

Exhibit No.:	
Issue:	Cost of Capital
Witness:	Donald A. Murry, Ph.D.
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-2010-0171
Date Testimony	
Prepared:	July 20, 2010

LACLEDE GAS COMPANY

GR-2010-0171

SURREBUTTAL TESTIMONY

OF

DONALD A. MURRY, Ph.D.

JULY 20, 2010

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1 I. INTRODUCTION

2 Q. PLEASE STATE YOUR NAME.

3 A. My name is Donald A. Murry. My business address is 5555 North Grand
4 Boulevard, Oklahoma City, Oklahoma 73112.

5 Q. ARE YOU THE SAME DONALD A. MURRY WHO FILED DIRECT
6 AND REBUTTAL TESTIMONIES IN THIS PROCEEDING?

7 A. Yes, I am.

8 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

9 A. I am providing surrebuttal testimony that offers conceptual and factual
10 responses and corrections to the rebuttal testimonies of Mr. Gorman and
11 Mr. Marevangepo in this proceeding. In some respects, these witnesses
12 made similar conceptual errors and misrepresentations in their rebuttal
13 testimonies. In some instances, matters that I wish to address are directed
14 to just one of these witnesses. I am also addressing some issues of risk
15 raised in rebuttal testimony.

16 II. SURREBUTTAL TESTIMONY

17 Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

18 A. In their rebuttal testimonies, both Mr. Gorman and Mr. Marevangepo
19 continue to essentially disregard the exceptional circumstances of the
20 recent volatile financial markets. Their rebuttals of my direct testimony
21 confirm this analytical deficiency. In this respect, their rebuttal comments
22 regarding my direct testimony miss the mark because they have taken my
23 calculations out of context.

24 Q. PLEASE EXPLAIN.

25 A. Both Mr. Gorman and Mr. Marevangepo have used the CAPM and DCF

1 methodologies very mechanically without recognizing the impact of the
2 current markets on these methods and the data used by these
3 methodologies. Such a narrow analytical approach is inadequate and
4 unreliable for measuring the cost of capital in these volatile markets and
5 periods of financial turmoil.

6 Q. WHAT IS THE PURPOSE OF THESE ANALYSES?

7 A. The objective of these analyses is to determine the cost of common equity
8 in the current markets. Stated another way, the rate necessary to attract and
9 maintain common equity capital for the near-term is the goal to be
10 determined by this process. Given the extreme fluctuations and
11 sensitivities of current market values, however, mechanical calculations
12 alone cannot be effectively employed to make this cost of common equity
13 determination. The most obvious demonstration of this fact is simple: at
14 this time, no experienced analyst or investor would risk his or her own
15 funds in the current market based on calculated results from these
16 methodologies without, at least, putting them into the context of the
17 existing economic and financial environment and considering prospective
18 returns from investments of comparable risks.

19 Q. ARE THERE OTHER MATTERS TO WHICH YOU WISH TO
20 RESPOND?

21 A. Yes. In addition to the above conceptual shortcomings, both Mr.
22 Marevangepo and Mr. Gorman have committed some computation
23 missteps in their cost of capital calculations. Both took my direct
24 testimony out of context. In addition, Mr. Gorman, in commenting on
25 Laclede Gas' proposed capital structure in this proceeding, misrepresented

1 my direct testimony.

2 III. CAPITAL STRUCTURE

3
4 Q. HOW DOES MR. GORMAN MISREPRESENT YOUR TESTIMONY?

5 A. Mr. Gorman, on page 14, lines 6-15 of his rebuttal testimony, indicates
6 that I mistakenly led him to believe that the capital structure in my direct
7 testimony was that of Laclede Gas Company and not Laclede Group. He
8 cites my direct testimony at pages 11-12 as support for his claim that he
9 was misled.

10 Q. WAS THERE ANY REASON FOR MR. GORMAN TO BE MISLED
11 BY YOUR TESTIMONY?

12 A. No. Right in the middle of page 12 of my direct testimony on capital
13 structure, I refer to Schedule DAM-6. That schedule clearly identifies the
14 common equity ratio of the “Laclede Group,” as compared to comparable
15 companies. In addition, in his direct testimony, Mr. Gorman’s citations are
16 not to my direct testimony, but to Laclede witness Glenn W. Buck’s
17 testimony and Laclede accounting schedules, both of which also clearly
18 indicate that the Laclede Group is the source for the capital structure.

