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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

MISSOURI GAS ENERGY,
a Division of Southern Union Company

CASE NO. GR-2009-0355

Jefferson City, Missouri
October 2009

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SURREBUTTAL TESTIMONY

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Q. Please state your name.

A. My name is David Murray.

Q. Are you the same David Murray who prepared the Rate of Return Section of the Staff's Cost of Service Report and rebuttal testimony in this case?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Mr. Frank J. Hanley. I will address appropriate costs of common equity, short-term debt, and long-term debt. I will also address my recommendation regarding a possible true-up in this case.

Q. Did Mr. Hanley's rebuttal testimony address any changes/updates to his original position in his direct testimony?

A. Yes. Mr. Hanley decided to update his cost of common equity analysis and is now recommending a 10.50 percent return on equity ("ROE") compared to his original recommendation of 11.25 percent. Mr. Hanley also updated his estimated cost of short-term debt from 4.92 percent in his direct testimony to 4.367 percent in is rebuttal testimony. However, Mr. Hanley did not update his proxy group's cost of long-term debt or the proxy group's capital structure.

EXECUTIVE SUMMARY OF SURREBUTTAL TESTIMONY

Q. Can you please summarize the main issues you will address in your surrebuttal testimony?

A. Yes. Mr. Hanley claims that my recommended cost of equity is not consistent with the financial literature and the Efficient Market Hypothesis ("EMH") because I relied primarily on the DCF methodology to estimate the cost of common equity. Apparently, Mr. Hanley believes that because he performed a risk premium analysis and a CAPM analysis based on his own inflated expected market returns, this makes his recommendation more reliable and consistent with the EMH. If Mr. Hanley had used expected market returns consistent with those used by individuals in the investment field, then I think his argument would have more merit. Of course, if he had used this type of information, then his estimated cost of common equity would have been much lower. It is not the number of methods or the number of calculations that makes an estimate reliable; it is the reasonableness of the inputs used in the methods that make them reliable.

Mr. Hanley also criticizes my decision to recommend the lower half of my proxy group estimated cost of common equity range because of MGE's straight fixed variable ("SFV") rate design and the fact that the comparable natural gas distribution companies have non-regulated operations. Mr. Hanley provides data on percentage of net income and percentage of assets attributed to regulated operations to attempt to support his position. Staff finds this argument interesting considering Mr. Hanley's contention in his direct testimony that 84.5 percent of his comparable companies' revenues were received from partially or fully decoupled rate designs. Mr. Hanley used this information to support his decision to not make a downward adjustment to his cost of common equity. Because

Mr. Hanley did not discuss the interaction of both decoupled regulated revenues and non-regulated net income and assets, Staff is not certain that the outcome of any of these calculations would have caused Mr. Hanley to ever consider making a downward adjustment.

Mr. Hanley also believes my recommended cost of short-term debt is grossly understated. Mr. Hanley relied on information provided to Southern Union in relation to Southern Union's negotiation for a two-year term loan. It is inappropriate for Mr. Hanley to rely solely on this information considering he has proposed a hypothetical approach in this case that relies on the proxy group's average capital structure and the costs of capital associated with the capital components in the proxy group capital structure. It doesn't appear that Mr. Hanley even attempted to investigate the cost of short-term debt for any of his proxy companies. This is not consistent with his proposed approach in this case. Staff discovered that most of the comparable companies selected by Mr. Hanley issue commercial paper and do so at a fairly low cost. This should be reflected in MGE's authorized ROR.

Finally, although Mr. Hanley updated his estimated cost of common equity and cost of short-term debt, he did not update the embedded cost of long-term debt or the capital structure. Although it is common practice to update the capital structure and the embedded costs without updating the cost of common equity, it is not common practice to update the cost of common equity and other capital costs, without updating the other capital components. Consequently, while Staff does not object to Mr. Hanley's proposed update of the cost of equity and short-term debt, Staff does object to not updating the other components.

