting are from utility trade organizations, or a book designed to describe a utility rate of return witness's perspective on estimating a return on equity for a utility. There has been no proof that the academic community accepts Dr. Morin's notion that an ECAPM with an adjusted beta produces a reliable estimate of a fair return for a company. Therefore, this methodology should be disregarded as unaccepted by independent authoritative sources.

For these reasons, Ms. Ahern's ECAPM analysis is fundamentally flawed because it includes adjusted betas rather than raw betas, and produces an inflated return on equity estimate.

Response to MGE Witness Steven Rasche

Q PLEASE DESCRIBE THE ISSUES YOU WILL RESPOND TO CONCERNING MR. RASCHE'S TESTIMONY.

A Mr. Rasche responds to my proposed capital structure adjustment by removing the common equity supporting the Company's goodwill asset. In opposition to this adjustment, Mr. Rasche asserts the following:

1. By removing the common equity supporting goodwill from Laclede's capital structure, the capital structure is turned on its head – i.e., the equity ratio decreases from 54% to 45%, and the debt ratio increases from 46% up to 55%.

2. This adjustment is an artificial and obvious attempt to reduce rates below the level that would have been paid had the Company not paid an acquisition premium and recorded a goodwill asset.

3. This adjustment is flatly inconsistent with the Stipulation and Agreement in MGE's acquisition case that says the acquisition premium is to have no impact on rates.

4. The adjustment is fundamentally flawed because it is a mistaken assumption that debt is supported by only MGE's hard assets, and equity investors are satisfied with investing in goodwill.

5. He believes that if my recommendation is adopted, that it would make access to capital more difficult for Laclede and at a higher cost.

Also, at page 9 of his testimony, Mr. Rasche stated that the Company anticipated that normal ratemaking actions would be used to assure that no recovery of the acquisition premium would be included in rates, and that he believes that my adjustment is inconsistent with these normal ratemaking treatments.

Q PLEASE RESPOND TO MR. RASCHE'S ASSERTION THAT REMOVING THE COMMON EQUITY SUPPORTING THE GOODWILL ASSET FOR THE RATEMAKING CAPITAL STRUCTURE TURNS LACLEDE'S ACTUAL CAPITAL STRUCTURE UPON ITS HEAD.

A The objective of removing the capital supporting the goodwill asset from Laclede's capital structure is to identify the ratemaking capital structure or capital cost that is incurred on Laclede's regulated rate base. To the extent this adjustment has a significant impact on Laclede's capital structure weights, then those changes are legitimate and necessary to accurately measure the cost of capital Laclede is incurring on its utility rate base.

Q PLEASE DESCRIBE WHY YOU BELIEVE IT IS APPROPRIATE TO EXCLUDE COMMON EQUITY CAPITAL IN REMOVING THE CAPITAL SUPPORTING THE GOODWILL ASSET.

A As described above, goodwill is an asset that is recorded only because of the acquisition accounting method chosen by Laclede. Goodwill is a paper asset that has no economic value because it does not produce cash flows. Goodwill simply represents the difference between the book value for MGE assets and the acquisition price Laclede paid for MGE's assets.

When Laclede bought MGE, it substituted its capital (including assumed debt) for MGE's rate base capital plus the acquisition required Laclede to fund the premium it paid to MGE's shareholders to take control of MGE's rate base.

The premium payment by Laclede to MGE represented a transaction between Laclede shareholders and MGE's shareholders. The capital used to fund this premium payment was not capital that was directly used by either Laclede or MGE to invest in utility plant and equipment. Rather, it, again, represents a payment for consideration of changing control of MGE's assets to Laclede shareholders from MGE shareholders.

This funding for the premium Laclede shareholders paid to MGE's shareholders cannot be supported by debt, because the premium or goodwill asset is a paper asset with no economic value that produces no cash flows and cannot support an annual debt service obligation. This premium or goodwill asset was funded entirely by equity capital from Laclede shareholders that was paid to MGE shareholders to take control and ownership of MGE's rate base.