19 Q. WHAT CAPITAL STRUCTURE DOES LACLEDE PROPOSE FOR
20 THIS CASE AS INDICATED BY YOUR DIRECT TESTIMONY?

21 A. As I set forth in my Schedules DAM-5, DAM-23, and on pages 11-12 of
22 my direct testimony, the capital structure proposed by Laclede, which is
23 the Laclede Group capital structure, contains 42.5 percent long-term debt
24 and 57.5 percent equity.

25 Q. MR. GORMAN INDICATES THAT IT IS INAPPROPRIATE TO USE

1 LACLEDE GROUP'S CAPITAL STRUCTURE. HOW DO YOU
2 RESPOND?

3 A. Mr. Buck has addressed this issue at length in his surrebuttal testimony. I
4 agree with Mr. Buck's analysis. As indicated on Schedule DAM-6 to my
5 direct testimony, the comparable LDCs with publicly traded common
6 stock had average common equity ratios of 58.1 percent for 2009, which is
7 similar to the Laclede Group's common equity ratio for the same period.

8 Q. WHAT DOES THIS INDICATE?

9 A. Given these roughly equivalent measures of financial risk, the comparable
10 LDCs are appropriate surrogates for estimating the cost of common equity
11 in this proceeding. Consequently, Mr. Gorman's concern expressed in his
12 rebuttal testimony, that the proposed capital structure is somehow
13 inappropriate for setting rates in this proceeding, is incorrect. To the
14 contrary, if we use comparable LDCs as analytical surrogates to estimate
15 the cost of common equity for Laclede Gas Company, major risk
16 components, such as common equity ratios, must be similar.

17 Q. ARE THERE OTHER RISK ISSUES RAISED IN REBUTTAL
18 TESTIMONY TO WHICH YOU WISH TO RESPOND?

19 A. Yes. As discussed in the Surrebuttal testimony of Michael T. Cline, the
20 Company is very concerned about the risk associated with the potential
21 loss of load associated with alternative rate designs. If the Commission
22 fails to adopt either the SFV rate design or a tracker to recover lost
23 revenues (Office of Public Counsel witness Meisenheimer Rebuttal, page
24 5, line 9 through page 10, line 3), either of which would mitigate the risk
25 to common equity holders somewhat, then an alternative to these rate

1 designs would be a specific, upward adjustment in the allowed return on
2 common equity of 25 basis points. This adjustment would be a return
3 compensation associated with the remaining risk of nearly certain decline
4 in usage.

5 IV. MARKET CONTEXT

6 Q. HOW DID MR. MAREVANGEPO'S AND MR. GORMAN'S
7 REBUTTAL TESTIMONIES TAKE YOUR DIRECT TESTIMONY
8 OUT OF CONTEXT?

9 A. Their testimonies ignored my discussion of the weaknesses of the DCF
10 and CAPM and the importance of relating these individual results to the
11 market environment. Both witnesses continue in their rebuttal testimonies
12 to rely on unrealistic, mechanical calculations of the DCF and the CAPM
13 in the current volatile financial markets. Their presentation of my direct
14 testimony results ignored my explanation of the results of academic
15 research where I pointed out analytical problems with the DCF and CAPM
16 methods. Neither considered the theoretical limits of either methodology
17 or the empirical problems presented by the current volatile markets. They
18 both define and calculate mathematical formulae for determining the cost
19 of capital as though the current financial turmoil, which often produces
20 illogical results, did not exist.

21 Q. DO YOU DISAGREE WITH MR. GORMAN'S AND MR.
22 MAREVANGEPO'S REBUTTAL POSITIONS?

23 A. Yes.

24 Q. WHY?

25 A. Their rebuttals of my direct testimony, which adhere to formulaic

1 estimates of the cost of capital, reveal weak and incorrect analysis. The
2 end result is that their rebuttals are off-the-mark and their recommended
3 allowed returns on common stock are understatements of the actual cost of
4 capital in the current markets.