COST OF COMMON EQUITY

Q. On page 38, line 18 through page 39, line 7 of his rebuttal testimony, Mr. Hanley claims that you should not have relied exclusively on the DCF method to estimate MGE's cost of common equity. Did you rely exclusively on the DCF model in determining a reasonable recommended ROE in this case?

A. No. I performed a CAPM to test the reasonableness of my recommended ROE along with several other sources of information that corroborate the reasonableness of my recommended ROE.

Q. If you had mindlessly used your CAPM results either by averaging the results with your DCF estimated cost of common equity or using them in a range similar to Mr. Hanley's approach, what impact would this have had on your recommended cost of common equity?

A. It would have been lower.

Q. What have you noticed over the last several years about cost of equity estimates using risk premium and CAPM methodologies?

A. They are quite sensitive to estimations of the equity risk premium estimate, which has always been the subject of much debate by academicians, investors and public policy makers. This sensitivity reaffirms Staff's confidence in the reliability of estimating the cost of equity using the DCF methodology as compared to alternative methodologies such as those that Mr. Hanley used. Mr. Hanley's use of multiple methodologies (two of which rely on his high expected market return estimates) with the same unreasonable inputs does not make his estimate more reliable. Staff has provided a significant amount of

corroborating evidence that supports the reliability of its estimated cost of common equity using the DCF methodology in this case.

Q. Does the DCF methodology incorporate all investors' estimated discount rates?

A. Yes. The DCF method, as it is used in utility regulatory proceedings, was derived by Myron J. Gordon and introduced for cost-of-common-equity determinations in 1962.[1] The original use of this model was for purposes of valuing cash flows to determine the inherent value of an asset, security and/or enterprise. However, in order to value these cash flows, investors had to determine a discount rate they believed was appropriate for the risk associated with the cash flows. Considering this, when the DCF model is used to estimate the discount rate; i.e. cost of common equity, in utility rate case proceedings, if the inputs are reasonable, then the estimated cost of common equity will represent the average of all discount rates (whether determined by the CAPM or some other model) investors have used to determine a fair price for the stock. Therefore, a proper application of the DCF indirectly incorporates investors' use of all models for discount rate estimation.

Q. On page 39, line 9 through, page 41, line 9 of his rebuttal testimony, Mr. Hanley explains why he believes it was inappropriate for you to recommend the lower half of your proxy group cost of common equity estimate because the companies in your proxy group are generally classified as natural gas distribution companies. Do you agree that your comparable companies are generally classified as natural gas distribution companies by the investment community?

[1] Frank K. Reilly and Keith C. Brown, *Investment Analysis and Portfolio Management*, Fifth Edition, The Dryden Press, 1997, p. 438.

A. Yes. This is why I selected these companies to determine an initial proxy group cost of common equity. However, as I researched commentary from the investment community about these companies, it became more evident to me that these companies had non-regulated operations that increased their risk profile. Considering that the investment community also favors decoupled rate designs, I felt there was enough compelling evidence to give this consideration by recommending the lower half of my estimated proxy group cost of common equity range.

Q. Did you recommend the lower half of your estimated proxy group cost of common equity range in the last MGE rate case, Case No. GR-2006-0422?

A. No. My position in the last rate case was that because most of my comparable companies' natural gas distribution operations had achieved decoupled rate designs, the reduced risk associated with these rate designs should already be reflected in the comparable companies' stock prices and, therefore, embedded in my DCF estimated cost of common equity.

Q. Why have you changed your mind?

A. Because Staff did not have access to various equity analysts' research reports in the last rate case that provide insight from the investment community about the general value equity investors place on these type of rate designs because of the reduced risk. In these same reports, the analysts comment on the increased risk associated with the non-regulated operations of these same companies. Because a proxy group cost of common equity estimate is based on the aggregate risk of the publicly-traded holding companies, this cost of equity is based on the sum-of-the-parts of these companies.

Q. Can you provide some examples of comments made in equity analysts' research reports that support your decision to recommend the lower end of your range?