Moreover, the acquisition price should be considered in essentially two tranches. First, Laclede issued capital or assumed MGE debt that reflects capital

used to invest in MGE's utility plant and equipment. Second, the premium portion of the acquisition price represents a transaction between Laclede shareholders and MGE shareholders. This premium capital was not used to invest in utility plant and equipment, but rather was consideration paid by Laclede shareholders to MGE shareholders to take ownership and control of MGE's assets. This change in control, or acquisition premium, should reflect a direct transaction of equity capital from Laclede shareholders to MGE shareholders. The cost of this equity share transaction is not a cost of capital related to funding utility plant investments.

Q MR. RASCHE ASSERTS THAT IT IS UNREASONABLE TO ASSUME THAT INVESTORS WOULD USE EQUITY CAPITAL ALONE TO FUND THE ACQUISITION PREMIUM. PLEASE RESPOND.

A He is wrong. It is common practice for utility stock investors to pay a premium to the underlying book value of a utility stock in order to take an equity interest in a utility company. This is evident by a comparison of the stock market price of utility stock shares compared to the underlying book value of the same company's stock shares.

For example, an investor that purchases the stock of LG will pay a market price of $45.17/share as quoted in the most recent *Value Line Investment Survey*.[2] In that same *Value Line* report, the book values for 2013 and 2014 for LG are noted at $32.70/share and $33.30/share, respectively. The premium between the market price and the book value of the assets that stock investors are willing to pay to take a share ownership of LG will not be included in the utility's cost of service. Rather, shareholders are willing to pay this market value premium for a share of LG's stock,

[2] *Value Line Investment Survey*, March 7, 2014.

because the underlying cash flows and earnings of the Company justify the market price.

Similarly, Laclede shareholders were willing to pay a premium to MGE's asset value in this arms length transaction. That premium is equity consideration between the Laclede shareholders and MGE's shareholders, to allow Laclede to take ownership of the MGE assets and receive the earnings and cash flows produced through MGE's rate base and utility operations. Hence, Laclede's willingness to pay a control premium to MGE's shareholders is the same as normal stock market transactions where utility investors routinely pay a premium to the underlying book value of utility stock because the utility cash flows and earnings from utility operations support the transaction or market price.

Q HAS LACLEDE RECOGNIZED THAT IT IS COMMON FOR UTILITY STOCK INVESTORS TO PAY A PREMIUM OVER THE UNDERLYING BOOK VALUE OF UTILITY SHARES?

A Yes. Laclede witness Ahern recognized that a market to book ratio premium is normal in the utility industry (Ahern Rebuttal Testimony at 33-34). Utility equity investors routinely pay a market price premium to the underlying book value of the utility equity shares. Laclede's proposed ratemaking treatment of the equity capital supporting the goodwill asset gives itself better cost recovery treatment of the market price premium relative to all other utility investors.

Q MR. RASCHE ALSO ASSERTS THAT NORMAL RATEMAKING TREATMENT SHOULD BE USED IN SETTING LACLEDE'S COST OF SERVICE, INCLUDING ADJUSTING ITS CAPITAL STRUCTURE OR REFLECTING ITS ACTUAL CAPITAL STRUCTURE. IS IT NORMAL TO ALLOW UTILITIES WITH SIGNIFICANT GOODWILL CAPITAL, TO SET RATEMAKING RATES OF RETURN WITHOUT ADJUSTING FOR THE GOODWILL ASSET?

A No. For utilities with small amounts of goodwill, I do not believe there is a standard practice on whether or not the capital structure is adjusted to reflect the goodwill assets. However, for utilities that have significant goodwill assets, like Laclede does now that it has acquired MGE, it is my experience that regulatory commissions typically do adjust the ratemaking capital structure and do not merely use the market observable capital structure in setting rates.

For example, the capital structure adjustment I am proposing here, to determine the appropriate regulatory capital structure that measures the utility's cost of capital supporting its utility plant and equipment, is required by electric utilities in Illinois[3] and is common policy and practice in New York.[4]

[3]Illinois Public Act 098-0015, (220 ILCS 5/4-301) (from Ch. 111 2/3, par. 4-301), Sec. 4-301.

[4]New York State Public Service Commission, Case 07-M-0906, Iberdrola, S.A.; Energy East Corporation; RGS Energy Group, Inc.; Green Acquisition Capital, Inc.; New York State Electric & Gas Corporation; and Rochester Gas and Electric Corporation, Order Authorizing Acquisition Subject to Conditions, Appendix 1, page 1; January 6, 2009; and Case 12-M-0192, Fortis Inc. et al. and CH Energy Group, Inc. et al., Order Authorizing Acquisition Subject to Conditions, Terms of Commission Approval, page 3, June 26, 2013.