5 Q. PLEASE EXPLAIN.

6 A. In both of their direct testimonies, they state as an objective that they are
7 attempting to determine the necessary return to attract investor funds.
8 However, in both instances, they ignore the actual earnings of the
9 comparable LDCs that they reported in their analyses. They exhibit this
10 shortcoming again in their rebuttal testimonies. In both of their rebuttals,
11 they criticize my interpretation of the results of my DCF calculations for
12 what they are, namely an estimate of the marginal cost of common equity
13 for a group of LDCs that were selected as comparable to Laclede Gas.
14 Instead of recognizing that market prices have deviated widely and
15 unpredictably in recent periods and investors are confronted with great
16 uncertainties, they each rigidly support a precisely defined calculation as
17 though this represents investors' expectations. Conceptually, their
18 critiques of my direct testimony do not pass a basic test of credibility.

19 Q. DOES MR. MAREVANGEPO SUPPORT A PRECISELY DEFINED
20 CALCULATION OF THE DCF?

21 A. Yes.

22 Q. HOW DO YOU KNOW THIS?

23 A. As an example, he criticized my use in my direct testimony of stock prices
24 over a period covering the previous year. He thought a narrowly defined,
25 shorter period was more representative of investor expectations.

1 Q. WHY DID YOU LOOK AT THIS TIME PERIOD?

2 A. I took this longer-term perspective because the purpose of this proceeding
3 is to determine the cost of capital that will attract funds to support
4 permanent capital assets. In this case, the Commission will set rates that
5 will last into the future for a period measured in years, and the returns
6 must be sufficient to attract and maintain capital investment for the life of
7 the determined rates.

8 Q. WHAT TIME PERIOD DID MR. MAREVANGEPO UTILIZE?

9 A. Instead of taking this longer-term perspective, Mr. Marevangepo, stated,
10 on page 7, lines 19-20 of his rebuttal testimony, "Staff used a 3-month
11 average (January through March) stock price that reflects current market
12 conditions."

13 Q. WHAT IS YOUR RESPONSE?

14 A. Under current market conditions, I believe a 3-month view is too narrow
15 to capture investor perceptions. In fact, in the short period since Mr.
16 Marevangepo's analysis ended on March 31, the markets have been
17 volatile and cash on-the-sidelines has been growing, reflecting investors'
18 wariness of common equity investments. At this time, the market is
19 exhibiting signs of investor flight to higher quality investments, and if this
20 persists, it can only increase the cost of common equity. A broader view of
21 market conditions is more likely to encompass investor perceptions in
22 these volatile markets.

23 Q. DO THESE RECENT MARKET CHANGES MEAN WITH
24 CERTAINTY THAT COMMON EQUITY COSTS WILL INCREASE
25 FURTHER IN THE NEAR-TERM?

1 A. No, of course not. One cannot predict with certainty that these recent rapid
2 market changes mean that the most pessimistic economic and financial
3 outcomes will transpire. However, these market changes do demonstrate
4 that investors' expectations are very unpredictable and sensitive at this
5 time, and an analyst cannot ignore them. Consequently the rigid adherence
6 to formulaic calculations over a relatively short period is insufficient in
7 determining the cost of capital. Analytical prudence demands putting both
8 the techniques used and the data generated by these markets in context and
9 to cautiously interpret the results.

10 Q. IN REVIEWING THEIR REBUTTAL TESTIMONIES, DO YOU
11 BELIEVE THAT EITHER MR. MAREVANGEPO OR MR. GORMAN
12 HAVE CONSIDERED THE PROBLEMS CONCERNING HOW THE
13 CURRENT MARKET CONDITIONS MAY HAVE IMPACTED THEIR
14 ANALYSES?

15 A. No.

16 Q. PLEASE EXPLAIN.

17 A. Mr. Gorman did not consider or mention the implications of the volatile
18 markets on either his DCF or CAPM methods, or the data that he used, or
19 in his rebuttal of my testimony. Mr. Marevangepo did reject the CAPM
20 results in his direct testimony without explaining the reason. However, he
21 seems to criticize my reporting of various diverging results for a DCF
22 calculation based on market data under a variety of circumstances, as
23 though these results were all equally plausible.