A. Yes. I already cited one of these reports in the Staff Cost of Service Report on page 36, lines 18 through 23, in which the equity analyst covering Atmos Energy Corp. implied that the reduced risk from a decoupled rate design outweighed the decreased value from a lower rate increase due to a 40 basis point reduction in the ROE.

Another report published by Goldman Sachs on March 9, 2009, discussed the impact that decoupling may have on allowed ROEs. The report specifically stated the following:

> ROEs are already trending down, and decoupling could accelerate this trend. As shown in Exhibit 19, allowed returns on equity in gas utility rate cases have trended lower in the last 10-15 years, from 11.0-11.5% in the early 1990s to 10.0-10.5% recently. Regulatory ROEs are generally designed to compensate shareholders for risk; to the extent decoupling mechanisms reduce risks to revenues and profits, regulators may argue allowed ROEs in future rate cases should be lower. Regulators in Maryland and Connecticut have lowered allowed ROEs by 25-50 bp to reflect the lower risks under decoupling mechanisms. We assume 10.0-10.5% long-term allowed ROEs in the majority of the subsidiaries in our company models, but there is downside risk to these estimates.

One may argue that because Goldman Sachs is assuming a 10.0 percent to 10.5 percent allowed ROE in their valuation that this should become the barometer for the reasonableness of a recommended ROE in a rate case. However, this would only be true if the valuation levels of gas utility stocks implied that these expected ROEs were equal to the costs of equity used to discount expected cash flows. Staff's estimated cost of equity based on its DCF analysis does not confirm this to be the case. In fact, Goldman Sachs itself does not use a 10.0 percent to 10.5 percent cost of equity when discounting gas utility cash flows to determine a fair value for natural gas utility stocks. I attached a revised Schedule 20 to

my rebuttal testimony that shows that Goldman Sachs uses a cost of equity of 9.0 percent when discounting expected cash flows for natural gas utility stocks. This is especially informative since these natural gas utility companies also have non-regulated operations which are generally considered riskier than their regulated operations. Consequently, it is logical to presume that if the parts were separated, the equity discount rate for the regulated operations would be even lower than 9.0 percent.

Q. Does Goldman Sachs provide an opinion in its March 9, 2009 report on its views of the risk reduction benefits of SFV rate designs compared to other alternative rate designs?

A. Yes. In this report, Goldman Sachs views Formula Rate Plans ("FRP") as the most advantageous in terms of risk to revenues and profits. FRPs adjust revenues to recover changes in rate base and expenses. While less advantageous than FRPs, SFV rate designs are generally considered to be more advantageous than weather normalized and traditional rate designs.

Q. Does Goldman Sachs quantify the impact the risk reduction associated with SFV rate designs has on its required return?

A. Unfortunately, no.

Q Are there any comments in this same report about the higher risk associated with non-regulated businesses?

A. Yes. The following commentary was made in this same report:

> **Non-regulated businesses provide higher returns, but higher risk**
>
> Given limited earnings growth from traditional utility investments, LDC management teams have turned to non-regulated ventures to increase returns and growth. However,

> non-regulated wholesale, retail, and merchant storage investments exhibit **significantly higher earnings volatility**. **[**emphasis added]

Q. Are these comments relevant to both yours and Mr. Hanley's proxy groups?

A. Yes. The companies covered by Goldman Sachs are AGL Resources, Atmos Energy and WGL Holdings. All of these companies are in both of our proxy groups.

Q. Mr. Hanley used percentage of net income and percentage of assets to attempt to justify his claim that there is no need to consider the proxy group's non-regulated operations in estimating the cost of common equity for MGE. Is Mr. Hanley consistent with the financial indicators he used in his direct testimony when dismissing the need to lower his cost of equity estimate because of MGE's SFV rate design?

A. No. Mr. Hanley analyzed percentage of revenues when evaluating rate designs, but in evaluating non-regulated operations he decided to use net income and assets. He did not explain his rationale for using different indicators in one situation versus the other.