Q DO YOU BELIEVE YOUR PROPOSED ADJUSTMENT MAY LIMIT LACLEDE'S ABILITY TO ACCESS CAPITAL UNDER REASONABLE TERMS AND CONDITIONS?

A No. Mr. Rasche has not provided any explanation for this assertion, so it is not possible to respond to his position.

However, Laclede's bond rating from Standard & Poor's ("S&P") has already been downgraded, in part, because of increased leverage realized at Laclede as a result of its funding structure for MGE. Further, increased leverage risk has been noted by Moody's, and S&P in recent credit reports for Laclede. (Gorman Rebuttal Testimony at 22).

To the extent Laclede's funding structure of its acquisition of MGE is causing increased leverage which will reduce its bond rating to below a reasonable level, and does have a material increase on its cost of capital, then it is up to Laclede to take actions to modify its capital structure supporting its utility rate base investments to offset this credit erosion. Ratepayers should not be obligated to fix a problem created by Laclede's management, which can be cured by utility management.

Q MR. RASCHE ALSO ASSERTS THAT YOUR ADJUSTMENT TO THE CAPITAL STRUCTURE TO REMOVE THE COMMON EQUITY SUPPORTING GOODWILL IS INCONSISTENT WITH THE SETTLEMENT AGREEMENT FOR LACLEDE'S ACQUISITION OF MGE. PLEASE RESPOND.

A Mr. Rasche's assertion is incorrect. In the settlement agreement, all parties agreed that the cost associated with the acquisition premium would not be included in

Laclede's cost of service, and that the acquisition premium would not be recovered, directly or indirectly, in rates.[5]

This includes the asset-related cost or acquisition premium, which will not be included in rate base, and will not be amortized in cost of service. However, acquisition cost also includes the capital cost associated with the goodwill asset. The cost of the goodwill asset is in many respects the same as the cost of Laclede's rate base investment. These costs include depreciation expenses, amortization expense, income tax expense, and cost of capital supporting the investments. Therefore, the total costs associated with goodwill include an amortization expense, tax-related expenses, and the cost of capital of the goodwill assets. All of these costs must be removed from Laclede's cost of service.

My adjustment to the capital structure removes the goodwill asset cost of capital from Laclede's regulated cost of service. Therefore, my capital structure adjustment accomplishes the objective of removing the goodwill capital cost from Laclede's regulated cost of service. This is fully consistent with the terms of the merger settlement. For all these reasons, Mr. Rasche's claim that the goodwill adjustment to the capital structure is inconsistent with the settlement agreement is an incorrect assertion.

[5]Public Service Commission of Missouri, Case No. GM-2013-0254, Stipulation and Agreement, page 8, Section 3, Premium and Acquisition Costs, July 2, 2013, emphasis added.

Response to Staff Witness Zephania Marevangepo

Q DO YOU HAVE ANY COMMENTS CONCERNING THE REBUTTAL TESTIMONY OF STAFF WITNESS MAREVANGEPO?

A Yes. At page 14 of his rebuttal testimony, Mr. Marevangepo "understands and acknowledges the reasoning behind [my] capital structure recommendation," and even goes on to state that "[My] approach is acceptable based on its own merits." However, Mr. Marevangepo continues to propose to set the overall rate of return in this proceeding using LG's consolidated capital structure composed of 53.08% common equity and 46.92% long-term debt based on the September 30, 2013 recording date based on Laclede's publically available capital structure.

Q DO YOU BELIEVE STAFF'S PROPOSED CAPITAL STRUCTURE IS APPROPRIATE FOR SETTING REGULATED UTILITY RATES IN THIS PROCEEDING?