24 Q. PLEASE EXPLAIN HOW MR. MAREVANGEPO SEEMS TO
25 CRITICIZE YOUR REPORTING OF DIVERGENT DCF RESULTS?

1 A. Although he applied ten-year and five-year historical dividend, book value
2 per share and earnings per share growth rates in his analysis
3 (Marevangepo rebuttal testimony, Schedule 11-3), he criticized my study
4 of the market's performance over just the previous 52 weeks. He stated,
5 "This is too long a time frame to use to reliably estimate the current cost
6 of common equity." (Marevangepo, rebuttal testimony, page 6, lines 22-
7 23). Without recognizing the contradiction of using ten-year old historical
8 growth data to reflect current market expectations, he stated further, "Staff
9 believes a cost of common equity estimate based on more recent stock
10 prices which reflect current environment and market conditions is more
11 realistic." (Marevangepo rebuttal testimony, page 6 line 23 to page 7, line
12 2).

13 Q. IS THERE OTHER EVIDENCE THAT MR. MAREVANGEPO DID
14 NOT ADEQUATELY CONSIDER CURRENT MARKET
15 CONDITIONS?

16 A. Yes. He states in his rebuttal, "Staff used a 3-month average (January
17 through March) stock price which accurately reflects the current market
18 conditions."(Marevangepo rebuttal testimony, page 7, lines 19-20). This
19 statement indicates the narrowness of Mr. Marevangepo's interpretation of
20 relevant data generated by the volatile markets and his over reliance on the
21 narrow formulaic results. This may be a reasonable assumption for
22 analysis during more normal times, but this assumption is too limiting to
23 cover the range of circumstances generated by the current markets.

24 Q. CAN YOU PROVIDE ANY EVIDENCE THAT MR.
25 MAREVANGEPO'S ASSUMPTION REGARDING MARKET PRICES

1 IS TOO NARROW?

2 A. The narrow perspective of Mr. Marevangepo's use of the DCF proves that
3 his criticism of my application of the DCF is misguided. His narrow
4 interpretation of relevant market prices when the market continues to be so
5 volatile cannot represent the range of investors' expectations. As I
6 carefully explained in my direct testimony, the DCF is a measure of the
7 marginal cost of capital, and in these markets it is imperative that an
8 analyst recognize it for what it is. Not to do so will virtually assure that
9 over time the regulated utility will not achieve returns sufficient to attract
10 and maintain capital.

11 Q. PLEASE EXPLAIN.

12 A. As I pointed out at some length (page 21, line 19 to page 25, line 24 of my
13 direct testimony), many analysts compensate for the theoretical, marginal
14 cost structure of the DCF in their analyses. Although Mr. Marevangepo
15 acknowledged in his rebuttal testimony (page 5, lines 2-6) the dispersion
16 of DCF results based on various data generated by the current volatile
17 markets, he apparently does not perceive the implications of applying a
18 marginal cost measure of the cost of capital during these volatile markets.
19 He stated, at page 6, lines 9- 13, as follows:

20 Investors do not pick the highest growth rate and apply the highest
21 growth rate and apply this to the highest dividend yield to
22 determine their required return. Instead, investors look at the
23 dividend yield of a company and determine a reasonable estimate
24 of the growth in the price of the stock to determine if he believes
25 that by buying the stock at its current price, he will be able to earn
26 his required return.

27
28 Q. IS ANYTHING WRONG WITH THIS STATEMENT?

29
30 A. Yes. Mr. Marevangepo's statement implies that he can determine in the

1 abstract what investors should be thinking. He ignores the alternatives
2 available to an investor, such as where else an investor might invest his
3 funds, and that is likely to determine the “required return”. This is
4 important because it is simply the “opportunity cost” of investment; stated
5 differently, this is also the principle of determining the cost of capital that
6 is equal to the return from investments of equivalent risk.