Q. Mr. Hanley indicates that your use of a current risk-free rate (4.41%) in your application of the CAPM is inappropriate because it is not prospective. Do current bond yields reflect investors' expectations of changes in interest rates in the future?

A. Yes. This is the same logic that is used in the DCF methodology for estimating the dividend yield. The expected dividend is applied to recent stock prices to determine the dividend yield. The expected dividend is not applied to expected or predicted stock prices. The current stock prices reflect all known information, which is the premise for the EMH. Current bond yields also reflect all known information.

Q. What has happened to average monthly U.S. 30-year Treasury bond yields since you prepared your direct testimony?

A. They have declined. The August 2009 average U.S. 30-year Treasury bond yield was 4.37 percent. The September 2009 average U.S. 30-year Treasury bond yield was even lower at 4.19 percent.

Q. On page 42, line 9, through page 43, line 4, of his rebuttal testimony, Mr. Hanley explains why he believes you erred by using the total return on long-term government bonds rather than just the income return when you derived the historical earned equity risk premium. Does an investor in government bonds only receive a return based on the coupon of the bond, which is the income from the interest rate stated on the bond?

A. That is true only if the investor holds the bond until maturity and bought the bond at par value. Otherwise, investors will receive a total return, which is based on changes in the price of the bond and reinvestment returns. Therefore, it is appropriate to measure the market risk premium by comparing total returns on stocks versus total returns on risk-free treasuries because this is what investors expect to receive.

Q. On page 43, lines 6 through 12 of his rebuttal testimony, Mr. Hanley explains why he believes it is inappropriate to use geometric averages in a CAPM analysis to estimate an equity risk premium. First, did your CAPM analysis cause you to change your cost of equity estimate using the DCF method?

A. No. I decided that the CAPM results were not consistent with the information I reviewed regarding the Missouri State Employees' Retirement System (MOSERS) expected market returns and costs of equity used by equity analysts. Also, "BBB" average monthly utility bond yields had been between 7 to 8 percent in recent

months so the CAPM results were not consistent with these higher yields. Quite frankly, common sense should be used when determining the reasonableness of certain cost of common equity estimates and I didn't believe the CAPM estimates should be used.

Q. What does common sense indicate when judging the reasonableness of Mr. Hanley's revised lower risk premium estimates in his updated estimate of MGE's cost of common equity?

A. They are not grounded in reality and should be rejected. Consequently, only Mr. Hanley's revised DCF estimated cost of common equity estimate of 9.20 percent is consistent with other investment analysts' estimates and the Staff's cost of common equity estimate in this case.

Q. What expected market returns did Mr. Hanley use for purposes of his risk premium and CAPM analysis?

A. 13.856 percent (.4 x 17.09% + .6 x 11.70%).

Q. How does this compare to expected equity market returns used by MOSERS for purposes of their investment strategies?

A. It is higher than their expected returns on even the riskiest of asset classes. MOSERS' expected returns for the international emerging markets asset class is 11.50 percent. Of course, the more relevant expected return for purposes of testing the reasonableness of Mr. Hanley's expected returns used in his risk premium and CAPM analysis is that of the domestic markets. MOSERS' expected returns for the large capitalization domestic equity market is 8.50 percent. It is only 7.25 percent for the small capitalization domestic equity market.

Q. Mr. Hanley claims that using an institutional investor's expected market returns, such as MOSERS, to test the reasonableness of expected market returns for purposes of estimating the cost of common equity is not relevant. Is this consistent with Mr. Hanley's methodologies in estimating the cost of common equity in this case?

A. No. On pages 25 through 28 of his direct testimony, Mr. Hanley explains why he believes his cost of common equity estimates are "market-based." If Mr. Hanley really believes he is providing "market-based" cost of common equity estimates, then one would believe he would want to consider other investor opinions on long-term market expectations.