A No. I believe that LG's publically available capital structure is not a reasonable estimate of Laclede's actual cost of capital supporting its regulated utility operations. More details underlying this assertion are described above in my response to Laclede witness Ms. Ahern.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

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Missouri Gas Energy

Value Added by Industry
[Billions of dollars]
Bureau of Economic Analysis
Release Date: January 23, 2014

Line		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	15-Year Arithmetic Average	15-Year Geometric Average	2004-2012 Arithmetic Average	2004-2012 Geometric Average	2011-2012
1	**Gross domestic product**	8608.5	9089.1	9665.7	10289.7	10625.3	10980.2	11512.2	12277	13095.4	13857.9	14480.3	14720.3	14417.9	14958.3	15533.8	16244.6					
2	**Annual Change - %**		5.58%	6.34%	6.46%	3.26%	3.34%	4.85%	6.64%	6.67%	5.82%	4.49%	1.66%	-2.05%	3.75%	3.85%	4.58%	4.35%	4.32%	3.59%	3.56%	4.58%
3	**Utilities**	172.1	163.9	180.2	180.3	184.1	180.2	187.1	202.7	201.4	230	235.1	240.1	253.7	272.8	280	275.1					
4	**Annual Change - %**		-4.76%	9.95%	0.06%	2.11%	-2.12%	3.83%	8.34%	-0.64%	14.20%	2.22%	2.13%	5.66%	7.53%	2.64%	-1.75%	3.29%	3.18%	4.00%	3.89%	-1.75%

Rolling 5-Year Average Growth

Gross domestic product											
Arithmetic Mean	5.00%	4.85%	4.91%	4.95%	5.46%	5.69%	5.06%	3.32%	2.73%	2.34%	2.35%
Geometric Mean	4.99%	4.84%	4.90%	4.94%	5.46%	5.69%	5.04%	3.27%	2.70%	2.31%	2.33%
Utilities											
Arithmetic Mean	1.05%	2.76%	2.44%	2.30%	4.72%	5.59%	5.25%	4.71%	6.35%	4.04%	3.24%
Geometric Mean	0.92%	2.68%	2.38%	2.24%	4.55%	5.46%	5.11%	4.59%	6.26%	4.01%	3.19%

Rolling 10-Year Average Growth

Gross domestic product						
Arithmetic Mean	5.35%	4.95%	4.11%	3.84%	3.90%	4.02%
Geometric Mean	5.34%	4.94%	4.08%	3.81%	3.87%	3.99%
Utilities						
Arithmetic Mean	3.32%	4.01%	3.58%	4.33%	4.38%	4.42%
Geometric Mean	3.17%	3.89%	3.48%	4.23%	4.28%	4.32%

Figures from Schedule PMA-11: As of April 25, 2013

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2004-2012 Arith.Mean	2004-2012 Geo. Mean
Gross domestic product	11853.3	12623	13377.2	14028.7	14291.5	13973.7	14498.9	15075.7	15684.8		
Annual Change - %		6.49%	5.97%	4.87%	1.87%	-2.22%	3.76%	3.98%	4.04%	3.60%	3.56%
Utilities	208	205.9	236	248.6	257.7	264.7	284.5	297.9	304.3		
Annual Change - %		-1.01%	14.62%	5.34%	3.66%	2.72%	7.48%	4.71%	2.15%	4.96%	4.87%

Missouri Gas Energy

Variations of the CAPM

Line	Company	Implied Raw Beta[1] (1)	Corrected ECAPM Adjusted Beta[1] (2)	Value Line Adjusted Beta[1] (3)	Ms. Ahern's Adjusted Beta[1] (4)	Ms. Ahern's Market Risk Premium[2,a] (5)	Risk Free Rate[2] (6)	CAPM Results: Implied Raw Beta (7)	CAPM Results: Corrected ECAPM Beta (8)	CAPM Results: Value Line Adjusted Beta (9)	CAPM Results: Ms. Ahern's Adjusted Beta (10)
1	AGL Resources, Inc.	0.60	0.70	0.75	0.81	7.18%	4.40%	8.69%	9.41%	9.79%	10.23%
2	Atmos Energy Corporation	0.67	0.75	0.80	0.85	7.18%	4.40%	9.22%	9.81%	10.14%	10.50%
3	New Jersey Resources Corporation	0.52	0.64	0.70	0.78	7.18%	4.40%	8.15%	9.01%	9.43%	9.96%
4	Northwest Natural Gas Company	0.45	0.59	0.65	0.74	7.18%	4.40%	7.61%	8.61%	9.07%	9.70%
5	Piedmont Natural Gas Co., Inc.	0.60	0.70	0.75	0.81	7.18%	4.40%	8.69%	9.41%	9.79%	10.23%
6	South Jersey Industries, Inc.	0.52	0.64	0.70	0.78	7.18%	4.40%	8.15%	9.01%	9.43%	9.96%
7	Southwest Gas Corporation	0.67	0.75	0.80	0.85	7.18%	4.40%	9.22%	9.81%	10.14%	10.50%
8	WGL Holdings, Inc.	0.45	0.59	0.65	0.74	7.18%	4.40%	7.61%	8.61%	9.07%	9.70%
9	**Average**	**0.56**	**0.67**	**0.73**	**0.79**			**8.42%**	**9.21%**	**9.61%**	**10.10%**