7 Q. DID YOU ADDRESS THIS RANGE OF ALTERNATIVES
8 AVAILABLE TO INVESTORS?

9 A. Yes.

10 Q. PLEASE EXPLAIN.

11 A. First, I recognized the actual market returns. In contrast, both Mr.
12 Marevangeo and Mr. Gorman reported actual market returns, but then
13 ignored them. Instead, they each defined a rather precise mix of dividends
14 and future returns that investors would, or perhaps should, expect along
15 with the perceived probabilities that the investors will achieve those
16 returns. Second, I recognized the range of DCF results, some more
17 plausible than others, that are presently generated by the current volatile
18 markets. I used reasonable data assumptions indicating perceptions of
19 investors that may be applicable during the current market period. Mr.
20 Marevangeo, however, offered no basis for his opinion concerning the
21 selection of certain data in his critique of my analysis. In fact, the recent
22 market performance, especially regarding potential sovereign defaults and
23 flight-to-quality, has shown his narrow opinion of data to be unreliable.
24 For example, as Schedule DAM-S1 shows, the Dow Jones Utilities Index
25 has been volatile and lost approximately 11 percent since the beginning of

1 2010. The beginning of this decline was the period that Mr. Marevangepo
2 said “...accurately reflects current market conditions.” (Marevangepo
3 rebuttal testimony, page 7, Line 20)

4 V. MR. MAREVANGEPO’S REBUTTAL

5 Q. ARE THERE OTHER ISSUES REGARDING MR. MAREVANGEPO’S
6 REBUTTAL TESTIMONY THAT YOU WISH TO ADDRESS?

7 A. Yes. At page 13, lines 6-9 of his rebuttal testimony, Mr. Marevangepo
8 indicates some confusion when reviewing the growth rates in my
9 Schedules DAM-16 and DAM-18. He apparently does not understand why
10 the growth rates differed.

11 Q. CAN YOU EXPLAIN?

12 A. Yes. As the schedules point out, the *Value Line* and *Yahoo!* growth rates
13 (Schedule DAM-18) are data provided by these financial services that
14 investors may act upon. Alternatively, the calculated growth rate
15 (Schedule DAM-16) represents a rate that may influence investors who
16 rely on both recent historical performance and *Value Lines’* predicted
17 estimated values for the period 2012-14. These two growth rates are not
18 the same thing, but they both may be relevant measures of investor
19 perceptions. In fact, Mr. Marevangepo’s comments in his rebuttal
20 testimony regarding the earnings per share growth rate in my testimony
21 only confirmed his misperception of investors’ expectations of earnings
22 growth in the current markets.

23 Q. HOW HAS MR. MAREVANGEPO DEMONSTRATED A
24 MISPERCEPTION OF INVESTORS’ EARNINGS GROWTH
25 EXPECTATIONS IN THE CURRENT MARKETS?

1 A. In the current markets investors will have little interest in the book value
2 per share growth rates, or a company's "break-up value", and they will be
3 interested in both dividends and capital gains, i.e, the earnings per share.
4 Had Mr. Marevangepo simply paid attention to the earnings per share
5 growth rates in his DCF calculations, he would have calculated an average
6 expected growth rate of 6.15 percent. (See Staff Cost of Service Report,
7 Schedules 11-1, 11-2 and 13.) Applying even his conservative dividend
8 yield of 4.25 percent in a DCF calculation, results in a DCF result of 10.4
9 percent. It is difficult to understand how he could have estimated a cost of
10 common equity range that did not even include this earnings per share
11 growth DCF at the upper end.

12 VI. MR. GORMAN'S REBUTTAL

13 Q. YOU INDICATED THAT YOU HAVE SOME SPECIFIC COMMENTS
14 REGARDING MR. GORMAN'S REBUTTAL TESTIMONY. WHAT
15 ARE THESE COMMENTS?

16 A. I have several concerns regarding specific misrepresentations or
17 misinterpretations described in his rebuttal testimony. Probably the most
18 important misrepresentation is his alteration and apparent
19 misunderstanding of the results of my DCF and CAPM calculations.