Q. Is this type of information relevant to estimating the cost of common equity?

A. Yes. Mr. Hanley claims that MOSERS' expected returns will be on the conservative side because of the fiduciary responsibility that MOSERS has to maintain the funding of the pension system. However, this is the very reason why these expected returns should be used in testing the reasonableness of expected returns used to estimate the cost of common equity. Expected returns used for purposes of investment strategy and investment decisions are those that will affect the valuation levels of stocks and, therefore, the cost of capital available to capital issuers.

Q. Mr. Hanley claims that he believes that MOSERS' investment horizon is for a limited time and, therefore, it is not reasonable to compare these expected returns to estimate costs of equity using the DCF methodology because of its assumed infinite investment horizon. Do you agree with this assertion?

A. No. The fact that Mr. Hanley would make such an assertion causes Staff concern as to Mr. Hanley's credibility in interpreting investor expectations and, therefore,

concern as to the credibility of any part of his recommendation in this case. Unless a pension fund is no longer associated with an ongoing viable entity, it will have a long-term investment horizon given the fact that its liabilities are long-term in nature. This is a simple matter of asset-liability matching for purposes of ensuring the continued funding of the pension fund. As long as the State of Missouri continues to exist and have employees, it will need to continue to fund the retirement benefits of its employees as long as it offers this benefit.

Q. Are you aware of any information from MOSERS that supports your understanding that they are investing for the long-term and, therefore, will make investment decisions based on long-term capital market expectations?

A. Yes. One of the basic tenets of MOSERS' Investment Objectives contained in its Investment Policy is the following:

> Establish an asset allocation policy that is expected to meet the RRO [Real Return Objective] over a long periods of time, while minimizing volatility.

MOSERS' investment objective clearly requires an evaluation of long-term expected returns for purposes of making investment decisions. If MOSERS was investing the state employees' pension assets based on short-term investment expectations as Mr. Hanley speculates, then Missouri state employees would have cause for concern about the management of their pension assets.

Q. Mr. Hanley indicates that your response to MGE's Data Request No. 0274 did not indicate the time horizon for MOSERS' expected returns. Were you able to locate the time-horizon contemplated for these expected returns?

A. Yes. The expected return information from MOSERS is based on a ten-year investment horizon. This information is posted on MOSERS' website. Please see http://www.mosers.org/About-MOSERS/Reports-Research/Summit-Strategies-Capital-Markets-Assumptions.aspx. The information I provided in response to the data request was based on a previous email I had received from MOSERS that did not indicate the time horizon of these expectations.

Q. Is this a reasonable time horizon for testing the reasonableness of the parties' estimated costs of equity in this case?

A. Absolutely. Mr. Hanley actually uses a shorter period (3-5 year Value Line expected return information) to justify his long-term equity risk premium estimates. It is disingenuous for Mr. Hanley to claim that pension fund expected returns are irrelevant because he believes they are short-term projections, but at the same time rely on 3-5 year Value Line projections to inflate his long-term market return expectations to allow for high cost of equity estimates.

Q. Mr. Hanley also claims that it is inappropriate to compare pension returns to recommended ROEs because of the "risk-reducing benefits of a diverse portfolio." Did Mr. Hanley's analysis incorporate a model that specifically recognizes that investors may diversify their investments in order to eliminate company-specific (unsystematic) risks?

A. Yes. Mr. Hanley used the CAPM, which is based on modern portfolio theory that assumes that unsystematic risk can be eliminated through diversification and the only risk faced by the investor is the systematic (market) risk. The systematic risk is measured by determining the covariance of the asset with the market portfolio, which is

referred to as the beta of the security. Consequently, Mr. Hanley's own analysis is based on modern portfolio theory, which assumes the risk-reducing benefits of portfolio theory.

Q. On page 47 and 48 of his rebuttal testimony, Mr. Hanley indicates why he believes the authorized RORs published by the Regulatory Research Associates ("RRA") do not support your recommendation in this case. How do you respond?