Source & Note:

[1] Schedule MPG-SR-2, page 2.

[2] Schedule PMA-20.

[a] The use of Ms. Ahern's risk premium on this schedule does not imply my acceptance of it. Rather, this is to illustrate her misuse of adjusted betas to develop an ECAPM analysis.

Missouri Gas Energy

Beta Calculations

Line	Company	Value Line Adjusted Beta[1] (1)	Value Line's Adjustment to Market Beta (2)	Value Line's Adjustment to Company Beta (3)	Implied Raw Beta [a] (4) = [(1) - (2)] / (3)
1	AGL Resources, Inc.	0.75	0.35	0.67	0.60
2	Atmos Energy Corporation	0.80	0.35	0.67	0.67
3	New Jersey Resources Corporation	0.70	0.35	0.67	0.52
4	Northwest Natural Gas Company	0.65	0.35	0.67	0.45
5	Piedmont Natural Gas Co., Inc.	0.75	0.35	0.67	0.60
6	South Jersey Industries, Inc.	0.70	0.35	0.67	0.52
7	Southwest Gas Corporation	0.80	0.35	0.67	0.67
8	WGL Holdings, Inc.	0.65	0.35	0.67	0.45
9	**Average**	**0.73**			**0.56**

Line	Company	Implied Raw Beta (1)	ECAPM Adjustment to Market Beta (2)	ECAPM Adjustment to Company Beta (3)	Corrected ECAPM Adjusted Beta (4) = (2) + (1)*(3)
10	AGL Resources, Inc.	0.60	0.25	0.75	0.70
11	Atmos Energy Corporation	0.67	0.25	0.75	0.75
12	New Jersey Resources Corporation	0.52	0.25	0.75	0.64
13	Northwest Natural Gas Company	0.45	0.25	0.75	0.59
14	Piedmont Natural Gas Co., Inc.	0.60	0.25	0.75	0.70
15	South Jersey Industries, Inc.	0.52	0.25	0.75	0.64
16	Southwest Gas Corporation	0.67	0.25	0.75	0.75
17	WGL Holdings, Inc.	0.45	0.25	0.75	0.59
18	**Average**	**0.56**			**0.67**

Line	Company	Value Line Adjusted Beta (1)	Ms. Ahern's Adjustment to Market Beta (2)	Ms. Ahern's Adjustment to Company Beta (3)	Ms. Ahern's Adjusted Adjusted Beta (4) = (2) + (1)*(3)
19	AGL Resources, Inc.	0.75	0.25	0.75	0.81
20	Atmos Energy Corporation	0.80	0.25	0.75	0.85
21	New Jersey Resources Corporation	0.70	0.25	0.75	0.78
22	Northwest Natural Gas Company	0.65	0.25	0.75	0.74
23	Piedmont Natural Gas Co., Inc.	0.75	0.25	0.75	0.81
24	South Jersey Industries, Inc.	0.70	0.25	0.75	0.78
25	Southwest Gas Corporation	0.80	0.25	0.75	0.85
26	WGL Holdings, Inc.	0.65	0.25	0.75	0.74
27	**Average**	**0.73**			**0.79**

Source & Notes:

[1] Schedule PMA-20.

[a] Value Line's adjusted beta is calculated by adjusting a company's raw beta by:
Adjusted *Bi* =0.35 + .67**Bi.*
This can be rewritten as: *Bi* = [Adjusted *Bi* - .35] / .67
where *Bi* = Company's Raw Beta.