20 Q. CAN YOU PROVIDE AN EXAMPLE?

21 A. Yes. He illustrated this on page 4 of his rebuttal testimony where he
22 removed the size adjustment from my CAPM.

23 Q. WHAT IS YOUR RESPONSE?

24 A. I fully explained in my direct testimony the theoretical basis for my
25 adjustment to remove the size bias from the typical CAPM methodology. I

1 even included, as Schedule DAM-20, the explanation from the 2008
2 *Ibbotson SBBI Valuation Yearbook* detailing the need for this adjustment
3 and its application. The necessity of adjusting for the size bias in the beta
4 calculation is empirically demonstrated and not, as Mr. Gorman stated at
5 page 12, line 13, of his rebuttal testimony, “unreasonable” and
6 “redundant.” Likewise, his assertion that this estimation bias is somehow
7 “...offset by differences in other risk elements” (Gorman rebuttal
8 testimony, page 12, lines 15-16) is simply wrong. In this case, altering my
9 correct CAPM methodology and failing to remove the estimation bias in
10 his estimates has resulted in his inordinately low CAPM results. In fact, as
11 I pointed out in my rebuttal testimony, the current persisting market
12 conditions have so impacted the administered “risk free” rate, the market
13 risk premium and the beta estimates that the CAPM is not presently an
14 effective measure of the cost of capital.

15 Q. DO YOU HAVE ANY OTHER CONCERNS ABOUT MR. GORMAN’S
16 INTERPRETATION OF YOUR CAPM ANALYSIS?

17 A. Yes. Mr. Gorman, on page 10 of his rebuttal testimony, incorrectly states
18 that I included market risk in the intercept term in my CAPM analysis.
19 The CAPM is a risk premium calculation, and in one application I
20 calculated the risk premium for LDCs as compared to the corporate bond
21 rate. As I pointed out in my rebuttal testimony, Mr. Gorman ignored the
22 influence of Federal Reserve policy in his CAPM analysis. My method
23 using the corporate bond rate would compensate for this problem
24 somewhat. Nonetheless, Mr. Gorman’s critique of my CAPM analysis
25 further confirms his focus on just the mechanics of the calculation

1 irrespective of the current market conditions.

2 Q. DO YOU HAVE ANY CONCERNS ABOUT MR. GORMAN'S
3 REBUTTAL OF YOUR DCF CALCULATIONS?

4 A. Yes. Mr. Gorman chose to simply average various DCF calculations that I
5 presented in my testimony, and he averaged them without regard for either
6 their purpose or the context for these calculations. Obviously, averaging a
7 set of un-weighted numbers has no analytical purpose and does not result
8 in a meaningful measure of the cost of capital

9 VII. CAPM AND DCF IN CURRENT MARKETS

10 Q. YOU HAVE COMMENTED ON THE MECHANICAL NATURE OF
11 BOTH MR. GORMAN'S AND MR. MAREVANGEPO'S CAPM AND
12 DCF METHODOLOGIES. CAN YOU SUMMARIZE IN LAYMAN'S
13 TERMS WHY THEIR APPROACHES ARE NOT APPROPRIATE IN
14 THE CURRENT MARKET?

15 A. Yes. As I stated previously, the objective of these analyses is to determine
16 the cost of common equity for Laclede Gas in the current markets. This is
17 the rate necessary for Laclede Gas to be able to attract and maintain
18 common equity capital for the near-term. In light of the extreme
19 fluctuations and sensitivities of current market values, however, it is
20 readily apparent that mechanical calculations cannot be effectively
21 employed to determine this rate. No experienced analyst or investor would
22 risk his or her own funds in the current market based on calculated results
23 from these methodologies without putting the results of these calculations
24 into the context of the economic and financial environment as well as
25 considering prospective returns from investments of comparable risks.