A. While I have not researched the specifics of the cases published in the RRA publication, I am sure other regulatory commissions throughout the country are evaluating evidence of the current capital markets much as this Commission is doing in this case. While it is informative to have knowledge of other commissions' allowed returns, it is also very important to evaluate the reasonableness of recommended ROEs based on an understanding of the requirements of the investment community. Staff has provided much evidence on the expected returns and costs of equity of those in the investment community. Because the objective of a ROR witness is to estimate investors' required returns, Staff believes this is the type of evidence the Commission should afford the most weight in evaluating the reasonableness of the recommended ROEs and RORs in this case.

Q. Do you have any other comments about authorized RORs?

A. Yes. The evidence in this case shows that natural gas utility companies are currently realizing a very low cost of short-term debt. These companies have been realizing these lower costs for almost nine months and may continue to realize these lower costs for quite some time. Most of the authorized RORs published in the RRA publication were probably based on capital market information analyzed before these capital market cost changes occurred. This is one of the reasons that the Commission should proceed with caution when giving weight to the RRA data.

Q. What about the authorized ROEs?

A. As I have previously discussed, if the Commission were to authorize an ROE based on The Office of Public Counsel's ROR witness Mr. Daniel J. Lawton's recommendation along with his recommended revenue requirement decrease for the SFV rate design, this authorized ROE would not reflect the cash flow consideration given to the SFV rate design in this case.

COST OF SHORT-TERM DEBT

Q. Do you agree with Mr. Hanley's updated cost of short-term debt?

A. No. Mr. Hanley is still using the same methodology he used in direct testimony, which does not reflect the cost of short-term debt available to his comparable companies. A proper application of Mr. Hanley's proposed hypothetical approach requires the use of the costs of capital associated with the capital structures of his proxy group. Mr. Hanley's use of term sheets for Southern Union's own short-term credit facilities is not consistent with his proposed approach in this case.

Q. Did Staff use updated cost of short-term debt information from its proxy group for its cost of short-term debt recommendation?

A. Yes. Staff used cost of debt information through June 30, 2009, for two of its proxy companies. Staff chose these companies because they had the same average S&P corporate credit rating as the proxy group ("A") and these companies provided this information in their SEC Form 10-Q Filings.

COST OF LONG-TERM DEBT

Q. Did Mr. Hanley update his embedded cost of long-term debt?

A. No, but he should have to be consistent with his decision to update the cost of common equity and cost of short-term debt.

TRUE-UP OF CAPITAL STRUCTURE AND CAPITAL COSTS

Q. Although Mr. Hanley and I use hypothetical approaches in this case, it is still important to update these hypothetical approaches as newer data for the companies in our proxy group become available. Do you think it is important for the Commission to order a true-up of embedded costs and the capital structure in this case?

A. Yes. I believe this is especially important in this case because of the impact that the authorized cost of short-term debt may have. If the cost of short-term debt continues to remain low through the true-up, then this should be reflected in the authorized ROR.

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your surrebuttal testimony.

A. My conclusions are listed below.

1. Mr. Hanley's criticisms of the reasonableness of my recommended ROE are not supported by evidence the Staff provided on investment community expected returns and cost of equity estimates. Mr. Hanley's lack of understanding of the basic investment strategies of institutional investors, such as the length of pension fund investment horizons, illustrates his inability to provide credible advice on investors' required returns.
2. Mr. Hanley has provided no counter evidence on the proxy groups' cost of short-term debt. He relied on Southern Union's information

to determine the reasonableness of his cost of short-term debt. This is inconsistent with the basic premise of his recommendation in this case, which is to not rely on Southern Union information. I relied on information from the proxy group to determine the cost of short-term debt. This is consistent with a hypothetical methodology.

3. Mr. Hanley should have updated his proxy group's embedded cost of long-term debt.

4. The Commission should order a true-up of the costs of long-term debt, short-term debt and the capital structure in this case even if the Commission adopts the use of the proposed hypothetical methodology.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy and Its Tariff Filing to Implement a General Rate Increase for Natural Gas Service	))))	Case No. GR-2009-0355

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Murray, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 18 pages to be presented in the above case; that the answers in the foregoing Surrebuttal 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 13th day of October, 2009.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

Notary Public