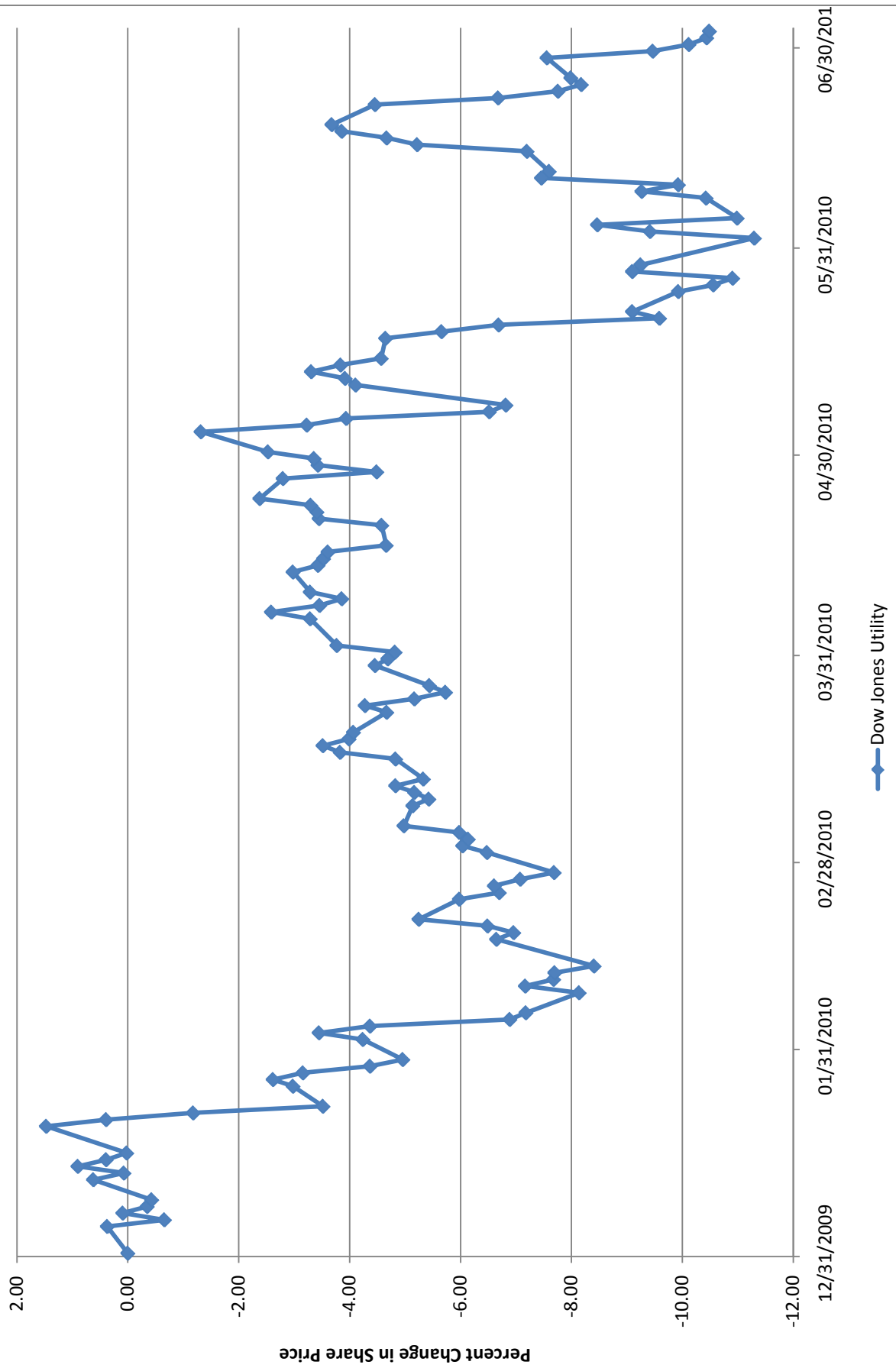
1 This is what I have done in my analysis and what the other witnesses have
2 failed to do.

3 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

4 A. Yes, it does.

Comparison of Changes in Dow Jones Utilities Index

Year to Date 2010




In the Matter of Laclede Gas Company's)
Tariff to Revise Natural Gas Rate Schedules) Case No. GR-2010-0171

STATE OF OKLAHOMA)
) SS.
COUNTY OF OKLAHOMA)

1. My name is Donald A. Murry. My business address is 5555 North Grand Boulevard, Oklahoma City, Oklahoma 73112; and I am Vice-President and Economist with C. H. Guernsey and Company.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony on behalf of Laclede Gas Company.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.


Donald A. Murry

Subscribed and sworn to before me this 19th day of July, 2010.

